

Breakout C – Digital Services Taxes

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Digital Services Taxes ↩

Your Panel:

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Digital Services Taxes ↖

Agenda:

- Introduction (the breakdown of the global tax consensus)
- What are Digital Services Taxes (and why should I care?)
- DSTs: State and Local Tax Developments
- DSTs: International Tax Developments
 - Background and Interaction with BEPs and Pillar One
 - Current State of International Legislation
- Where is this all heading?

Digital Services Taxes – An Introduction

Digital Services Taxes ↖

The Perceived Problem:

- Breakdown of a 50-year consensus on taxing global, cross border, and fungible revenue (e.g., the “permanent establishment” problem) – we live in an increasingly digitized and frictionless world
- Desire of governments to tax in their home market jurisdiction – where the customers are - not where value is created
- Increased global dependency ratios and a need for increased tax revenues

Digital Services Taxes ↖

The Possible Solutions:

- Increase Income Tax or VAT Revenues
- Increase Global Tax Enforcement (e.g., FATCA and CRS information sharing)
- Create a new type of tax - a “Digital Services Tax”

Digital Services Taxes ↖

The Players:

- State and Local Governments (esp. in the US)
- National Governments and blocs (EU, US, UN)
- Powerless International Think Tanks trying to remain relevant (e.g., OECD)
- Taxpayers and their advisors (The Tax Industrial Complex)

Digital Services Taxes ↖

The Moving Parts:

- New “Unilateral” Taxes (e.g., Digital Services Taxes)
 - DSTs tend to be imposed unilaterally or by regional blocs and generally take one of three forms:
 - Specifically defined ‘transactional taxes’
 - Imposition of existing indirect taxes (i.e., VAT or GST) on certain ‘digitized’ transactions
 - Imposition of existing withholding taxes (indirect taxes) on specified transactions
- OECD Pillar One – Reallocation of Taxing Rights to Market Jurisdictions
- OECD Pillar Two – Global Minimum Tax Agreement
- Negotiate New Tax Treaties (e.g., change the definition of PE; thank you, United Nations)

Challenges of Digital Economy for Tax Administrations

- **Challenges:**
 - **Identification** of suppliers, sellers, and service providers
 - Determining **the extent of activities**
 - Information **collection and verification**
 - **Identification of customers**
 - The attribution of **value created from the generation of data** through the use of digital products and services
 - The characterization of income derived from new business models
 - Diversity of Revenue Models: **(several may co-exist; value drivers can be different)**
 - Advertising-based revenues
 - Digital content purchases or rentals
 - Selling of goods (including virtual items)
 - Subscription-based revenues
 - Selling of services
 - Licensing content and technology
 - Selling of user data and customized market research

Digital Service Taxes

- Users in the local country create “value”, justifying a tax on gross revenue of digital activity
- Can be levied on loss-making companies
- Can result in domestic and international double taxation
- Compliance challenges
- Burdensome recordkeeping
- Costs likely to be shifted to consumers
- Trade violations?

Digital Services Taxes ↩

Targeted Transactions (varies by jurisdiction):

- Online advertising
- Video streaming or downloading
- eCommerce sales or services
- Crypto transactions

Generally, but not exclusively, focused on B to C transactions

State and Local Updates

Why Are DSTs a Growing Trend Within the U.S.?

- Perceived tax base erosion as a result of the transition to a digital economy.
- Digital goods and services may not be captured by state and local transaction taxes (i.e., “untapped” source of revenue).
- State attempts to capture such revenue have taken various forms, including the expansion of existing sales tax or gross receipts tax bases.

State Approaches to DSTs Overview

- States have taken varying approaches to attempts to tax digital advertising services:
 - Impose new taxes on the sale of digital advertising services (e.g., MD (enacted), CT (proposed), NY (proposed), MA (proposed));
 - Impose new tax on consumer or user data (e.g., NY (proposed), MA (proposed));
 - Impose new tax on social media providers (e.g., CT (proposed)); or
 - Expand existing sales tax base to include digital advertising services (e.g., NY (proposed)).
- This trend is expected to continue.

State Approaches to DSTs

Taxes on Gross Receipts from Digital Advertising Services

Maryland

- HB 732 (legislature overrode governor's veto February 12, 2021) creates a new gross receipts tax on "digital advertising services."
- Applies to companies with minimum of \$100 million gross annual revenues (maximum rate = 10%)
- Comptroller's office charged with adopting sourcing regulations
- Issues:
 - Vague definitions and computation of tax
 - Internet Tax Freedom Act
- Some attempted fixes in subsequent legislation
- Two pending lawsuits
- Maryland also imposed a sales tax on digital products (HB 932)

State Approaches to DSTs

Taxes on Gross Receipts from Digital Advertising Services (cont'd.)

