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Ensuring Fair Taxation in An Increasingly Digital Economy

Jessica Silbering-Meyer
Robert Sledz



SPECIAL REPORT



In an economy that is increasingly digital, defining where value is created has become much more complex than when the corporate tax rules of most countries were written. This prompts the question: how do you ensure fair taxation in a digital, global economy? Tax authorities around the world are trying to find the answer.

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 profit 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 profits are registered and taxed where businesses have significant 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 first 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 "significant economic presence" in India constitutes a business connection. Significant 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 specific 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. Specifically, the proposal includes an initiative aimed at reforming corporate tax rules so that profits are registered and taxed where businesses have significant 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 final 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 identification of two key concepts of the international tax system – the “nexus” and “profit allocation” rules – which relate to how taxing rights are allocated between jurisdictions and how profits 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:

“The U.S. firmly opposes proposals by any country to single out digital companies. Some of these companies are among the greatest contributors to U.S. job creation and economic growth. Imposing new and redundant tax burdens would inhibit growth and ultimately harm workers and consumers. I fully support international cooperation to address broader tax challenges arising from the modern economy and to put the international tax system on a more sustainable footing.”

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 affirms *Quill* and the physical presence requirement; or 3) the Court overturns *Quill*, ending the physical presence nexus requirement. The Court may also leave it to Congress to decide whether to modify or replace the physical presence requirement.

With continued inaction by the U.S. Congress, we can expect more U.S. states to consider imposing economic/digital nexus requirements on remote sellers.

How tax professionals can prepare

1. Take advantage of research tools

With ever-evolving tax legislation, corporations need a trusted provider of up-to-date tax research and guidance. Look for a provider that specializes in expert research, guidance, technology, tools, learning, and news. Timely updates and authoritative insights on key tax developments that impact your business are key to maintaining compliance in a complex digital landscape.

2. Utilize integrated compliance software

With complicated regulations and nuances to country-specific rules, MNEs must understand new laws and make forecasts based on this legislation. Using multiple sources or multiple jurisdictional sites for rate changes or legislative information is cumbersome, so make sure the latest changes to tax legislation are in a centralized location and linked to compliance platforms. The value of an integrated tax compliance and research offering becomes more appealing since each change has a downstream impact on another tax process.

3. Be proactive

While some organizations may choose to adopt a reactive approach, the many implications of the digital economy require proactive planning — and the time to start is now. Map your global operations, the way you may have for country-by-country reports, to have a better understanding of where your business activities may create digital tax “nexus.”

From transfer pricing documentation and tax return preparation to sales and use tax compliance, a comprehensive tax technology solution can simulate changes, document them, and keep you updated as legislation continues to evolve.

With the agility and foresight technology brings, you can turn the challenges of the digital economy into an opportunity to showcase the strength and importance of your tax department in executing company strategy.

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