No tax and chill

Case Study

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Agenda

Introduction

As we already know for a long-time, multinational companies to obtain a greater profit margin, move or choose tax havens as their registered office countries , where the percentage of taxes to be paid is considerably lower. Some examples are companies like Fiat or Amazon. In this case, the story of the multinational Netflix will be treated in a specific way as it represents substantial differences regarding the previous history of evasion. In fact, being a company that has its registered office in Amsterdam, he is challenged under Italian law for having an organized and profitable system operating in the digital economy in the territory, it is capable of producing large revenues to society without having to submit to the Italian tax system. The peculiarity of the case, however, lies in the organizational structure of the company that is defined as occult, which means, completely free of personnel and characterized exclusively by an advanced technological structure, making the episode extremely unique. The story focuses mainly on the application of only one article, that is Article 4, thanks to which the Guardia Di Finanza first, and the Agenzia delle Entrate after, have identified the technical and legal conditions for considering the infrastructure "essential and significant "considering the assets that the American company uses in Italy (cables, optical fibers, computers, servers, and algorithms), within the concept of "stable material".

Netherland's structure

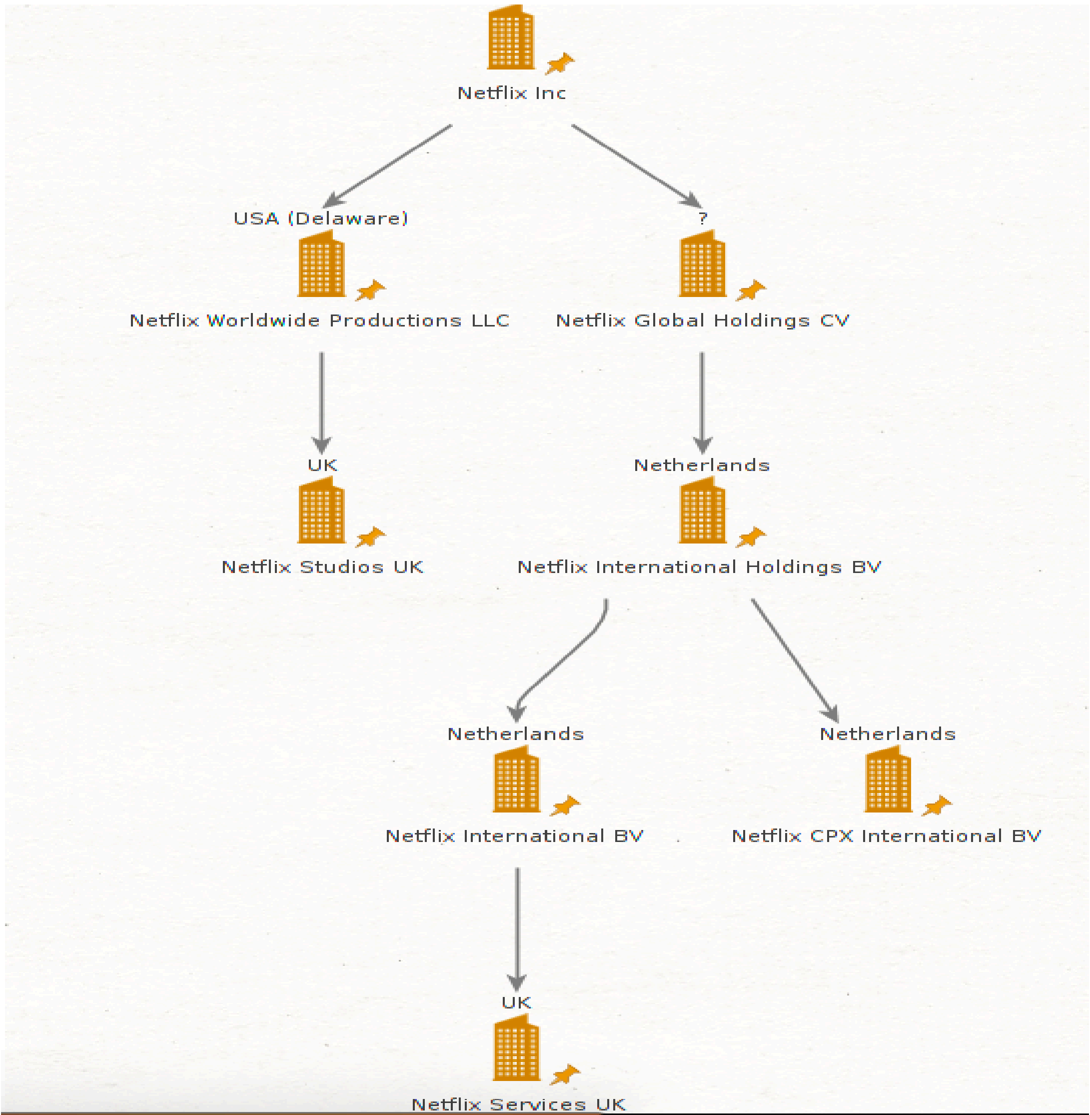
Netflix was accused of using the Netherlands as a major part of a tax haven scheme to reduce its income tax liabilities globally. UK government said Netflix moved between $327 and $430 million into tax havens in 2018, out of its total global profits that year of $1.2 billion.