Connecticut (Proposed) (HB 6443 and SB 1106):

- Two bills currently proposed, contain exactly the same provisions. H.B. 6443 is the Governor's budget implementer bill and more likely to pass.
- Similar to Maryland's enacted digital advertising tax.
- As with the Maryland tax, there is no meaningful guidance on sourcing. The bills would authorize the Commissioner to adopt regulations.

New York (Proposed) (S1124):

- Similar to Maryland bill (including definitions, tax rates and brackets)
- Provides an apportionment formula, but no guidance on sourcing (instead authorizes the Commissioner to adopt regulations).
 - Numerator: "The annual gross revenues of a person derived from digital advertising in the state . . ."
 - Denominator: "The annual gross revenues of a person derived from digital advertising in the United States . . ."

State Approaches to DSTs Taxation of Personal Information or User Data

New York (Proposed) (S4959 / A6199)

- Excise tax on the collection of consumer data.
- The proposed legislation would impose an excise tax on "commercial data collectors"
- The rate of tax varies depending on the number of New York consumers on whom the commercial data collector collects data per month.
 - Low end: if over 1 million, but not more than 2 million NY consumers
 - Tax rate: \$0.05 per month on number of NY consumers over 1 million, but not more than 2 million
 - High end: if over 10 million NY consumers
 - Tax rate: \$2,250,000 per month + \$0.50 per month on number of NY consumers over 10 million.
- Raises constitutional concerns involving the Commerce Clause, the Foreign Commerce Clause, and potentially the Takings Clause given that the imposition of the tax has no connection to the receipts or income, if any, arising from such data.

State Approaches to DSTs Social Media Taxes

Connecticut (Proposed) (HB 5645):

- This is a "proposed bill," which is a short statement in non-statutory language explaining what the Finance, Revenue and Bonding Committee should propose by way of legislation, rather than a fully drafted bill with statutory language (statutory language generally drafted in Committee and contained in "raised" bills).
- Purpose is to "establish a tax on social media provider companies on the apportioned annual gross revenue derived from social media advertising services in the state."
- The bill was proposed on January 27, 2021 and referred to the Joint Committee on Finance, Revenue and Bonding. A public hearing was held on March 8, 2021, but no further action since then.

State Approaches to DSTs

Taxes on Gross Receipts from Digital Advertising Services (cont'd.)

Massachusetts (various proposals)

- **HD.3210 (Gross Receipts Tax at up to 15%):** similar to Maryland, but includes sourcing provisions
- **HD.3601 (Flat Rate Excise Tax):** would impose a flat 5% excise tax on “annual revenue from digital advertising services within the commonwealth.”
- **HD.3558 (Revenue Commission):** would not impose any new taxes, but instead would establish a special joint commission to “conduct a comprehensive study relative to generating revenue from digital advertising that is displayed inside of Massachusetts by companies that generate over \$100 million a year in global revenue.”
- **HD.3812:** contains no substantive language; merely states “draft being worked on by House counsel.”
- **S.1938:** reporting requirement for future tax recommendation

Why Are States Adopting European Digital Service Taxes

- State DSTs attempt to impose French-style DSTs
- But this is misguided: it ignores reasons why some countries adopted DSTs
- States can utilize economic nexus, not just PE
- State actions contradict and undermine federal position on similar taxes

Global Update

EU Proposed DST in 2018

- 3% tax on gross revenues derived from certain digital services, such as:
 - Selling online advertising space.
 - Digital intermediary activities that allow users to interact and transact with each other.
 - Selling user data from user-provided information.
 - Would apply to (domestic and foreign) companies with (i) total annual worldwide revenues of €750 million, and (ii) EU revenues of €50 million (both domestic and foreign companies)
- The EU DST framework inspired initiatives in different Member States:
 - France was the first to enact a DST
 - Italy, Austria, Spain now have enacted DSTs
- DSTs now enacted or proposed in more than 30 countries around the world

Countries that have recently enacted DSTs:

(Source: Bloomberg Tax & Accounting 3 September 2021)

