Ensuring Fair Taxation in An Increasingly Digital Economy

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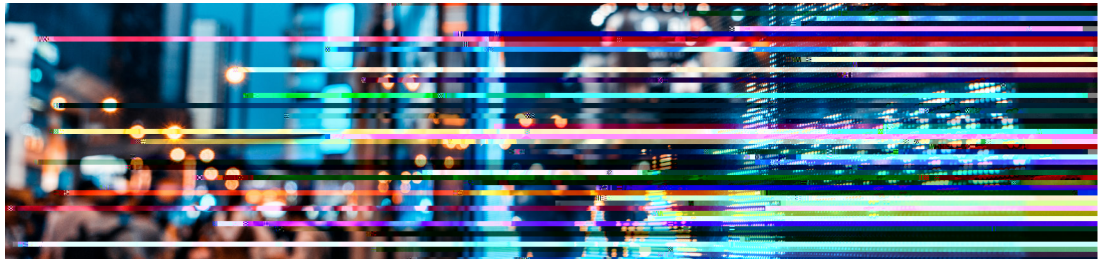
SPECIAL REPORT



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For the most part, traditional corporate tax rules do not account for the realities of the modern global economy. The reason for this is two-fold: 1) they do not capture business models that pro t from providing digital services in a jurisdiction without being physically present under traditional permanent establishment (PE) rules; and 2) they fail to recognize the evolving role that users play in generating value for digital companies.

With such disparity between value creation and where taxes are paid, many countries are beginning to reform their corporate tax rules so that pro ts are registered and taxed where businesses have signi cant interaction with users through digital channels — and it is time multinational enterprises (MNEs) take notice. Recent global activity proves this type of legislation will be accelerating in the very near future.

A look at recent tax authority activity

India

In March 2018, India published the Finance Act 2018, becoming one of the rst countries to expand its PE rules to include activities of non-residents that do not give rise to a physical presence in India.

The Finance Act 2018 amends Section 9(1)(i) of India's Income Tax Act, 1961 (ITA) to provide that "signi cant economic presence" in India constitutes a business connection. Signi cant economic presence will mean either of the following:

- Any transaction in respect of any goods, services, or property carried out by a non-resident in India, including downloading data or software in India, if the aggregate payments arising from such transaction(s) during the previous year exceed a speci c threshold
- Systematic and continuous soliciting of its business activities or engaging with a certain number of users in India through digital means

The measures will apply beginning April 1, 2019.

European Union

The European Commission (EC) recently proposed new rules to ensure that digital business activities are taxed fairly in the EU. Speci cally, the proposal includes an initiative aimed at reforming corporate tax rules so that pro ts are registered and taxed where businesses have signi cant interaction with users through digital channels. Secondly, the proposal responds to calls from several EU member states for an interim tax, which covers the main digital activities that currently escape tax altogether in the EU.

In terms of next steps, the proposals will be submitted to the Council of the EU for adoption and to the European Parliament for consultation. The EU will also continue to actively contribute to global discussions on digital taxation and push for international solutions. While several EU member states oppose the EC proposals (e.g., the Netherlands), a clear majority of them do not, so the likelihood they will be enacted is large.

Organisation for Economic Co-operation and Development

During a meeting with the EU in April 2018 on the EC's proposals, the Organisation for Economic Co-operation and Development (OECD) — an organization focused on promoting policies that will improve the economic and social well-being of people around the world — announced that it may accelerate its own nal report on digital taxes from 2020 to 2019, due to the recent EC push for such measures at the EU level.

In the OECD's 2018 interim report, Tax Challenges Arising From Digitalisation, a glimpse of what's to come is highlighted by the identi cation of two key concepts of the international tax system — the "nexus" and "pro t allocation" rules — which relate to how taxing rights are allocated between jurisdictions and how pro ts are allocated to the different activities carried out by MNEs.

This report, once complete, will surely signal countries around the world to enact legislation in accordance with the OECD's guidance.

United States

In the U.S., the recently passed Tax Cuts and Jobs Act (TCJA) introduced global intangible low-taxed income (GILTI), a new controlled foreign corporation (CFC) anti-deferral-type provision requiring certain U.S. persons who are "U.S. shareholders" of CFCs to include in income their pro rata share of GILTI for the taxable year.

In general, this provision was enacted to address the situation where CFCs were generating high returns primarily through foreign IP, with little or no tangible business assets. The U.S. shareholder (e.g., corporation) can deduct up to 50% and take an 80% deemed paid foreign tax credit (FTC) for GILTI. A U.S. company can also deduct up to 37.5% of its foreign-derived intangible income (FDII) for the taxable year. The FDII rules encourage the development of intangibles in the U.S., with a reduced tax on a U.S. corporation's intangible income derived from foreign use. It remains to be seen whether the World Trade Organization (WTO) will classify FDII as a prohibitive export subsidy.

While the EC is in favor of short-term measures to tax the digital economy, the U.S. Treasury Secretary, Steven Mnuchin, issued the following statement regarding the OECD's 2018 interim report in March 2018:

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> HSPXUI *NQPTJOH OFX BOE SFEVOEBOU UBY CVSEFOT
> XPSLFST BOE DPOTVNFST * GVMMZ TVQQPSU JOUFSOB
> DIBMMFOHFT BSJTJOH GSPN UIF NPEFSO FDPOPNZ BOE
> NPSF TVTUBJOBCMF GPPUJOH ³

Further adding to this complexity in the U.S. is the recent Supreme Court arguments in South Dakota v. Wayfair. Under current Supreme Court precedent (Quill v. North Dakota), online retailers are not required to collect sales taxes, unless they have a physical presence in a state. That leaves traditional brick-and-mortar retailers that collect sales taxes at a disadvantage, not to mention states potentially losing out on billions of dollars in revenue. In recent years, states have tested the limits of Quill by adopting click-through and economic nexus policies or imposing onerous reporting requirements on remote sellers.

The June 2018 outcome of this case will result in one of three actions: 1) the Court does not rule on the merits and there is no immediate change to the status quo; 2) the Court af rms Quill and the -1.eec and the (cen)2 (t y)3.1 (t)-3 (t ar)8 ne t;s t1_0 1 vtinF00540003005800500056la rms and the