In 2015, just after the company started selling subscription in Luxembourg,Netflix moved its European operations to Amsterdam and a Dutch company,Netflix International BV which now accounts for the majority of revenues the company makes outside the US.

Netflix BV is owned by Netflix international Holdings, called Netflix Global CV.

CV usually denotes a Dutch Company, however the Netflix global account state that the company is based in the USA, however a search of corporate registries in the US yielded no record for the company. Founding documents of Netflix International Holding state that the CV has an address in the Cayman Island. Netflix now says that they have retired their Caiman entity.

Where the company is actually domiciled remains a mystery.



What is BV?: A private limited company, or in Dutch a bestolen vennotschap(bv) is a business structure with legal personality. This means that the BV is generally speaking liable for any debts, rather than you as an individual..

How Netherland's operation really works?

Let's take a step back:Netflix sells to UK customers its services via a Dutch subsidiary. Doing so doesn't require any business premises in the UK. Instead, Netflix's UK customers contract with its Dutch subsidiary, Netflix BV, which has servers based in the UK to efficiently provide its streaming service.

Having local servers is commercially very important as they enable quicker response times for streaming services.

The OECD guidance actually allows such servers to be taxed as if they were a business premises selling physical goods in a country. However, interestingly, the UK intentionally opted out of this system. It has therefore in effect unilaterally decided not to tax the UK profits of Netflix BV,unlike Italy, which decided, as we'll see, to tax profits Netflix BV makes from its Italian Customers.

During the OECD's lengthy BEPS negotiations, agreement could simply not be found as to how the digital economy should be taxed. This means that, in the absence of any international consensus, the activities of internet-based companies like Netflix are being taxed by domestic laws.

About 4 million euros were paid in tax to the Netherlands for 2018 activities, where the company uses three different Dutch BV corporations to shift money, the report stated. No tax was paid to the Netherlands the year prior.

"Corporate taxation is an important and much-debated issue. Ultimately, it's for governments to decide the rules when it comes to tax — and in every country in which we operate, Netflix respects those rules," the spokesperson said.

Netflix countered that, telling Deadline that tax relief programs allowed it to invest a half-billion dollars in a slate of British programs last year. The company claims it generated 20 thousand jobs and apprenticeships in doing so.

How netflix makes profit

How much profit Netflix makes, or doesn't make outside of the US is a bit of a mystery. In fact, Netflix themselves appear to have difficulty with that calculation.

According to the consolidated annual accounts of Netflix, the company made losses in its "International Streaming" segment in every year between 2011 and 2018, when it turned a profit for the first time.

Despite this, the Netflix accounts in 2017 disclosed that the company had accumulated a total of $484.9m in foreign earnings. The disclosure was made as part of their calculations of their liability for the transition tax imposed on US companies as part of the Trump administration's reforms to corporate taxation.

Until 2017 US corporations were in theory subject to US federal taxation on their worldwide profits, but corporations could permanently defer paying taxes if they re-invested those profits overseas. This led to many US corporations moving their non-US profits into tax havens, where they were 'permanently re-invested' in government bonds and marketable securities. Corporations built up huge cash piles offshore that were untaxed anywhere.

The transition tax was designed to deal with this historic issue, and the tax was imposed on the profits that US corporations had accumulated in tax havens from their non-US operations. As part of their disclosure, Netflix stated that their figures on non-US profit that would be subject to the tax were provisional pending more detailed work required to calculate the exact liability.

In the 2018 accounts for Netflix, that detailed work had been completed, and Netflix reversed their entire tax liability arising from the transition tax. There is no detailed explanation provided on how the calculations on accumulated foreign income could been incorrect by almost half a billion dollars.

In December 2018 The Times reported that Netflix's accounts were under examination by HMRC, although there was no detail provided on specific issues HMRC were probing. Newspapers reporting on the news noted how Netflix reported tiny revenues in the UK, which did not match information about the number of subscriptions the company is known to have in the UK.

Some commentators were quick to point out that selling subscriptions from overseas was not tax avoidance, people in the UK are free to buy products from overseas.

However, there is little doubt that Netflix has structured itself to avoid paying tax, and evidence from the company's US filings suggest that the company is moving money from its international markets into tax havens.

In 2017, in addition to the one time transition tax, the US federal government introduced a number of anti-avoidance rules to ensure that profits made overseas were subject to some minimum level of taxation. One of these rules is the GILTI – which targets returns to intellectual property in low tax jurisdictions. The operation of the GILTI rule is complex, but the effect is to put a minimum tax of 10% on profits on intangible assets located overseas.

Because of the way in which the tax includes credits for taxes paid to foreign governments, the tax only targets profits declared in jurisdictions with a tax rate of less than 13.125%.

As part of their tax disclosure in their 2018 annual report Netflix notes that the company was subject to a tax charge of $43m due to the US Minimum Tax on Foreign Entities. We believe that this is likely to be the Global Intangible Low Tax Income (GILTI) provision of the 2017 Trump Tax Reform.

The disclosure from Netflix that some of its income is subject to a minimum tax level, appears to confirm that the company is moving profits into tax havens. The disclosure that $43m is subject to the a minimum tax rate, suggests that between $327.8m and $430 of non-US profit was shifted into tax havens by Netflix in 2018, to minimize taxes in its operations outside of the US, and maximize the amount that the company receives from the taxpayer in the form of tax credits.

The UK office sells its services to the wider Netflix group at a low margin and as a result there is little profit left in the UK. It is likely that the company operates in a similar way in other jurisdictions.

In 2018, Netflix Services UK made revenues of just €48m and a profit of €2.3m. Had Netflix's revenues from its UK subscribers been included in the accounts, it would have had revenues of £860m.

It is difficult to say how this would translate into profit in the UK without access to more detailed accounts of Netflix's operations.

Netflix's own figures show that the company has historically made a loss on its international streaming segment, however this does appear to conflict with data published by the company elsewhere, particularly regarding its potential liability for taxes on its foreign profits in the US.

The numbers published on the U.S. GILTI charge, suggest that the company moved between $327.8m and $430 of non-US profit into low tax jurisdictions in 2018.

This structure is particularly concerning given the steep rise in the profits at Netflix in recent years, which suggest that the problem can only get worse.

There is also another concern in the UK, given the fact that the company is substantially increasing its production activities and could be eligible for UK tax credits for high-end television.

Background of the dispute

The investigation conducted provides very interesting tax insights because it is the first case in the world in which the existence of a permanent establishment of a foreign company operating in the digital economy is disputed and is characterized by the total absence of personnel on Italian territory and the sole endowment of a very advanced technological structure used exclusively for conducting business in Italy. The investigations aimed at proving the existence and operation in Italy of a "hidden" (i.e., undeclared to the Italian tax authorities) permanent establishment of the Netflix group's Dutch company. In this case, the "presence" in Italy of a foreign entity, despite the absence of any territorial connection with the Italian state, was disputed. This assessment is based on the new concept of permanent establishment introduced by Law No. 205/2017 in letter f-bis of Article 162, paragraph 2 of Presidential Decree 917/1986, which considers a significant and continuous economic presence to be a necessary prerequisite for justifying the state's taxing power. It represents situations in which a company participates in the economic life of a country on a regular and continuous basis without having a permanent establishment. In other words, an attempt was made to delineate a "virtual" permanent establishment, that is, freed from the requirement of physicality, to intercept those multinationals that, operating through the web, manage to more easily avoid the taxation of income produced in Italy, precisely because of the absence of a fixed place of business. According to Action 1 of BEPS, significant economic presence should be measured based on certain indices or factors based on the following elements, to be jointly assessed to identify a connection (to be understood as "regular and sustained participation") in the economic life of a given country:

Revenues generated in a state (revenue-based factors), generated from the sale of goods and services, including through automated digital platforms of the nonresident enterprise with customers located in other jurisdictions;

Digital factors, such as, for example, the use of a local domain name, a local characterization of the digital platform, the use of local payment methods, etc.

• User-related factors (user-based factors), such as, for example, the number of monthly active users, the conclusion of online contracts with users, etc.

How are Article 4 and Netflix connected?

The Tax Police identified the technical-legal prerequisites, required by international and domestic standards, for the configuration of the Dutch company’s concealed permanent establishment, which was deemed suitable for producing business income in Italian territory. It indicated Netflix as a resident of Italy, meaning a company who, under the law, is liable to tax there by:

- Customers residence
- Place of effective management (the place where it is incorporated or a place where central management, decision, and control take place),
- Legal seat

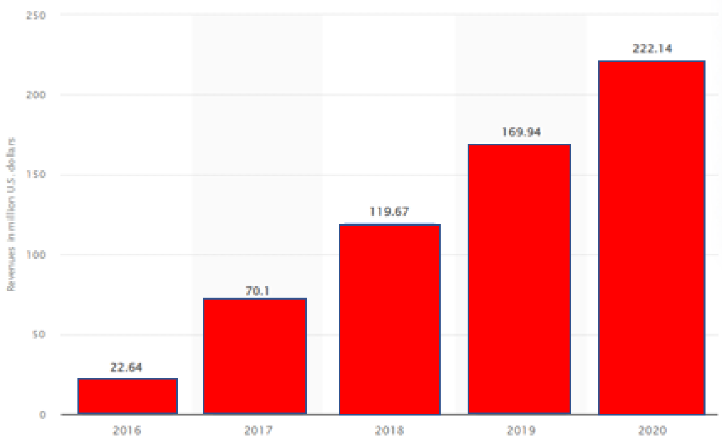
Italian scenario

In 2015 Netflix arrived also in Italy and little by little it reached a huge slice of customers that was getting bigger and bigger.

Through a covert permanent installation of the group's Dutch firm (Netflix International BV), the company was operating in Italy.

Despite the fact it had no physical presence in the country, Netflix was supposed to pay taxes in the country but it didn’t do it. Prosecutors in Milan believed Netflix was evading tax in Italy. Prosecutors argued that the digital infrastructure the company had in place to provide its services to 1.4M users in Italy (reached in 2018) could have warranted a tax contribution to the state. They believed that cables and computer servers used by Netflix could symbolize a physical presence in the country. They constitute a digital infrastructure that made revenues taxable under Italian law.

Italian prosecutors had previously also probed into the taxation of other U.S. tech giants such as Apple, Amazon and Facebook. However, unlike these cases, Netflix is the only one that had no companies, officers or employees in Italy, nevertheless it earnt millions selling streaming services to Italian customers as illustrated on the following chart, which is referred to Netflix revenues in Italy from 2016 to 2020.



Therefore prosecutors had opened an investigation against Netflix into potential tax evasion for the period between 2015 and 2019. This investigation had been triggered by checks conducted by Italy's tax police.

Italian sentence

After the investigation, Italian prosecutors probed Netflix over alleged undeclared taxes in Italy for media products sold to Italian customers.

At the end of the assessment phase conducted by the Agenzia delle Entrate , it has been established that Netflix had to pay 55.8 million euros to the Italian tax authorities as taxes, penalties and interest, for the period between October 2015 and 2019.

The investigation showed that the company had an infrastructure in Italy with which it spread its services since October 2015, without any branch being fiscally identified in the country.

The company's content distribution network was composed of more than 350 servers used exclusively by Netflix and permanently installed in Italy at data centers and major telephone operators.

Netflix closed the dispute with the Agenzia delle Entrate by paying about 55 million and 850 thousand euros in a single solution.

A Netflix spokesperson claimed that the company was pleased to have put an end to the affair they were involved in. They alleged they maintained cooperation with the Italian authorities and they still believe that they have acted in compliance with Italian and international rules.

Why did Netflix decide to open a branch in Italy?

As already happened in Spain, France and the United Kingdom, Netflix started accounting in Italy. And it complies with the directives of the Agenzia delle Entrate.

Starting from January 2022, in fact, a new company was born in Italy called Netflix Italia and the payment of monthly subscription fees are transferred to it. Netflix has set up this company under Italian law that has begun to stipulate contracts and invoice the fees from subscriptions signed with Italian users. This determines the taxation in Italy of the income produced by the sale of subscriptions to users resident in the national territory.

The decision to account in Italy has been taken following the dispute with the Italian prosecutors which believed that the company owned stable organizations and essential physical infrastructure without paying taxes on profits deriving from subscriptions.

The company is strengthening its presence in our country, increasing the investment in Italian productions. That's why the presence of a physical structure in Italy was necessary for the American giant.

So, with Netflix Italy it is possible to analyze the revenues obtained by the platform in our country that also changes taxation, in fact in addition to VAT it has also been added taxes on the income of workers transferred or hired in Italy.

Conclusion

The case under comment is very important in that for the first time the technological element has prevailed over the physical element (fixed locations and/or personnel) to challenge the presence of a permanent establishment in the territory of the state and the consequent omission of tax returns.

The "assets" that the multinational used in Italy (computers, servers, fiber optics, and algorithms) would have brought Netflix within the concept of a permanent establishment in the territory of the state. After initial resistance from the Dutch company, this agreement was reached, which certainly sets a precedent for other disputes that have arisen under the same premise. The concept of a "virtual permanent establishment" has also been introduced at the European level, which is increasingly necessary as the digital economy progresses and has the same purpose of finding a connection in the state of the source of income in the absence of physical elements present there.

Suggestions

How European countries are taxing Netflix to invest in cinema

Several EU countries have struck deals with big streaming companies to invest heavily in the country's film ecosystem.

Netflix and other streaming companies already must invest 1% of their revenue back in Portugal, 2% in Denmark and 5% in Spain.

However, the EU countries with the most Netflix cash inflows are Italy and France.

Italy recouped 12.5 percent of Netflix's investment in the film industry. But thanks to an EU directive, the country has doubled Netflix's investment in Italian and European content to 25% by 2025.

From 2017 to 2020, Netflix invested 300 million euros in producing more than 45 series in Italy.

The world has changed. Tax should too

Global Taxation

Another potential solution could be what happened in October 2021, when more than 130 countries, representing more than 90% of the global economy, agreed to set a global minimum tax rate of 15% from 2023.

The GTA is a major change in international tax rules. The OECD program aims to reduce tax planning and tax avoidance of all multinationals by limiting tax competition and changing where companies pay taxes.

Who is the target?

Beyond low-tax jurisdictions, the proposals aim to address the low effective tax rates paid by some of the world's largest companies, including big tech giants such as Apple, Alphabet and Meta, as well as companies such as Nike and Starbucks.

These companies often rely on a complex network of subsidiaries to generate profits from key markets in low-tax countries such as Ireland, the British Virgin Islands, the Bahamas or Panama.

To achieve this, the proposal is divided into two separate programs: Pillar One, the partial re-allocation of taxing rights, and Pillar Two, the minimum effective taxation of profits of Multinational Enterprises (MNEs).

OECD Pillar 1

Pillar 1 would expand a country's taxing powers to include a company's share of profits from sales in that country, regardless of the company's physical location. This will cause some companies to pay more taxes in the country where their customers or digital users are located, even if the company does not have a permanent local presence in that country.

Under the agreement, if participating multinationals generate at least €1 million in revenue from that jurisdiction, the jurisdiction will receive a portion of the redistributed profits. For smaller jurisdictions with a GDP below EUR 40 billion, the level of revenue generated is set at EUR 250,000.

For companies with a global turnover of more than 20 billion euros and a profitability of more than 10%, Under a new formula based on the location of a company's customers, 25 percent of profits above 10 percent will be taxed.

The first pillar will also include a dispute settlement mechanism aimed at increasing tax certainty for businesses.

The company has €40 billion in annual revenues and profits of €10 billion (a profit margin of 25%). €1.5 billion of its profits will be impacted by Pillar 1.

- Total profits: €10 billion
- Profits above 10% Profit Margin (in excess of €4 billion) - €6 billion
- Pillar 1 Profits (25% of profits above a 10% Profit Margin) – €1.50 billion

OECD Pillar 2 – Global minimum tax

Pillar 2 of the global tax agreement will limit tax competition and the so-called "race to the bottom" of corporate tax rates. It would set a minimum percentage, or global minimum tax rate, for the effective tax rate applicable to cross-border investments by large multinational companies with a "significant economic footprint" around the world. The proposed minimum global tax rate is 15%.

Pillar 2 consists of three rules that apply to companies with sales more than 750 million euros.

- Income Inclusion Rules: Determine when a company's foreign income should be included in the parent (principal) company's taxable income.
- Overdue payment rule: Allows a country to refuse to deduct cross-border payments to parent companies.
- Comply with tax rules: Allow the state to tax low-tax payments between companies.

According to the European Union tax observatory, by adopting the 15% minimum tax, Italy could collect a revenue of 2.7 billion euros from its multinationals, while the European Union would obtain a total of 48.3 billion euros.

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