The future of consumer and retail – a tax perspective

The evolution of traditional consumer and retail companies into E-commerce and direct-to-consumer businesses drive unique operating model and tax considerations

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Non digitally native consumer and retail (C&R) companies have been adopting e-commerce and direct to consumer (D2C) strategies and operating models for years to supplement and diversify their brick-and-mortar channels. While e-commerce and D2C are not new operating models for these companies, COVID-19 has amplified online businesses and elevated e-commerce to new levels, with the market growing at double digits[1] in the United States. Additionally, a range of transformative forces have been challenging C&R companies, including digital surge and disruptions, shifts in consumer behavior, rising customer expectations and pressure on costs and margins. To respond to these forces, C&R companies are revisiting their e-commerce and D2C strategies with large-scale digital transformations and targeted customer centric strategies.

Transformative forces are urging C&R businesses to adopt new e-commerce and D2C strategies

The various forces that are disrupting C&R businesses are discussed below. Forces such as these are prompting companies to revisit their e-commerce strategies and more broadly their business models to keep consumers engaged, improve their experience while controlling pricing and maintaining margins.

1. Digital surge

C&R organizations are increasingly adopting artificial intelligence, machine learning, platforms, software, applications to manage digital sales, e-market places and customers experiences and data analytics. They are adopting digital tools and technologies throughout their organizations from the front, middle, and back offices to drive operating efficiencies and better customer experiences. While C&R companies have long understood the importance of digital transformations, the recent digital surge combined with the COVID-19 pandemic have greatly accelerated the urgency of legacy C&R businesses to adopt digital transformations. Enterprise-wide digital transformation is becoming a critical framework for C&R businesses to survive in a highly competitive environment where competition intensifies through access to the market of emerging disruptive players that adopt digital technologies to address consumers more easily and effectively.

[1] KPMG eCommerce survey, November 2021

2. New consumer behaviors: shop "anytime, anything, anywhere"

Digital is also changing the way consumers interact with products and brand by putting the consumer experience at the center of buying decisions. Consumers no longer want to spend the time traveling from store to store to locate the product that they want to purchase, nor do they have the time. Consumers now tend to search online extensively before shopping even for inexpensive items. Consumers enjoy the price transparency that a digital shopping experience brings to them and it forces C&R companies to compete on pricing. Consumers are also becoming more demanding in terms of product availability, fast delivery turn around, generous return policies and multi-channel shopping capabilities.

