NOVEMBER 7, 2019

Not Whether but When and How: U.S. Response to Unilateral Digital Taxation

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Given the disruption in world order evidenced by recent elections, civil wars, mass protests and Brexit, perhaps it is not surprising that this is a time of great change in international taxation as well.

Countries have become alarmed that the nature of Internet business seems to be eroding many countries' tax bases. Digital giants such as Google and Facebook, almost all of which are U.S. companies, are paying little tax despite having users that number in the billions.

Some countries and tax policy institutions seem to have gone into crisis mode, developing policy solutions and legislation at a frantic pace. Certain countries, most notably France, are becoming vigilantes in the fight against lost tax revenue and are unilaterally proposing or enacting digital services taxes (DSTs) to bring the Internet companies to fiscal justice.

This commentary reviews recent developments and considers how U.S. companies and the U.S. Treasury Department might react.

Background

Traditionally, taxing jurisdiction has developed on a country-by-country basis. When a country found that its taxing jurisdiction overlapped with another country's, potentially subjecting some taxpayers to double tax, countries carved up the playing field by passing bilateral tax treaties. There have been few efforts to coordinate taxing jurisdiction among multiple nation states.

Generally, nations' tax regimes and tax treaties have delineated taxing jurisdiction based on type of income (e.g., interest, dividends, royalties, rents) and the level and duration of a taxpayer's physical presence in the jurisdiction.

Tough cases have always involved situations that seemed to transcend physical presence – for example, transporting goods or people across state lines, exploration or development of natural resources in remote territories or the activities of itinerant loggers and travelling entertainers.

As business has become more global, however, business activities have become less constrained by physical location. Supply chains grew to cover the production and development of inventories across the world. Management activities have lost their dependence on physical proximity, with participants dialling in from remote locations and conducting deals by video conference. The obsolescence of physical location is now reaching a peak, with business conducted through instantaneous worldwide communication, artificial intelligence and blockchains.

Current Picture

Tax policy-makers and legislators seem to always be several steps behind the marketplace. Current efforts to address the digitalization of the worldwide economy have been in development since 2012, when the Organisation for Economic Co-operation and Development (OECD) began developing its comprehensive and multilateral project on base erosion and profit shifting (BEPS). The importance of the

digital economy is reflected in the fact that Action 1 of the BEPS project focuses on taxation of Internet businesses. The OECD is expected to release its final report on Action 1 sometime in 2020.

At the end of May 2019, the OECD released a Programme of Work under Action 1 that generally describes the two-pillared approach that is expected to form the basis of the final report. On October 9, 2019, the OECD followed up on the Programme of Work with a public consultation document titled "Secretariat Proposal for a 'Unified Approach' under Pillar One," which provides additional detail on the first pillar, described below. The public consultation document provides some detail on a "unified" allocation methodology to determine the portion of the income of a digital business that is taxable in a particular jurisdiction, but the main purpose of the public consultation document is to ask for comments and raise questions about the implementation of the proposed approach.

The OECD's proposals in the Programme of Work and Unified Approach are organized around two "pillars." The first pillar consists of revised nexus and profit allocation rules. Since taxpayers can now generate income from a jurisdiction without a physical presence, nexus rules will have to be revised to capture companies that only have virtual contacts with that jurisdiction.

Under the first pillar, once a company has nexus with a country, it would have to allocate its income between that country and the other jurisdictions from which the company has income. The Programme of Work discusses several methods to do this – the "modified residual profit split method," the "fractional apportionment method," and a "distribution-based approach" – and the public consultation document provides a unified approach to allocation based on a formulary apportionment of a business's estimated residual profit, a fixed return on marketing and distribution activities, and dispute resolution mechanism.

The second pillar of the Programme of Work is a global anti-base-erosion proposal (GloBE), which consists of a minimum tax on corporate income, and provisions to eliminate deductions for base-eroding payments.

Revenue-hungry nations, however, are tired of waiting for the OECD to find a consensus solution. Some countries are exploring unilateral approaches to expanding their taxing jurisdiction with respect to large, usually U.S., Internet companies. Spain, Italy, the United Kingdom, India and New Zealand have all proposed DSTs, and two countries, France and Hungary, have enacted DSTs.

