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Digital Services Taxes: How Did We Get Into This Mess?

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In this article, Barnes and Rosenbloom consider the state of digital services taxation following the OECD's initiative to develop global digital tax rules.

A version of this article will be published this year in a special edition of *International Taxation in China* by the Belt and Road Initiative Tax Administration Cooperation Mechanism advisory group.

By the end of 2020, the OECD is likely to propose that countries impose a net basis income tax on large consumer-facing digital services companies, a proposal that will fly in the face of international tax principles dating back over 100 years. Moreover, the proposal will not be clear or detailed and will be nearly impossible to administer.

Why is this happening, and what are the reasonable alternatives?

The proposal will have just enough specificity so that it feels like an achievement. For instance:

- The new tax will apply to companies with annual revenue above a threshold (such as €750 million per year), so it will be possible to identify which companies will be affected and which will not.
- The proposal may sweep in companies outside the digital services space — that is, those that rely heavily on intellectual property (especially high-value brands) to earn revenue, such as luxury good producers and franchisers.
- The proposal will have multiple levels of calculation. A slice of income will be assigned to jurisdictions where the taxpayer has physical locations or employees. Other income will be allocated by formula to most or all of the countries where the taxpayer has customers or makes sales.
- The tax will be imposed on a taxpayer's consolidated global operations. Separate-entity accounting will be disregarded.

That is the big picture. Taxation, however, requires not only policies and aspirations but also rules, and rules require details. It is understandable that many countries want to raise revenue from digital behemoths such as Google, Uber, and Facebook and to demonstrate that they are "doing something" about those invariably foreign, but locally successful, enterprises. Without specifics on how the OECD proposal is to be understood and administered, however, implementation looks like chaos in the making.

As longtime international tax practitioners, we want to be clear at the outset about what we are saying. First, the international tax system is far from perfect. Changes to the century-old rules may well be appropriate, including (perhaps even especially) changes that increase the amount of tax raised by source or market countries (which would include the United States to a major extent).

Second, determining the "right" amount of income to ascribe to a particular jurisdiction is difficult. The arm's-length standard for transfer pricing is challenging to apply. However, discarding well-established principles in favor of a formulaic allocation of income will lead to inappropriate results and almost endless disputes.

Third, underlying the debate on digital services taxes is a mistaken notion that where customers are located is necessarily indicative of where value is created. That notion was considered and rejected decades ago, long before the digital economy existed. It is unclear why that concept should be reconsidered now. But if it is, and if a jurisdiction wants to impose tax based on sales, there is a wonderful tool for that: consumption taxes, either VAT or retail sales taxes. The DST debate focuses on net basis income taxes, and that is a mistake. Consumption taxes, or conceivably gross-basis income taxes, would be much better for raising local revenue.

The pressure from political forces to tax large, successful digital companies — most of which are U.S. based and owned — is overwhelming. Those companies appear to be unstoppable and pernicious, eating up our lives and our workers' livelihoods. As advertising dollars migrate to online companies, local newspapers struggle to survive. But the need for tax rules to adjust to changes in the business landscape must be tempered by a clear understanding of why the long-standing tax principles are what they are.

Taxing digital services companies is highly important to China and the members of the Belt and Road Initiative Tax Administration Cooperation Mechanism (BRITACOM). China is home to at least two companies — Alibaba and Tencent — that would be targets of the proposal. Further, China and many BRITACOM members already struggle to administer complex international tax rules; the OECD proposal, with its untested complexities, will exacerbate administrative challenges.

A Little (Recent) History

When the OECD designed its base erosion and profit-shifting initiative in 2012 and 2013, taxation of the digital economy was set as action 1. The OECD was aware that digital commerce might raise new international taxation issues. But those issues are difficult, and the participating OECD members did not reach consensus regarding what, if anything, should be done to levy taxes on digital services companies. In its final report, the OECD said it would continue to study the question.

The international community could not wait for further study, however. The G-20 pressured the OECD to act quickly. India, Israel, and several EU countries proceeded with their own initiatives. Generally, those single-country efforts resulted in gross-basis taxes on various income streams, such as advertising revenue, subscription fees, and income from data sales.

