Insight

Digital Services Taxes: A Primer

GORDON GRAY, JENNIFER HUDDLESTON | MARCH 25, 2021

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Executive Summary:

- Given the rise of the digital economy, some countries are seeking to impose taxes on multinational tech companies based on their digital rather than physical presence.
- These unilateral taxes defy international tax norms and threaten to cede the U.S. tax base to nations imposing such taxes.
- The costs of such taxes are likely to be passed on to consumers and result in increased prices for beneficial internet services, such as advertising and third-party marketplaces, used by small businesses.

Introduction

Over the last few years, several countries including the United Kingdom, France, and Italy have asserted a new right to tax revenue they determine to derive from online economic activity, or the "digital economy," within their borders. But these new taxes defy international tax norms and appear to be largely targeted at profitable U.S. firms, and by extension, potentially the U.S. tax base. Moreover, the costs of such taxes are likely to be passed on to consumers and result in increased prices for beneficial internet services, such as advertising and third-party marketplaces, or the loss of these services entirely in these countries.

Global Digital Service Taxation

The global proliferation of digital platforms, products, services, and intellectual property has been perhaps the most discernable evolution in the post-war global economy. These innovations have enhanced global prosperity and growth and found their way into the homes and, indeed, hands of users around the globe. The digital economy is something of a term of art that seeks to adequately capture the economic activity generated by technologies in part defined by their ease of transmissibility. For tax collectors, these features raise potential complications underscored by the simple observation that the internet recognizes fewer borders than do tax authorities. That some of the firms behind these innovations have become highly valuable multinational corporations has unsurprisingly invited greater attention from policymakers and observers.

Supranational fora, particularly the Organisation for Economic Co-operation and Development (OECD), have been grappling with the taxation of multinational firms and have yet to reach substantial consensus on reforms in general, or on the taxation of the digital economy more specifically. These deliberations coincide with the European Commission's proposal of the Digital Services Act and Digital Markets Act. While those multi-year negotiations continue to evolve, individual nations have begun taking unilateral steps to tax foreign, and largely U.S.-based technology companies on revenues earned in jurisdictions even where those firms do not have a substantial physical presence. These new taxes defy prevailing norms in international taxation, which typically preclude taxing foreign firms without a permanent presence or "nexus" in a given tax authority's jurisdiction. These new taxes have further complicated an international trade and tax outlook that has seen a diminution in rules-based practices.

What Is a Digital Service Tax?

Digital service taxes (DSTs) are taxes imposed on multinational firms based on their digital activities in a particular jurisdiction. Whereas tax treaties and other agreements typically define a nexus and establish taxing rights between trading partners, major European nations, the European Commission, and other world economies are asserting a novel concept (from the standpoint of prevailing multilateral and bilateral tax treaties) – a digital presence – to establish taxing rights on certain digital activities. These definitions vary across jurisdictions, but typically take the form of [1]? The applicable tax base also varies considerably, from online betting or digital hospitality platforms such as Airbnb, to substantially more expansive applications such as in France, which imposes a 3 percent tax on the revenue. Irrespective of their application, gross revenue taxes have structural deficiencies in that they can lead to both taxing the same input multiple times and high effective tax rates regardless of a firms' profit margins because the cost of inputs cannot be deducted. It is important to distinguish DSTs from other more indirect taxes, such as value-added taxes (VATs), that include certain digital activity in the tax base. derived from digital intermediaries (e.g. Amazon) and digital advertising based on the number of French users. Irrespective of their application, gross revenue taxes have structural deficiencies in that they can lead to both taxing the same input multiple times and high effective tax rates regardless of a firms' profit margins because the cost of inputs cannot be deducted. It is important to distinguish DSTs from other more indirect taxes, such as value-added taxes (VATs), that include certain digital activity in the tax base.

Proliferation of Global DSTs

As of March 2021, 26 nations had DSTs or similar direct taxes on the digital economy, though these policies vary substantially across nations.[2] Fifteen additional nations have announced or otherwise proposed similar tax policies, while seven nations, including the United States, have announced they would await a multilateral solution. It is important to note that all of these policies have been enacted and proposed within just the last five years. Within the context of international tax negotiations, this trend is somewhat revealing. In 2013, the OECD embarked on an ambitious international tax reform agenda centered around base erosion and profit shifting (BEPS). This agenda included 15 action items, the first of which, Action Item 1, identified the complexities in taxing the digital economy. A key principle of international tax rules is that income should not be taxed twice, but neither should it escape tax. These goals are often in tension, and the BEPS process and follow-on international tax negotiations recognize the tradeoffs between these imperatives. The proliferation of unilateral DSTs in recent years, however, plainly points to a breakdown in that process. Indeed, in the absence of any other considerations, a new unilateral DST is appears to be a plain exercise in seizing another jurisdiction's tax base – distinctly at odds with the intention of the BEPS process.