France's DST has attracted significant attention, notably from President Trump, who threatened to retaliate by taxing French wine. The United States and France have recently announced that they have come to a deal regarding the French DST.

Practical Aspects of Unilateral Action on Digital Taxation.

The deal with France notwithstanding, it is clear that the U.S. government regards the recent crop of DSTs as a targeted attack on U.S. Internet businesses. In the absence of an agreement, however, the U.S. has several ways to resist other countries' DSTs.

Reactive Posture

DSTs May Be Inconsistent with Existing Law

As noted above, bilateral tax treaties are the main way that countries divide up tax revenue when their tax jurisdictions seem to overlap. It is not clear whether a DST violates standard tax treaty provisions, but it does seem to go against their spirit.

Tax treaties generally only limit a contracting state's tax jurisdiction with respect to certain enumerated types of taxes. For example, the U.S.–France tax treaty provides that, in the case of France, the treaty applies to "all taxes imposed on behalf of the State, irrespective of the manner in which they are levied, on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, as well as taxes on capital appreciation" (Article II(1)(b) of the U.S.–France tax treaty). The French DST is structured as a sales tax, and tax treaties generally do not apply to sales taxes.

DSTs, however, flout those provisions of tax treaties that limit taxation based on physical presence. Under the permanent establishment provision that appears in most tax treaties, a country agrees not to tax the business profits of a non-resident unless that non-resident has a physical presence in the country. Even though France's DST is structured as a sales tax, the fact that it is imposed to remedy a perceived failure of the nexus system to capture digital profits suggests that the DST may be an income tax masquerading as a sales tax.

Accordingly, the DST can be considered to violate the permanent establishment provision of a tax treaty. This may be a necessary result of a tax designed to apply to businesses that are not tied to any physical location.

All the tax treaties of the U.S. include a non-discrimination provision that prevents one contracting state from imposing more burdensome taxes on the other state's taxpayers than it imposes on its own residents. Moreover, these non-discrimination provisions are generally not limited to a particular type of tax, such as income taxes, and could therefore apply to a sales tax. DSTs are already widely regarded as discriminatory because they seem designed only to apply to certain U.S. businesses, but the way that some of these provisions are drafted would let a taxpayer with no permanent establishment fall through the cracks.

DSTs could also be vulnerable under international law other than tax treaties. For instance, the fact that DSTs tend to discriminate against a handful of U.S. companies or the fact that many DSTs are being proposed retroactively could form the basis of a challenge in front of the World Trade Organization or under other trade agreements.

Who Bears the Costs?

If the DSTs survive legal challenges to their implementation, it is likely that companies that pay the DST would simply pass the costs on to consumers. This reaction to DSTs is similar to the way companies react to trade tariffs. These tariffs are usually paid by importers, that then raise their prices to pass the cost on to consumers. If the companies that pay a country's DST then raise prices on their customers in that country, the cost of a DST may ultimately be borne by the citizens of the country that enacts the DST.

Social Media

Another way the U.S. could fight another country's DST would be by raising awareness of the harmful effects of the DST among the country's citizens. It would be poetic justice for Facebook, Google and other online advertisers to bring down a DST through an information (or disinformation) campaign targeted at the DST-imposing country's voters.

Governmental Retaliation

If all else fails, the U.S. could take matters into its own hands and retaliate against a country that adopts a DST.

The U.S. began an independent investigation into the French DST under the U.S. *Trade Act of 1974*. This investigation was abandoned as part of the deal between France and the U.S., but determining that a country instituting a DST is engaging in an "unfair trade practice" would generally be an essential first step for the U.S. in formulating a response to a DST.

One option would be to rely on an obscure provision in the Internal Revenue Code (the Code) known as section 891. Under this provision, if the President finds that a country's tax system discriminates against U.S. persons, the President can cause the tax rate applicable to citizens and corporations of that country to double. There is little guidance on the actual operation of this provision, and no President has ever tried to put it into effect. However, it would be a considerable deterrent to have, say, the withholding rate for dividends paid to a country's citizens increased to 60%.