- Austria
- Argentina*
- Bangladesh+
- Cote d'Ivoire
- Republic of Congo+
- France
- Hungary
- India
- Indonesia
- Israel
- Italy
- Kenya
- Malaysia+
- Mexico+
- Nigeria
- Pakistan+
- Paraguay+
- Peru+
- Poland
- Portugal
- Sierra Leone
- Slovakia
- Spain
- Sweden
- Taiwan+
- Tunisia
- Turkey
- United Kingdom
- United States (MD only)
- Uruguay
- Vietnam
- Zimbabwe

*DST/VAT
+WHT

Pillar One – Proposed Global Solution

OECD Statement On October 8, 2021

- In-scope companies
 - Revenue >20B €, Profit Margin >10%
 - Extractives and regulated financial services excluded
- Nexus
 - Allocation of Amount A to a market country when company derives at least 1M € in revenue from jurisdiction
 - For smaller countries with GDP lower than 40B €, nexus set at 250K €
- Amount
 - 25% of residual profit above the 10% profitability threshold subject to tax
 - Allocated to market country by a revenue allocation key

OECD Statement on October 8, 2021

- Sourcing
 - Revenue sourced to end market countries where goods or services are used or consumed
 - Detailed rules to be developed
- Tax base
 - Financial accounting income, with a small number of adjustments
- Segmentation
 - Only in exceptional circumstances
 - Based on segments disclosed in financial accounts

OECD Statement on October 8, 2021

- Marketing and distribution profits safe harbor
 - If residual profits are already taxed in market country, safe harbor will cap residual profits allocated to market jurisdiction through Amount A
 - Detailed rules to be developed
- Relief from Double Taxation
 - Exemption or credit method
 - Entity(ies) that will bear tax liability will be drawn from those that earn residual profit
- Tax certainty
 - Binding dispute resolution mechanism to be developed

OECD Statement on October 8, 2021

- Unilateral measures
 - **Remove all Digital Services Taxes and other relevant similar measures**
 - **No newly enacted measures imposed on any company from October 8, 2021 through December 31, 2023, or coming into force of a Multilateral Convention**
 - **Coordinated efforts to remove all existing Digital Services Taxes**
- Implemented to come into effect in 2023 globally
 - Details of Amount A, Multilateral Convention, and Model Rules for domestic legislation expected in early 2022
 - Hoping to open Multilateral Convention to signature by mid-2022

Digital Services Taxes – Where do we go from here?

A false premise?

Global Effective Tax Rate Comparison:

	5-Year Averages		3-Year Averages	
	Average	Average	Average	Average
	Profit Margin	Effective TRs	Profit Margin	Effective TRs
Traditional Corporations (EuroStoxx50)	10.6%	27.1%	11.4%	26.7%
Digital Group Corporations	17.4%	26.8%	17.2%	28.1%
MSCI Digital Services Corporations	15.2%	29.1%	15.1%	32.0%

Note: This chart was taken from an article by Daniel Bunn, Vice President of Global Projects for The Tax Foundation, a Section 501(c)(3) organization.

Digital Services Taxes – Financial Statement Implications

Are DSTs an income tax? Probably not.

- If Yes, ASC 740 applies. If Not, apply ASC 450.
- The reporting standards of ASC 740 and ASC 450 are quite different.
 - ASC 740: essentially a “more likely than not” approach: if >50% chance of liability (regardless of audit risk) one should accrue and disclose.
 - ASC 450:
 - Probable: Considered “likely” to occur – assumed to be a 65% to 75% chance of occurring; including consideration of detection risk; potential liability must be accrued if the liability is both **probable** and **reasonably estimable**.
 - Disclosure: Liability must be disclosed, but not accrued, if the amount is either:
 - Probable but not reasonably estimable; **or** reasonably possible and material. Reasonably possible is somewhere in the range of 25% to 75% chance of occurring.
 - Remote: if liability is remote, no accrual or disclosure.

The Challenges of Digital Services Taxes and Pillar One

Additional Compliance Burden:

- Income Taxes (including increased compliance/tp burden of Pillar One)
 - Reallocation of residual profit
 - Reporting and documentation
- Indirect (sales and VAT) Taxes
- Digital Services Taxes – a new set of compliance requirements

The Future of Digital Service Taxes and Pillar One

- Why create a third category of tax when complex income and indirect tax systems already exist?
- What happens after Pillar One to the current DSTs and taxpayers' obligations to comply in the jurisdictions (domestic and international) in which they are already implemented?
- DSTs get passed on to consumers, but is Pillar One a better solution?
- What happens to state and local DSTs now?
- What does US Congress do (not a rhetorical question)?
- What happens if Pillar One isn't implemented as planned?
- What should companies do now?

Thanks!