It is difficult to know how much revenue those taxes are collecting and how readily they can be administered. Administration is helped by the fact that the taxpayers targeted by the new levies are all major multinational corporations that want to comply with their tax obligations. The challenge is not identifying taxpayers but identifying the tax due. It will be several more years before the full impact of the unilateral taxes can be assessed.

The OECD, seeing countries taking unilateral action and pushed by political forces, decided that accelerating efforts to seek global consensus on new taxes was preferable to allowing countries to go their individual ways. Thus, the digital services tax program (known as pillar 1 of the OECD initiative to reshape international tax rules) was born.

Significantly, the OECD has generally persuaded countries that have adopted unilateral DSTs to consider those taxes interim measures pending a global consensus on new net income tax rules. The idea is that the unilateral (and inconsistent) taxes will give way to the consensus approach once it is reached.

A Net- or Gross-Basis Tax?

At the core of the digital debate is a single question: Should a specific group of companies, however defined, be subject to new income tax rules in countries where their customers reside? In short, should market countries receive a slice — and, in some cases, a larger slice — of the total income tax pie, regardless of the business model the taxpayer adopts?

Current international income tax rules generally require a physical nexus (either directly or through an agent) for a jurisdiction to tax a nonresident. Consumption taxes, on the other hand, commonly apply to imports, using a VAT or another levy of that nature. Some digital services companies (and other companies, as discussed below) can engage in significant commercial activities with little or no physical nexus in a particular jurisdiction. If the local income tax is based on the income attributable to assets and activities associated with that limited physical nexus, the tax collected will likely be modest.

Most non-U.S. observers have a reflexive response: Yes, digital services companies should be subject to additional income tax in market countries – and that is the premise the OECD is operating on in developing its proposal. However, two core questions must be answered first:

- what is meant by digital services companies, and are those companies sufficiently alike that they should be lumped together and subjected to a new income tax regime; and
- why is a net-basis income tax, rather than a gross-basis tax (whether a consumption tax or an income tax), appropriate for those companies?

A tax on net income would need to identify allowable deductions, and for digital service companies, most of those deductions will not be in market countries. It is unclear how the OECD's proposal will address the often intractable problems of administering a net income tax on foreign taxpayers. If the answer is to rely on a formulary piece of accounting income, elaborate new rules will be needed to mesh the OECD proposal with existing laws on deduction eligibility.

The distinctions the OECD is trying to make to justify the new income tax are not sound — or at least not sufficiently clear and persuasive to justify dismissing long-standing principles of international income tax administration. If countries believe additional tax should be collected on those transactions and services, the better approach is to use gross-basis taxes such as those that have been adopted by countries imposing unilateral interim measures.

All Companies Are Digital Companies

One reason the OECD did not include a DST proposal in its BEPS project was the recognition that most companies are becoming digital. All but the smallest companies (and even some of those) have a website and communicate with customers through the internet. Where does the line between a digital and non-digital company lie? That's an impossible question.

Remote sales to local customers did not begin with digital companies. Sales into a jurisdiction from a foreign site have been occurring for decades. The link between the advent of digital companies and the development of new income tax rules seems tenuous.

In early analyses, the OECD and commentators identified traits that might justify a tax on some global services companies and not others:

- the companies achieve scale without mass, meaning they can have large amounts of revenue and reach many customers with comparatively little investment in plants and equipment;
- IP is a key element of the business model; and
- user input may be a valuable part of that model.

Those characteristics may or may not apply to a specific digital company, and they do not by themselves explain why the long-standing international tax rules that rely on physical presence and arm's-length pricing should not apply. Why must a new income tax system be adopted for those companies?

While all companies are (or are becoming) digital, those that are indisputably digital in nature vary greatly in their business models, which the OECD recognizes. In a recent statement, the OECD described the kinds of business models that will likely be included in the proposal, such as online search engines and advertising services; social media platforms; digital content streaming; and cloud computing services.

Imposing a new income tax regime on some or all of those models is not sensible because the models are not relevantly different from other types of models. Compare Netflix and Saudi Aramco, for example. Netflix is a streaming service that allows subscribers to watch its proprietary entertainment, as well as content licensed from other entertainment companies. Saudi Aramco, an oil production company, is the most profitable company in the world (according to its own estimates and Bloomberg.com); it owns the world's second largest oil reserves and is the second largest daily producer of oil.