3. Data economy

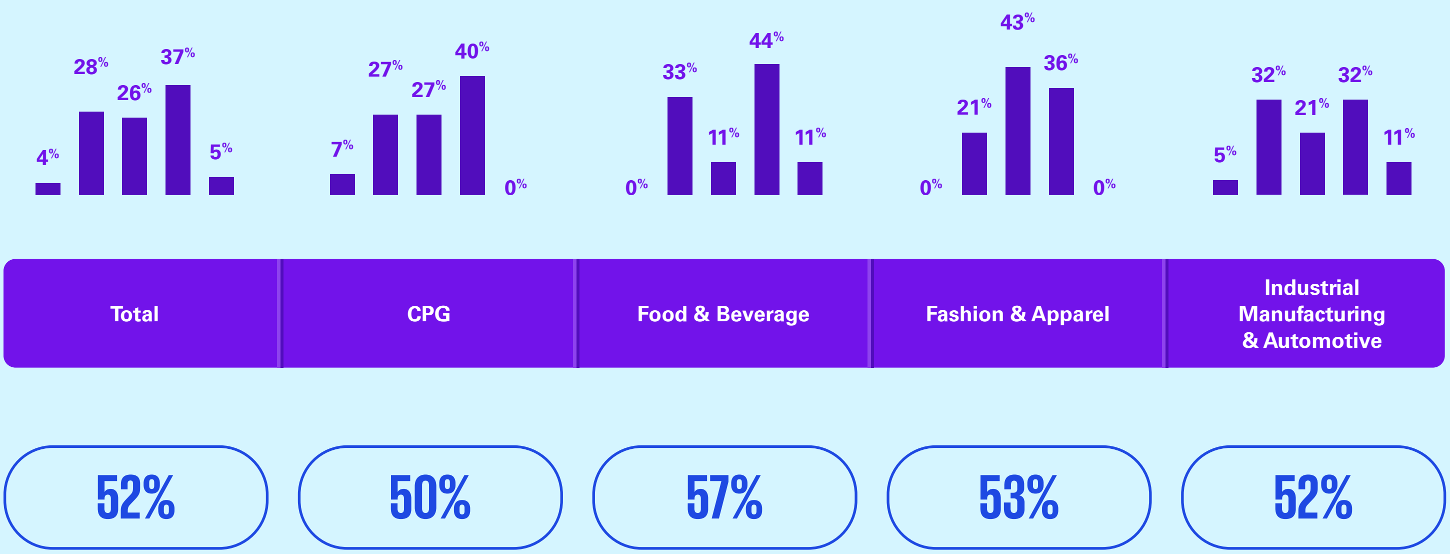
Within this new consumer paradigm, data and advanced data analytics capabilities play a key role in detecting consumer shopping habits, establishing real time, direct connections with individual shoppers, and understanding what, why and when consumers buy products or services. Companies that invest in strong data analytics capabilities to increase the frequency and quality of touch points with consumers achieve additional strategic benefits. These benefits include greater control over price perception, insights into the customer experience, and the possibility to capture real-time feedback on products allowing more focused product development decisions. According to a survey conducted by KPMG on eCommerce[2], Information Technology and Analytics are expected to see the highest levels of investments in the upcoming years. Based on the KPMG 2021 Consumer & Retail CEO Outlook Pulse Survey, 78 percent of C&R executives reported that they plan to invest more in e-commerce, and 77 percent said they would spend more in customer-centric technologies in the coming year.

4. The rise of online sales and the importance of an omnichannel model

Online sales are on the rise for C&R companies. Based on the KPMG eCommerce survey, approximately 50 percent of sales of the companies surveyed are already occurring online across different industries, with expected growth over the next 3 years particularly for C&R and industrial manufacturing companies. Nearly all companies surveyed experienced an increase of online sales during the pandemic.

[2] KPMG eCommerce survey, November 2021

Percentages of total sales from online channels



However, as online presence becomes more concentrated, digitally native brands are facing challenges driven by increasing customer acquisition costs, order fulfillment costs along with pressures to elevate customer experiences in an omnichannel setting. Companies that have primarily been only online are opening retail stores (or alternative forms of retail presence) to offer personalized, convenient shopping experiences. For similar reasons, non-digitally native companies are expanding their online offerings introducing models such as in-store fulfilment of online orders. Based on the KPMG eCommerce survey, 87 percent of the C&R companies surveyed have adopted buy-online-and-pick-up-in-store and ship-from-store omnichannel fulfillment processes. Omnichannel strategies require using retail stores to fulfill online orders, having online orders shipped to a store from a distribution center or even allowing items to be shipped from store to store if it is closer to the consumer. The many models include buy-online-pick-up-in-store, ship-from-store, and others. These models would not be possible without the underlying technology that drives them.

