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Digital Services Tax: Why the World is Watching




BY AMIE AHANCHIAN, DONALD HOK, PHILIPPE STEPHANNY, AND ELIZABETH SHINGLER

The digital economy is equivalent to 15.5% of global GDP and is growing two and a half times faster than global GDP over the past 15 years, according to the World Bank.

This rapid expansion has sparked global debates in many legal and regulatory realms. In the field of international taxation, the debate focuses on whether the current rules are appropriate in the modern global economy, especially regarding the allocation of income and profits among countries for tax purposes or purposes of being potentially subject to tax.

As a result, in 2018, the European Commission (EC) proposed a temporary Digital Services Tax (DST) to be imposed a rate of 3% on revenues derived from online advertising services, receipts or income from digital intermediary activities, and sales of user-collected data. Businesses with annual worldwide revenues exceeding $915 million (750 million euros), and taxable revenues within the EU exceeding $61 million (50 million euros) would be subject to the tax. Although the initial proposal was rejected at the EU level, several EU—and non-EU—countries have seen DSTs as an effective way to generate revenue, and have modeled their proposed DSTs after the EC proposal.

Amie Ahanchian is a principal in Trade and Customs at KPMG. Donald Hok is a senior manager in the trade and customs services group of the Washington National Tax practice of KPMG LLP. Philippe Stephanny is a Senior Manager, WNT-SALT at KPMG LLP. Elizabeth Shingler is a manager in the Trade and Customs practice of KPMG LLP.

In response, the U.S. has threatened to impose retaliatory tariffs, arguing that DSTs unfairly target U.S. multinational corporations (MNCs). As a result, while only a portion of businesses will be immediately subject to DSTs, many more will feel the impact if the tariffs go into effect. This article summarizes the various DST proposals globally and discusses potential duty mitigation strategies should the U.S. choose to respond with retaliatory tariffs.

Overview of DSTs

In 2013, the Organization for Economic Cooperation and Development (OECD)/G-20 began the Base Erosion and Profit Shifting (BEPS) Project, which aims to create a single set of consensus-based international tax rules. Addressing the tax challenges raised by digitalization has been a top priority of the OECD/G20 Inclusive Framework in BEPS since 2015 with the release of the BEPS Action 1 Report. At the request of the G20, the Inclusive Framework has continued to work on the issue, delivering an interim report in March 2018. In 2019, members of the Inclusive Framework agreed to examine proposals in two pillars, which could form the basis for a consensus solution to the tax challenges arising from digitalization. In the meantime, several countries have begun to impose (or are contemplating imposing) digital taxes to raise tax revenues (to arguably create a level playing field) until the OECD/G-20 inclusive framework reaches an agreement. While the OECD initially intended to reach an agreement by the end of 2020, the OECD announced in October that it expects an agreement by mid-2021. This announcement has renewed the interest of jurisdictions in DSTs, with Spain being the latest country adopting such a tax, and the EC claiming it is ready to propose a DST structure should the OECD not be able to reach an international agreement. In addition, the African Tax Administration Forum (ATAF) recently published a paper on the Suggested Approach to Drafting Digital Services Tax Legislation, which includes a model DST law. (Orbitax, ATAF Releases Paper on Suggested Approach to Drafting Digital Services Tax Legislation (Oct. 5, 2020).)

Most DSTs that have been implemented or proposed have similar characteristics and are aimed to be temporary measures (though India did not state that the expanded Equalization Levy would only be a temporary measure). They are a mix of gross receipts taxes and transaction taxes that apply at rates ranging from 1.5% to 7.5% on receipts from the sale of advertising space, provision of digital intermediary services such as the operation of online marketplaces, and the sale of data collected from users. For the large part, DSTs are aimed at a small number of large digital companies. To be subject to a DST, a company, on a group level, must generally satisfy a double threshold: a worldwide revenue threshold (for example, $915 million (750 million euros) in DSTs imposed by France, Italy, Austria, and Turkey) and a domestic taxable sales threshold (for example, $30.5 million (25 million euros) in France or $6.71 million (5.5 million euros) in Italy). The sourcing of DST revenue is generally based on whether the taxed service is viewed or enjoyed by a user that has a device located in the jurisdiction imposing the DST. A device is generally deemed located in a DST jurisdiction based on its internet protocol address (IP address) or any geolocation method.