Both Netflix and Saudi Aramco sell goods and services worldwide. Think about a country — say, Canada — where both companies make their products available to customers. Yes, there are differences in the transactions: Saudi Aramco delivers the goods by ship or pipeline, and the customers are generally large refiners or other businesses in the oil industry. Netflix stores its content on computer servers that Canadian customers access via the internet. Saudi Aramco sells its goods by the barrel. Netflix charges a monthly subscription fee.

But what differences between the two companies suggest that a different income tax regime should be applied? Both companies track customer preferences and adjust their marketing accordingly. Neither needs a significant physical presence in Canada to generate millions, or even billions, of dollars in sales. Yet there is no suggestion in the OECD's work that Canada or any other country should be entitled to a share of Saudi Aramco's net income. Indeed, the OECD said in its recent statement that "extractive industries and other producers and sellers of raw materials and commodities will not be within the consumer-facing definition" of companies that would be taxed in a new manner.

Is the reason for exempting Saudi Aramco that it is not consumer facing? Perhaps. But that seems odd. There is not generally one set of tax rules for customer-facing businesses and another set for business-to-business enterprises.

With consumption taxes, there are often administrative differences in applying a VAT or retail sales tax in a business-to-business context than in a business-to-consumer context. But the substantive tax liabilities are the same. With the DST proposal, the OECD intends to create substantively different tax obligations for transactions with consumers than for transactions with businesses. The argument that brands and reputation do not matter in a business-to-business context is false. Business purchasing managers routinely buy goods and services from well-known, well-regarded global suppliers, even when those goods and services cost more than they would from a generic supplier.

Limiting the OECD proposal to consumer-facing businesses creates difficult line-drawing problems. If Netflix establishes a line of business that provides training videos to businesses, would that operation be exempt from the new tax rules? If Saudi Aramco establishes a local operation to sell five-gallon cans of gasoline to individual customers, would it — and a share of its profits from extracting oil in Saudi fields — be captured by the new tax net?

Further, extractive businesses sometimes sell directly to consumers. Consider, for instance, bottled-water suppliers that aim for a consumer market. Are they exempt from the OECD proposal because they are extractive, or are they included because the brand name creates global value? Just asking the question points out the difficult line drawing that will accompany the OECD proposal.

Not Every Company Is Facebook

There is no single motivation for imposing a new tax on digital companies, but there is a poster child for the exercise: Facebook.

The animus in the tax world toward Facebook seems disproportionate. The argument for taxing Facebook is both simple and simplistic: Much of the content posted on Facebook is generated by customers, who are in countries where Facebook may have little or no physical presence. Without customer-generated content, Facebook's successful business model might not exist. Facebook could not sell ads or gather user data that has value to it and to data purchasers. That single fact seems to serve to justify a demand by market countries to impose income tax on Facebook.

A similar argument can be made for other social media companies, such as Pinterest, or possibly even YouTube. The user content, so the argument goes, constitutes value creation in the jurisdiction seeking to impose the new income tax.

If that is the case, a perfect reflection of the value created by user postings already exists: the advertising revenue Facebook earns from each jurisdiction. Levying a gross-basis tax on advertising revenue — not creating a wholly new regime for net income tax — is the historically consistent and administratively achievable way to tax that revenue.

What About Pharmaceutical Companies?

One challenge for the OECD is to determine how far the new regime extends beyond core digital companies. Consider, for instance, the pharmaceutical industry.

Are pharma companies consumer facing? Yes. Some products require a physician to write a prescription (and so could be considered business facing), but many are available to anyone who asks. And even prescription drugs are now often advertised on television and in print, so that potential customers will ask doctors about possible benefits. There is extensive customer input; pharmaceutical companies closely monitor the results of their treatment regimens and respond accordingly. IP is a cornerstone of the pharmaceutical industry. And manufacturing pills is a prominent example of a business that can achieve scale without mass.

Should pharmaceutical companies be subject to the new rules? One huge stumbling block is that drug prices differ dramatically from country to country. Indeed, because of the high price of drugs in the United States and price controls in other countries, a fair cost accounting would conclude that almost all those companies' profits are from U.S. sales. Under the OECD proposal, would that be ignored, with a portion of a drug company's global profits allocated to countries where price controls effectively eliminate most, if not all, net income?