Domestic Policy Considerations

In the United States, taxes paid to foreign jurisdictions is typically creditable against U.S. taxes through the foreign tax credit.[3] While an oversimplification, when a foreign nation asserts a new taxing right and taxes income that would otherwise be taxable in the U.S., the U.S. tax base is reduced. In this benign scenario, a U.S. company can offset the liability from a new tax against U.S. taxes through the foreign tax credit to avoid being taxed twice. It is conceptually a zero-sum proposition – the foreign taxing entity gains revenue, and the U.S. government loses revenue.

But DSTs add a wrinkle to this concept.In proposed regulations, however, the Treasury Department denies U.S.

taxpayers foreign tax credits against DSTs. This denial is informed, as Treasury notes, by the fact that these new taxes "diverge in significant respects from traditional norms of international taxing jurisdiction." In part, because DSTs do not comport with these norms, they are not creditable as they arguably should be. U.S. tech firms, therefore, are stuck with the tab. However, as these taxing rights remain the subject of ongoing international negotiations very much, the credibility of DSTs against U.S.s tax may evolve. This raises some additional concerns about ceding what is arguably part of the U.S. base to foreign taxing jurisdictions.

The United States has protested the proliferation and application of these taxes in the current Inclusive Framework – a consortium of 139 nations convened by the OECD and the G20 to implement the BEPS action plan. It serves as the key multilateral forum for harmonizing these outstanding issues. More consequentially, the United States has pursued retaliatory tariffs on major trading partners that have proposed or enacted DSTs. In January of this year, the United States Trade Representative suspended its announced tariffs on French goods to accommodate additional similar investigations against other major countries, including Spain, and additional developments in international negotiations.

DSTs Impact on Consumers and the Digital Market

Many DSTs are notionally tied to growing concerns about tech companies – principally U.S. firms – and their global economic footprint. Two global economic crises within roughly a decade have also spurred nations to seek new sources of revenue. In pursuing DSTs, however, tax authorities do not appear to have adequately considered the effects these new taxes will have on their domestic consumers or markets.

The internet has lowered the cost of advertising and made it easier for small businesses to reach their audiences. Research by the Progressive Policy Institute indicates that from 2016 to early 2019, print advertising prices fell by 6 percent and digital advertising fell by 23 percent. Digital advertising also enables small businesses to target advertising to those consumers most likely to be interested in their products and services. At the same time, digital services can allow small, local companies to gain a global reach that would have previously required much more expensive advertising options in more competitive national outlets. But DSTs are likely to cause the overall price of advertising to rise, as large tech companies such as Google may raise their ad prices to recoup the cost of these taxes. These price increases would impact small businesses and other advertisers globally, not only in the countries with DSTs.

DSTs would not only impact online advertising but would also raise fees for many marketplace platforms. Such marketplaces have reduced the costs for small businesses to create an online presence and increased the options available to consumers. Many sellers are able to use multiple marketplaces to maximize the consumers they reach. As with advertising, the costs of DSTs are likely to be passed along to users of these services. For example, after France levied its DST, Amazon noted that it would raise fees for third-party sellers on Amazon.fr by 3 percent. In some cases, increased cost might decrease consumer choice if these sellers found it was no longer valuable to have an online presence in countries with a DST. More commonly, these increased costs for third-party sellers are likely to be passed along to consumers in the form of higher prices.

Conclusion

For many nations looking for new sources of revenue, there is perhaps no more attractive target than profitable U.S. tech companies. But in defying tax norms to impose unilateral excise taxes, these nations are asserting a taxing right that amounts to little more than a revenue grab, notionally financed by U.S. firms. In so doing, they also ignore the incidence of these taxes, which will likely be borne by domestic consumers and markets rather than the tech giants targeted. This impact is felt well beyond the borders of the countries instituting such taxes including in the United States' economy.

[1] DST's tend to be structured like excise taxes, however, there are other mechanisms that can similarly raise the effective tax on similar digital services such as withholding taxes.

[2] Argentina, Austria, Costa Rica, Germany, Greece, Hungary, India, Indonesia, Italy, Kenya, Malaysia, Mexico, Nigeria, Pakistan, Paraguay, Poland, Sierra Leone, Spain, Taiwan, Tunisia, Turkey, United Kingdom, Uruguay, Vietnam, Zimbabwe

[3] Note that certain income earned abroad faces an additional layer of U.S. tax including a limitation on available foreign tax credits. See: https://www.americanactionforum.org/research/global-intangible-low-taxed-income-taxation-a-primer/