Global Counsel

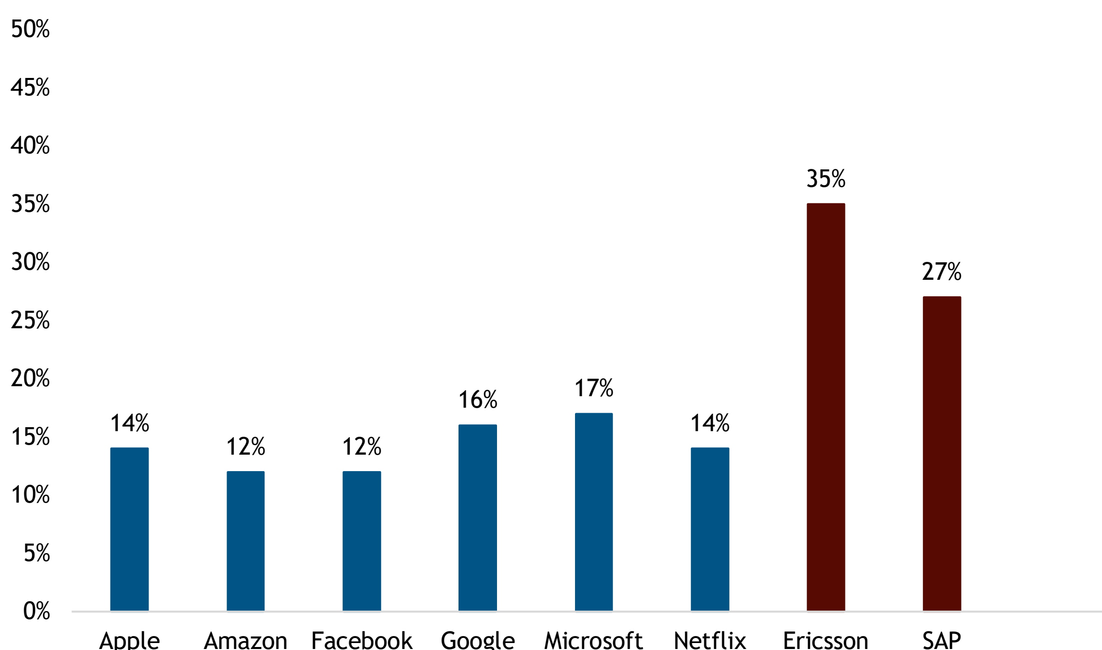
US fights back: the challenges to taxing digital

Blog post by Miranda Lutz, Senior Associate, 9 April 2021

The meteoric rise of digital commerce and virtual services has raised the issue of how to tax companies that do not generate value based on their physical footprint, but nonetheless place a burden on the jurisdictions in which they operate. The digital tax issue has been percolating for several years but as major tech companies like Facebook and Netflix have raised the ire of politicians on a spate of policy topics, so too has the political attention on how to tax these companies ratcheted up.

The current international tax regime is heavily reliant on where firms are physically present – in terms of both office and employees – a regime that looks increasingly obsolete in the wake of covid-19 and the rise of remote work. To give a sense of the scale, major US tech firms have all reported tax rates well below the statutory federal rate of 21%, which for many companies is increased by a couple of percentage points due to state and local taxes (see below). In comparison, major European tech firms like Ericsson and SAP pay a much higher corporate rate in their home countries – Sweden and Germany, respectively.

Comparison of fiscal 2020 provisions for income tax



Source: company filings & annual reports

The digital tax issue has been front and centre at the Organization for Economic Cooperation and Development (OECD) through its Inclusive Framework project – or BEPS 2.0 (BEPS stands for Base Erosion and Profit Shifting) – since 2015. The BEPS project has two pillars: the first is focused on how to tax profits from cross-border digital services and products as well as marketing and distribution activities; the second looks at establishing a global minimum tax regime applicable to all countries. The initiative has progressed in fits and starts over the years as countries, frustrated with the lack of progress at the international level, have taken unilateral actions to address this issue through digital services taxes (DSTs).