Take the discussion one step further and apply the pricing problems to a company like Netflix. Subscription prices vary by country, and a formulaic method for allocating and apportioning a company's global profits ignores those variations in pricing models. Similarly, Facebook's advertising rates per view differ significantly by market; should global income be averaged and then shared equally with each country based on the number of users?

Under the OECD proposal, revenue and net income from high-margin countries will likely be reallocated, at least in part, to lower-margin countries. High-margin countries will resist that reallocation, of course, while lower-margin countries will push for equality under the guise of simplicity.

That same problem arises in transfer pricing. The global rules require that country-specific markups and profit margins be respected. Why would we take a different approach in taxing digital companies?

What Should Be Done?

As stated at the outset, it may be appropriate, and certainly is not novel, for market countries to seek to collect an increased level of tax on cross-border businesses. They have long sought to do so, and some commentators have long noted that international tax rules tend to favor residence-country taxation over source-based taxation. The United States may be the biggest beneficiary of that skewing, because it is a net capital exporter, as well as the biggest loser, because of overly generous tax rules for investors into the United States.

The question, however, is what additional taxes on cross-border commerce should be collected. It seems the unilateral interim measures adopted by several countries get it right: impose a gross-basis tax on specific kinds of payments, such as subscription fees and payments for digital advertising. The OECD should seek to harmonize the interim measures, rather than throw them out in favor of an entirely new income tax regime.

The objection to that approach seems twofold.

First, and perhaps most important, the economic burden of gross-basis taxes likely falls on in-country customers and advertisers, not on nonresident companies. As financial institutions that offer cross-border loans and global IP licensors have long known, it is business as usual to mark up any interest or royalty charges to compensate for gross-basis taxes in market countries.

Second, the approach lacks the theoretical purity the OECD seems intent on: assigning net income to each jurisdiction through a global formula that accounts for each location's contribution to value creation. That pursuit of perfection will never succeed. Even with the use of safe harbors and averages — indeed, especially with that use — the result will be only an approximation of perfection. Gross-basis taxes appear to offer an equal measure of accuracy.

A subtle point to make involves the creditability of any gross-basis taxes. That applies primarily to the U.S. companies subject to the new taxes but also to Chinese and other companies resident in countries that use a foreign tax credit regime to relieve double taxation. It is unclear whether the gross-basis taxes that have been adopted as interim measures are creditable under the U.S. FTC system, or whether they should be viewed as non-creditable consumption taxes. The taxes imposed as interim measures have characteristics of both kinds of tax.

The U.S. companies targeted by DSTs obviously would prefer that the taxes be creditable; that is a multibillion-dollar issue annually. The gross-basis taxes might be creditable as taxes in lieu of income taxes under section 903. For the international insurance industry, gross-basis taxes imposed on insurance premiums are treated as creditable taxes because they are considered economically equivalent to income taxes imposed on other industries. The same analysis may well apply to DSTs. However, for gross-basis taxes to be creditable in the United States, they must be in lieu of generally imposed local income taxes, and that may be a problem for a company that has both a local presence and substantial remote sales. So the U.S. digital companies may prefer the OECD regime, despite its flaws, to a system in which the same level of taxation is imposed but the taxes are arguably not creditable under the U.S. system.

Whether DSTs are treated as creditable taxes for U.S. tax purposes should not drive how activities should be taxed. Gross-basis taxes on specific streams of income are the traditional way that countries have sought to collect tax on payments to nonresidents, especially on payments involving the use of IP. That kind of approach should be adopted, rather than the global formulaic income tax rules under consideration.

It will be fascinating to watch the entities participating in the DST debate race toward a proposal by the end of this year. We believe that race is chasing the wrong result. Rather than seek to develop a new income tax regime to apply to some group of multinational companies, the OECD should redirect its attention to the imposition of harmonized gross-basis taxes on defined categories of income. Those rules could be administered and applied by all relevant companies (regardless of their annual revenue). And the discussion could change from seeking a transformation of international tax rules to how to make long-standing rules work better. ■