There are, of course, variations among DSTs. For instance, Austria applies its DST only to digital advertising, while Poland assesses its DST only on streaming services. Interestingly, Turkey levies its DST on digital content as well as advertising, intermediary activities, and sale of user data. By contrast, India and Kenya tax receipts from a broad variety of digital services. Moreover, some countries do not apply significant revenue thresholds. For instance, the threshold of the expanded equalization levy in India is far lower - nonresident businesses must comply with the levy if they have taxable gross receipts above INR 20 million ($260,000). Kenya's DST, on the other hand, which is effective Jan. 1, 2021, currently does not have an application threshold. Finally, countries have adopted various exemptions to the DST, including for payment services (e.g., France, Italy, and Turkey), digital content (e.g., France and Italy), and intragroup services (e.g., Italy).

These DSTs arguably distort market behavior by discriminating primarily against large U.S. MNCs and correspondingly provide a relative advantage to local businesses that fall below the revenue threshold. Another major criticism of DSTs is that they are imposed on a business input that will likely be passed on to consumers, even though some jurisdictions, like France, have stated that consumers should not absorb the tax. As a result, several companies have already announced that they would increase their prices because of these DSTs. Moreover, the lack of harmonization in the application of these taxes may result in double taxation if for instance two or more countries consider that a certain revenue stream is sourced there. Currently, only the U.K. has a provision in place addressing such situations.

The following table describes the DSTs proposed or enacted in the various countries.

(DST implementation status source: *What European OECD Countries Are Doing about Digital Services Taxes*, Tax Foundation, https://taxfoundation.org/digital-tax-europe-2020/ (last accessed Oct. 29, 2020); Taxation of the digitalized economy, KPMG (Oct. 27, 2020))

While DSTs target primarily large digital companies, the differences in scope and thresholds may result in a broader range of companies being subject to these taxes. For instance, the Indian Equalization Levy applies also to online education services, thus potentially affecting higher education institutions. This risk will only increase as more countries implement DST regimes diverging from the initial EU proposal (e.g., Kenya). Moreover, in the absence of an agreement on the OECD/G-20 inclusive framework, countries may be tempted to broaden the scope of their DSTs either by adding new services to the list of taxable services or reducing the high thresholds they have initially implemented. As a consequence, companies that sell digital services internationally, including those that are not currently targeted or included by these measures, should consider the potential impact on them. Businesses should continuously track the global developments regarding the implementation of these taxes and determine if they have any obligations by reviewing the scope of their services and tracking sales amounts. As countries have issued relatively little guidance and the practical application of DSTs is unclear, there are numerous uncertainties that may affect businesses including the definition and parameters of in-scope services, treatment of bundled transactions, sourcing transactions, data requirements, and registration and filing obligations.

Finally, businesses involved in the sale of digital services should also consider their foreign value added tax (VAT) obligations. In over 80 jurisdictions, the provision of digital services by a nonresident to individuals (often including online education) triggers an obligation to register for, collect, and remit VAT, even if there is not a local presence (e.g., permanent establishment) or the entity has nonprofit status. Further, many of these jurisdictions have a very low or zero registration threshold (i.e., minimum revenue requirement before becoming liable for VAT). Generally, the types of services subject to VAT are those that are essentially automated in their delivery with minimal human intervention. However, there are some jurisdictions in which human intervention, or lack thereof, is not relevant. Therefore, a broader range of businesses are currently subject to these VAT rules than are subject to DSTs. Make no mistake, however, businesses may be subject to both VAT and DST, significantly increasing their tax burden.

Potential U.S. Retaliation

On July 10, 2019, the U.S. Trade Representative (USTR) initiated an investigation of France's DST to determine whether the tax would discriminate against U.S. companies, the retroactive application of the tax, and whether France's DST diverged from norms reflected in the U.S. and international tax system. In December 2019, the USTR issued a Notice of Determination in which it found that France's DST was ''unreasonable or discriminatory and burdens or restricts U.S. commerce.'' (84 Fed. Reg. 66956 (Dec. 6, 2019).) This was followed in July 2020 with an announcement that a 25% tariff would be imposed on certain French-origin luxury products such as makeup and handbags. However, the implementation was delayed for a period of up to 180 days as the DST was not yet in effect. (85 Fed. Reg. 43292 (July 16, 2020).) At the end of November, the French government began issuing DST collection notices to internet companies, indicating that the tax was moving forward. (''Tariffs on French Handbags, Cosmetics Could Begin, Wyden Warns'', Int'l Trade Today, Vol. 36, No. 230 (Nov. 30, 2020).) The tariffs are effective on Jan. 6, 2021.

Further, on June 5, 2020, the USTR announced that it was initiating a Section 301 investigation into countries that had either adopted or were considering implementing a DST. This list includes Austria, Brazil, the Czech Republic, the European Union, India, Indonesia, