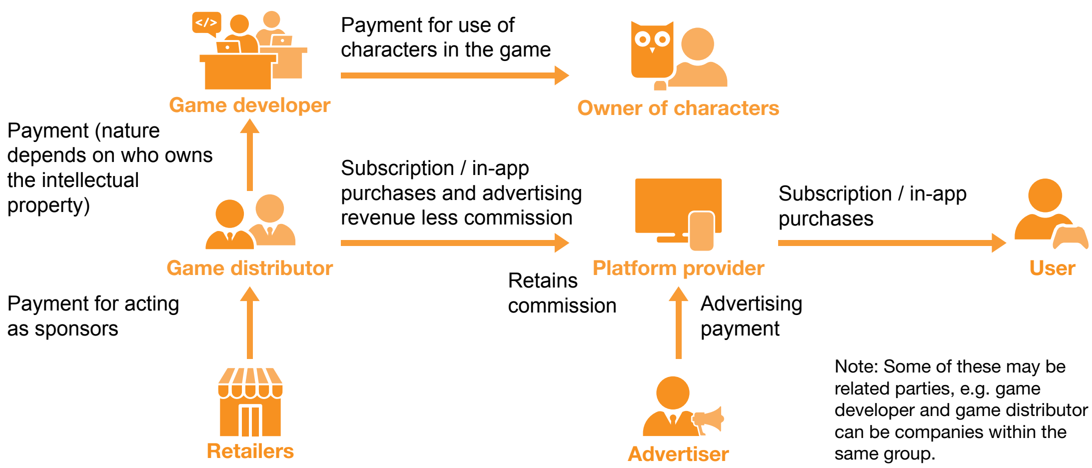
Video Gaming: Pokémon GO – Where Does the Tax Go?

Entertainment & Media Outlook 2016

Video gaming is no doubt one of the hottest segments of the entertainment and media industry. As game developers hope to hit the global games market with the next Pokémon GO, they also need to be aware of the changing regulatory environments they are exposed to in running their international businesses.
Governments around the world are responding to changes in the way businesses are conducted. In particular, the shift from traditional trades to transactions in digital form as well as the increased complexity of business models nowadays have led governments to reconsider the appropriateness of their taxation systems in today's digital economy.

The Organisation for Economic Co-operation and Development ("OECD") has, as part of a wider action plan, recently made recommendations on how transactions in the digital economy should be taxed, with a view to aligning taxation with the location of economic activity and value creation, and putting an end to international tax avoidance. Many jurisdictions around the world, including not only OECD members but also non-members (such as China and Hong Kong), are considering these recommendations, and some of them have already started implementing them.

The exact OECD pronouncements are highly technical and probably comprehensible by tax experts only. This article seeks to provide only high level information on how the video gaming industry, with potentially complex business models, may be affected by these latest developments.
Here is an example of a video game business model involving a number of parties, each of which could be located at different jurisdiction.



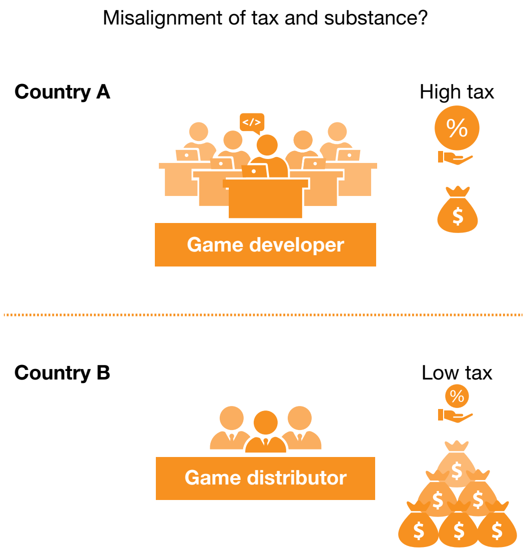
How may tax be imposed on the value chain?

One of the most important assets of a video game business is the underlying intellectual property ("IP") subsisting in the games. Such IP is the value (and revenue) driver of the business. Enterprises are therefore tempted to locate the IP in jurisdictions with favourable tax regimes, in order to enhance the overall tax efficiency. In light of the OECD recommendations, video game businesses need to be aware that:

- Countries offering IP-related preferential tax regimes may be revisiting their regimes to include, inter alia, a "substantial activity" requirement, meaning that substantial research and development activities need to take place in that particular jurisdiction in order to qualify for the tax incentives.
- In line with the above, legal ownership of IP itself can no longer justify returns from the IP. Instead, returns should accrue to IP development, enhancement maintenance, protection and exploitation functions.

Aligning corporate tax with the location of economic substance

In short, the imposition of corporate tax should be in line with the location of economic substance. To illustrate this point using an example (refer also to the diagram on the right), a corporate group may have its top management and 100 programmers working in Country A (as the "game developer"). Top management in Country A may also be making decisions as to how the game is marketed. To facilitate global distribution, the corporate group may set up an entity ("game distributor") in Country B, a country that offers IP-related tax incentives, to own the game IP and contract with the platform provider. However, the game distributor may have no or very few employees (taking only administrative roles) based in Country B. In this situation, if the bulk of the returns from the exploitation of the game are allocated to the game distributor in Country B, it may be questionable as the economic substance of the corporate group and the main value-creating activities are in Country A.



Furthermore, depending on the nature of the cross-border payments depicted in the first diagram above, there could be potential withholding tax implications associated with these payments. Withholding tax is typically imposed on passive income such as royalties (i.e. payment for use of IP). For instance, payments made by the game developer (located in Country A) to the owner of characters (located in Country C) for the use of these characters in Country A could be subject to a withholding tax in Country A.

Indirect tax may not be a cost but still an additional burden

Apart from corporate tax (a direct tax), enterprises should also be aware that there is a tendency for governments to pay more attention to indirect tax. Indirect taxes such as value-added tax (“VAT”) and goods and services tax (“GST”) are taxes imposed on consumers, but collected by enterprises. While indirect taxes are not generally a cost to the enterprises, they do add to the burden of the enterprises in terms of overall compliance, as well as affect their pricing strategies.

The key recommendation by the OECD from an indirect tax perspective for digital economy is that indirect taxes should be collected in the country where the consumer is located. For instance, if a video game company in Country X sells games online, a consumer in Country Y downloading the games would be required to pay Country Y VAT, but such VAT would be collected by the video game company and paid to the government in Country Y. This model is already being adopted by the European Union, and other countries are gradually following suit. Thus, indirect tax compliance could potentially become a global concern for digital businesses.

Given the latest international tax developments, video game businesses should bear in mind that the costs of doing business could be on the rise, in terms of increase in tax costs (if historical tax benefits are no longer available) and compliance costs. In addition, reputational risk could be a concern due to increased media coverage on companies not paying their “fair share” of taxes. It is important for enterprises to properly manage these areas.

If you would like to further discuss with our team, please contact us.

Gwenda Ho

Hong Kong Technology,
Entertainment & Media,
Telecoms Tax Leader
+852 2289 3857
gwenda.kw.ho@hk.pwc.com
LinkedIn

Steven Wong

China Technology,
Entertainment & Media,
Telecoms Tax Leader
+86 (10) 6533 3113
steven.wong@cn.pwc.com

Wilson Chow

China / Hong Kong Technology,
Entertainment & Media,
Telecoms Leader
+86 (755) 8261 8886
wilson.wy.chow@cn.pwc.com
LinkedIn

Jianbin Gao

China Technology Leader
+86 (21) 2323 3362
gao.jianbin@cn.pwc.com
LinkedIn

Stephen H Wong

China Telecoms Leader
+86 (10) 6533 2255
stephen.h.wong@cn.pwc.com

Cecilia Yau

China / Hong Kong
Entertainment & Media Leader
+852 2289 1385
cecilia.yau@hk.pwc.com
LinkedIn

Dr Colin Light

China / Hong Kong Experience
Centre and Digital Services
Leader
+852 2289 2655
colin.light@hk.pwc.com
LinkedIn

Follow us on

PwC LinkedIn

PwC weChat

PwC Global Entertainment & Media Outlook 2016 website link

www.pwchk.com