End-to-end impact of e-commerce and D2C on value chains

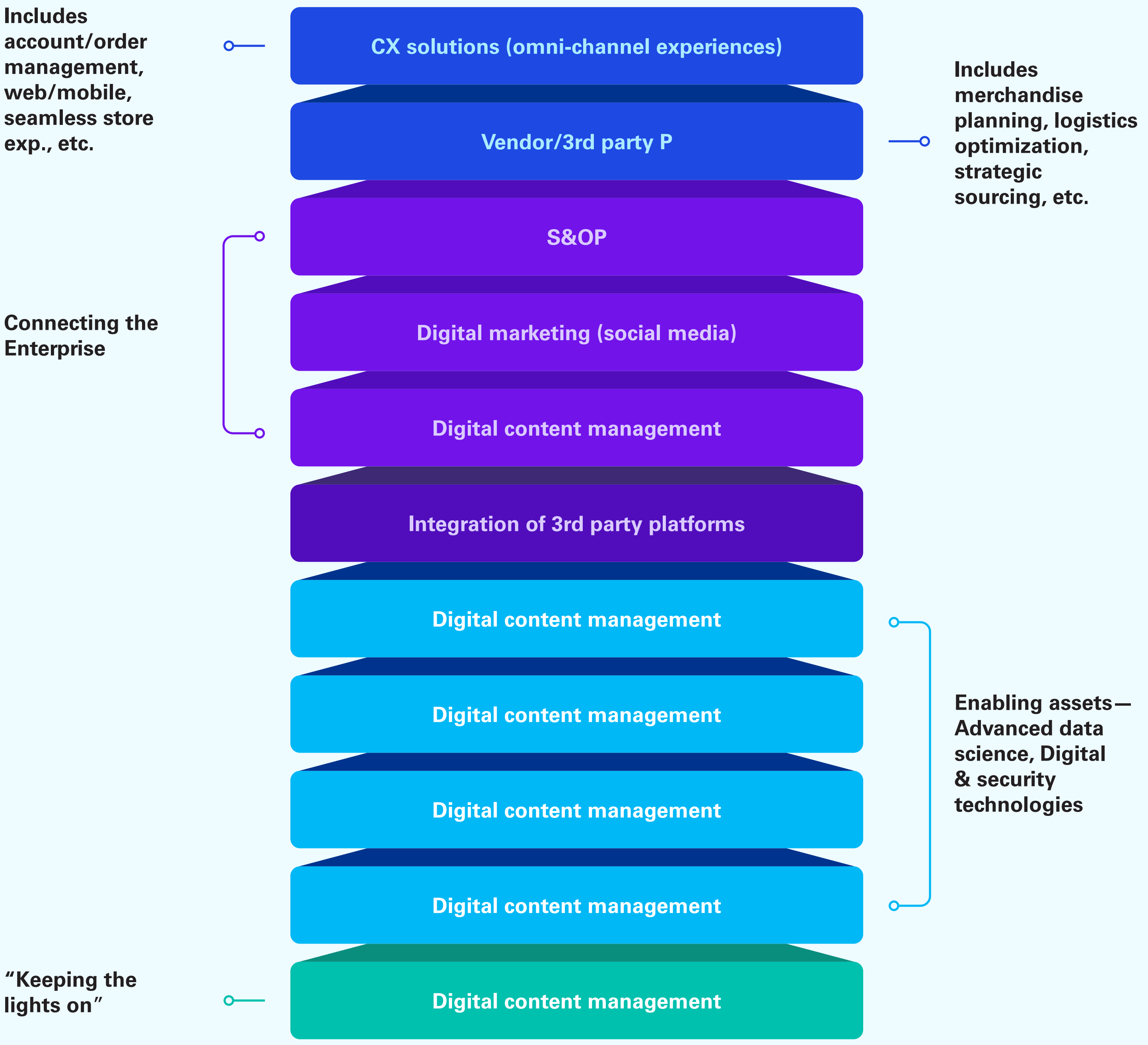
Digital surge and evolving consumer behaviors are forcing C&R businesses to move away from traditional mass marketing and branding resulting in the adoption of new e-commerce and D2C strategies. All of these strategies impact several areas of the value chain including business processes and the development of intangible assets, the creation of new roles and responsibilities within the organization, product development, supply chain management, sales and marketing.

1. New business processes and the development of intangible assets

Delivering products and services through digital and omnichannel strategies requires investment in new technologies, software, platforms, and advanced data analytics. The development of an e-commerce platform, whether internally developed or licensed from a third-party with development of additional features, is a crucial part of an e-commerce strategy. Such strategy may also include the development of applications to manage customer experiences and relationships such as account and order management capabilities, contactless payments, web/mobile and seamless store experiences. Digital evolution also typically involves new developments on the sourcing side of the equation—technology typically used on the vendor management side include platforms for merchandise planning user-interface connecting APIs, and strategic sourcing tools such as buy-side pricing analytics.

Using digital sales channels often requires strong data acquisition and data management capabilities in the form of acquiring or developing Internet of Things (IoT) applications, data analytics platforms and implementing artificial intelligence solutions. Technology and data also play a key role as light and "smart" supply chains that leverage artificial intelligence and data analytics are becoming critical to respond to complex omnichannel dynamics. Acquiring data with respect to consumer shopping patterns is also helping companies enhance their digital marketing efforts. The chart below summarizes the digital assets that may be observed in an e-commerce and D2C framework.

Digital assets typically observed in an e-Commerce/D2C framework



2. Other areas of impact in the value chain

The use of consumer data analytics may also impact product development decisions with the development of new products or services based on feedback from consumers or the creation of personalized product offerings based on loyalty and specialty programs. For some apparel companies for example, the information collected through data analytics allows expedited feedback on collection themes or styles with the possibility of almost real time redirecting the collections resulting in significant financial benefits.

Supply chain management and logistics are other key aspects of e-commerce and D2C strategies that may significantly impact value chain and value drivers. As an example, the strategies to acquire or expand DTC capabilities impact the value chain in different ways. Companies generally may choose to build, partner or buy D2C capabilities. The first model is where companies own and operate their website as well as brick-and-mortar stores thus relying less on external intermediaries for operations such as warehousing, production, and order fulfilment. The second model is where companies choose to partner with other players that specialize in the activity outsourced including company owning and running its e-commerce front-end and relying on a partner to support back-end; or a company owning its e-commerce and partnering with pop-up stores or third-party retailer partners; or a brick-and-mortar company selling online via e-commerce partners. The third model is comprised of companies that focus on acquiring capabilities and D2C partners to accelerate their presence on the market.

Other key operational decisions are related to integrated versus separated digital and brick and mortar supply chains. These include decisions on last-mile delivery. Faster delivery and last-mile strategies are also increasingly important in the industry and also impact the cost of delivery. Another critical decision revolves around marketing. Digitally enabled marketing where companies interact with consumers on a personalized basis through technology using digital content, social media channels, influencers, and other digital initiatives. From a sales function perspective, the decisions on transaction flows, contracting model for the online business and channel integrations may also significantly impact the value chain.

Critical tax implications

1. Direct taxes, transfer pricing and intellectual property ("IP") considerations

The emergence of new categories of assets and business processes critical for the success of e-commerce and D2C strategies creates several tax considerations:

- Are new intangible assets being developed?
- Are these assets relying on different development, enhancement, maintenance, protection, and exploitation (DEMPE) functions?
- Is the value of legacy intangible assets (brands, customer and marketing intangibles, technology) being enhanced because of e-commerce initiatives?
- Are new high value functions being performed (for example, digital marketing, advance data management and analytics, supply chain and e-commerce inventory management)?
- Ultimately, do all the above constitute new value drivers that increase existing revenue, generate new revenue streams or create cost efficiencies?

The entities that own the intangibles, manage the investment and control the risks associated with all these initiatives need to be remunerated with adequate returns, also considering DEMPE implications. Where will future intangible related returns be recognized and taxed? What locations are considered advantageous considering the U.S. and international tax landscape as well as the availability of tax regimes for the digital economy and tax incentives? What is the appropriate compensation for the entities that develop software or control data platforms and provide advanced data analytics? The characterization and determination of fees remunerating digital assets or data capabilities depends on many factors including the specific assets, functions and risks employed. The significant value driven by these digital assets should be adequately reflected in the transfer pricing model adopted for these transactions. The characterization of the transaction as services, sale, license, lease or Software-as-a-Service (SaaS) is a sensitive area of analysis also considering withholding tax, transfer pricing and other tax implications.