Covid-19 has super-charged these unilateral efforts, with many countries looking for new ways to generate revenue to support post-pandemic spending and recovery. Over 15 countries have proposed or adopted DSTs in the past year, and there are some broad-stroke similarities among the measures. The DSTs' rates range from 1.5% to 7.5% on revenue from digital advertising, operation of online marketplaces, and sale of user data. In most countries the revenue would be based on the number of users viewing or using the taxed services within the jurisdiction. There are some exemptions – in France, Italy, and Turkey, for instance, payment services are not subject to the digital services taxes. The common denominator in all the proposals is that the thresholds determining when these taxes apply are structured in a way so that they are only applicable to large – mainly US-based – tech companies.

And there's the rub. Despite bipartisan frustration with Big Tech, US lawmakers are equally reticent to see American companies specifically targeted on the international stage and put on the chopping block for these taxes. President Donald Trump initiated Section 301 investigations into several countries that proposed or adopted DSTs, providing a means for retaliatory trade actions. However, after finding that most of these DSTs were counter to international tax law and unfairly harmed US companies, the previous administration opted to leave it up to the Biden White House to determine if the US should move forward with trade remedies.

But private sector firms hoping that the threat of new tariffs would dissipate under Biden are likely to be disappointed. On March 31st, US Trade Representative Katherine Tai announced USTR would move forward with the process to implement retaliatory tariffs on Austria, India, Italy, Spain, Turkey, and the UK under Section 301 in response to the countries' DSTs. The USTR's proposed remedy is a 25% tariff applied on an amount of goods roughly similar to the revenue each country is expected to collect from US companies under their respective DST regimes. For instance, in the UK, US$325 million of goods would face these additional duties, while in Spain the tariff would apply to $155 million worth of goods. The tariffs would apply to a number of goods including apparel, ceramics, carpets, linens, jewellery, seafood, handbags, footwear, textiles, and electronics.

What does USTR's action mean for the international negotiation discussed earlier? By maintaining the threat of tariffs, the US re-establishes its leverage in negotiations. Under the Trump administration the US position on the OECD's proposal was that it must be voluntary – which would allow big US companies to "opt out" – a non-starter for the other countries participating in the negotiations. Treasury Secretary Janet Yellen dropped this demand for a safe harbour provision in allowing the negotiations to move forward, but at the same time left the US with less firepower in the talks. The US is set to begin hearings on the proposed tariffs in May 2021 – though the OECD is

not expected to come to an initial agreement until later in the summer of this year. This timing puts a lot of pressure on the OECD to quickly reach a consensus.

Yellen's statements this week advocating for a global minimum tax rate also have implications for the future of digital services taxes and negotiations at the OCED. As President Biden looks to increase the corporate tax rate to fund his recently released infrastructure proposal, Yellen's call for a unified international approach highlights the administration's sensitivity to concerns that if the US increases its taxes alone it could be harmful to the economy and incentivise offshoring. Biden's proposal would establish a 21% minimum corporate tax rate. Yellen's comments suggests that the US fully endorses the OECD's negotiations over whether other countries should adopt similar minimums and is willing to broaden the international debate on corporate income tax. This is potentially quite meaningful not only for large tech companies, but for all multinational corporates.

The powerful tech lobby will continue to use its influence to push international negotiations away from a framework that is sector specific. But even companies that do not meet the current thresholds should be tracking these developments. If an international agreement at the OECD continues to be out of reach, individual countries could be tempted to expand the applicability of the taxes to more firms that sell their services globally. India's tax already applies to online education services. Because this is a new area of tax law, the application of DSTs is still a grey area and the implications could be more far reaching than many companies expect.

These domestic and international trend lines point to increased corporate taxes over the next several years – but it increasingly looks like a tax that only targets FAANG companies will be unacceptable in Washington, diminishing the chances of these digital services taxes *as currently structured* from being implemented at the international level.