Alternatively, under section 901(j) of the Code, a foreign tax credit can be denied with respect to taxes paid to certain foreign countries. Denying foreign tax credits would discourage U.S. companies and other taxpayers from conducting business and investment activities in the country. This provision of the Code, however, only applies to a country if

- the U.S. generally does not recognize the government of the country;
- the U.S. has severed or otherwise does not conduct diplomatic relations with the country; or
- the U.S. Secretary of State designates the country as a supporter of international terrorism.

Using section 901(j) would require drastic measures from the U.S. Department of State.

If the U.S. wanted to act outside of the tax system, it could impose import tariffs or otherwise impose sanctions on goods imported from the offending country. As noted above, however, the cost of those tariffs would likely be passed on to consumers of those goods in the U.S., which would nullify the effect of the tariff.

As a final measure, the U.S. could turn to draconian retaliatory actions, such as stepping down diplomatic relations between the U.S. and the offending country or implementing restrictions on immigration.

Administrative Issues

In addition to the political issues described above, DSTs present a number of practical administrative problems that lack an obvious solution. Even if a DST survives the challenges described above, there are significant problems with its implementation.

Determining Jurisdictional Nexus

The intangible nature of the services being taxed under a DST raises the issue of how to connect a taxable service with the country imposing the DST. Traditional tax principles, which look to physical presence, are unlikely to provide guidance on determining nexus. New rules will have to be drafted from scratch.

For example, the French DST applies to services "provided in France." The fluid nature of Internet businesses may make it difficult to determine when these services are actually provided in France. For instance, if an individual in Paris uses Airbnb to reserve an apartment in Tokyo for a relative who lives in New York, have services been provided in France? If the relative pays the Japanese renter directly, what exactly is the intangible value realized in France and how does a state measure such a thing?

Determining Thresholds and Accounting Methods

The DSTs currently being proposed and enacted generally use gross revenue thresholds to determine which companies are subject to the tax. Again, the fluidity of Internet businesses gives companies a high degree of flexibility regarding how and where they realize revenues and income. Unlike traditional businesses, there may not be a single top holding company where all the value ends up.

The value generated by the companies targeted by a DST may be exceedingly difficult to measure. For example, if a Canadian company employs Google to show advertisements to a certain type of consumer, what amount becomes taxable if that ad is shown to a consumer in France? Will that amount change if the French consumer clicks on the ad? What if that French consumer views the ad through a proxy server, so Google is not even aware that the ad is being viewed by a French person?

Other Issues

Other administrative problems are raised by the current crop of DSTs. Consider the following, for example:

Many of the DSTs are retroactive, which means the companies subject to those DSTs did not have time to prepare for them. The companies are unlikely to have compliance systems in place that can extract the necessary data to determine the amounts subject to tax, especially for the period before enactment.

The tax authority in a country that adopts a DST is similarly blindsided by the hasty passage of these rules. Guidance is not likely to be available for the interpretation of the statutory language. The lack of guidance increases compliance risk for taxpayers, who may be forced by the lack of clarity to take overly conservative positions and, as a consequence, overpay the tax.

The mechanics for how to pay the tax will take time to work out. The intangible nature of the DST is certain to draw taxpayers into a country's taxing net who do not understand how to comply with that country's tax procedures. It is unclear how a country will detect taxable activity under a DST, and how the country will notify a company that it is subject to the tax.

Conclusion

Despite all of the noise, resolution of conflicts among nations over the proper standards and rules for the taxation of the digital economy is probably a matter of time. The U.S. has a history of resisting measures that have come out of the BEPS program and other international tax policy initiatives. It may be unlikely that the U.S. would change its approach in the case of DSTs.

The recently announced deal with France may nonetheless suggest that the U.S. is softening its stance against international tax harmonization efforts. The details of the deal, however, are yet to be released. If the U.S. is opening its mind to DSTs and similar measures, the practical questions may turn out to be the real barriers to implementation.

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