More broadly, the answers to all the questions mentioned above depends on the choice of the operating model adopted for these digital assets and the other components of the e-commerce supply chain. In this respect, a critical decision is whether separating supply chain functions related to e-commerce from the legacy supply chain. Also, whether the e-commerce sales are recorded in each market directly by the entity responsible for the e-commerce supply chain or by local related party distributors determines tax, transfer pricing and indirect taxes implications. If local distributors book and manage both e-commerce and non-e-commerce sales, consideration needs to be given to the transfer pricing policies for both channels. A local distributor could perform several functions in relation to the e-commerce sales ranging from redirecting web traffic to the website to more complex omnichannel functions. Specific comparables should be identified to support the arm`s length returns of local e-commerce functions. It is worth noting that the presence of public D2C companies transacting with several unrelated organizations may create availability of external comparable situations under a Comparable Uncontrolled Price transfer pricing approach. This approach may prove relevant to benchmark certain fees including marketplace listing fees, fulfilment fees, website traffic redirecting fees, and others. Permanent establishment risks should also be considered to assess whether e-commerce activities, including last-mile delivery and other logistical activities performed in local markets by foreign entities may create permanent establishment issues.

2. Global indirect taxes

The emergence of e-commerce and D2C strategies have led Tax Authorities worldwide to introduce regulations aimed at taxation of e-commerce transactions. Apart from the United States, over 170 countries employ transaction taxes in the form of a value-added tax ("VAT") also known in certain countries as goods and services tax ("GST"). An increasing number of these countries have introduced, or are in the process of introducing, VAT/GST rules aimed at the digital economy, creating global tax obligations for US—based companies who earn revenue from various e-commerce models. This means that US companies with no physical presence outside the US may have VAT/GST compliance obligations in many countries around the world. These rules focus on three main aspects of the digital economy: i) remote sales of digital services, ii) remote sales of so called low-valued consignments, and iii) tax obligations of digital intermediaries such as online platforms or marketplaces.

VAT/GST rules aimed at the digital economy have an impact beyond tax:

Record keeping: The location, language, and length of the record keeping varies greatly between jurisdictions (e.g., up to 10 years in the European Union)

Legal: Contracts and general terms and conditions need to reflect the legal obligations

Pricing: VAT/GST inclusive versus VAT/GST exclusive?

Customer experience: Businesses must determine when and how the customer should provide their information without impeding the customer experience

Systems: Businesses must customize their enterprise resource planning (ERP) systems and/or tax engine in order to meet these global requirements.

Sales and Use Tax ("SUT")

SUT is an important area for e-commerce businesses with U.S. sales and operations. Many States rely on the notion of nexus to determine the ability to subject businesses to SUT. In June 2018, the U.S. Supreme Court ruled in South Dakota v. Wayfair, Inc. (Dkt. No. 17-494) that physical presence is no longer required for SUT nexus to be established. In short, the Court ruled that based on the modern economy, substantial nexus can be created through non-physical means such as the creation, maintenance, and direction of a web presence into a market state in order to take advantage of that state's marketplace. The economic nexus standard set forth by South Dakota was upheld and many States across the nation quickly adopted similar provisions. Most States introduced remote sellers'—or intermediary marketplace—economic nexus, requiring registration for SUT collection and remittance purposes, provided certain thresholds are met. Therefore, in the post- Wayfair environment, SUT is an important matter for e-commerce businesses with US domestic sales and operations. Additional considerations include the following areas:

- Registration and compliance obligations in new jurisdictions
- Sales to wholesales/distributors—generally exempt
- Is remote seller or intermediary marketplace/facilitator responsible for collection and remittance?
- Products subject to SUT and rates
- Exemptions and certificate collection obligations
- Increased complexity of new delivery models and returned good flows
- SUT implications on new technology (hardware, software, etc.) purchases as well as the transaction flow of tangible property and services between intercompany entities

As such, further to new and developing indirect taxation measures applying to companies employing e-commerce and D2C models, there are several considerations for businesses to manage their global indirect tax obligations:

- Ensuring multi-jurisdictional compliance with indirect tax obligations requires consideration of a feasible compliance model, effective controls and utilization of resources, e.g., centralized or regional compliance model, outsourcing compliance function etc.
- Businesses should continuously monitor and analyze the types and scope of digital supplies included within the digital economy VAT/GST rules. The tax rules are everchanging.
- Adequate data management processes and incorporation of indirect tax rules into IT platforms are crucial to ensure accurate indirect tax reporting and effective management of audit queries.
- E-commerce activities often result in a new mix of supply offerings for VAT/GST purposes which may not fit the conventional category of goods/service supplies. These activities often require appropriate analysis to ensure the correct tax treatment is applied.
- New VAT/GST e-commerce rules can often create tax reporting obligations for parties that 'facilitate' sales transactions between buyers and sellers i.e., sales are deemed to be made by the marketplace facilitator to the end buyer. In many instances, companies may not even be aware that they are out of compliance until a penalty or an audit request from the tax authorities is requested.
- Noncompliance with the VAT/GST rules aimed at the digital economy may lead to significant non-compliance issues including penalties and interest, potential criminal charges, as well as potential damage to business relationships and reputation.

Based on indirect tax developments impacting businesses with e-commerce and D2C models, there is a constant challenge to companies attempting to fulfill these requirements. The lack of regulatory standardization and the different levels of maturity across the regions will require an investment in technology and resources to meet these requirements.

Tax planning considerations and potential approaches and solutions

As C&R companies adapt new operating models and accelerate their e-commerce and D2C strategies to respond to transformative forces affecting their businesses, new sources of value are emerging and creating significant implications from an operational and tax standpoint. Companies are adopting different approaches to respond to these critical tax implications. Depending on the maturity scale of e-commerce strategies and overall tax considerations, these approaches can range from defensive tax planning mostly focused on transfer pricing positions to a more comprehensive approach that looks at the entire operating model with the goal of unlocking operational and financial value in addition to address critical tax positions. Under the first approach, at a minimum, companies should review their group transfer pricing policies to assess how e-commerce spend, assets and related returns should be treated from a transfer pricing perspective and what is the impact on the legacy transfer pricing model including DEMPE considerations. Under the second approach, companies have also an opportunity to maximize both pre-tax profit potential as well as after-tax earnings.

Based on our experience, while C&R businesses are all on a journey of evolving their e-commerce and D2C strategies, the maturity scale of these initiatives vary. Companies may approach it with defensive tax planning limited to managing the transfer pricing policies and DEMPE associated with the digital and legacy models. However, to truly unlock the value these critical activities are creating, companies must look at the entire operating model to structure in a way that harnesses that value. Depending on the maturity of the digital journey, an operating model may be structured around fewer or more digital assets and functions.

For example, companies may establish a Digital Centre of Excellence (DCoE) that is responsible for owning and developing the e-commerce related software and technologies. DCOEs operationally can contribute to creating an agile and more cutting edge offering that distinguishes the business and provides a significant financial benefit. A DCoE is organized with a governance model that houses certain key decision makers around the digital assets. These are made available to other operating units of the group that are responsible for the e-commerce supply chain. Benefits also exist for companies to create hubs built around data management & analytics (Data and Analytics Hubs) that provide critical insights to other operating units. Companies may also combine a DCoE and Data and Analytics Hub achieving significant incremental benefits. C&R companies with a predominant domestic footprint have an opportunity to review their domestic activities and potentially design an effective operating model built around data, a domestic Data and Analytics Hub responsible for the use of data externally and internally.

Companies can implement an end-to-end operating model focused on the e-commerce supply chain and separate from the legacy supply chain. In these cases, companies may create an entity that in addition to owning digital assets and data is also responsible for the other processes of the e-commerce supply chain from sales and digital marketing (Connected eCommerce Principal) to supply chain management, manufacturing, sourcing, and product development (Connected Integrated eCommerce Principal).

Conclusion

All C&R companies investing in e-commerce should revisit their operating models and structures to ensure they are properly addressing the relevant tax implications and potentially unlocking tax value. From a practical perspective, there are certain fact patterns that, more than others, call for C&R tax and financial leaders' prompt attention and action. Those include but are not limited to the following: Are online sales rapidly growing and reaching 10 percent of total sales? Are data part of the business strategy impacting revenue and value internally or externally? Is the company internally developing a platform for e-commerce or developing customizations on a platform licensed from a third party? Are public statements being made on e-commerce, digital and data related initiatives including use of artificial intelligence? Are data scientists, chief data officers, chief digital transformation or technology officers being hired?

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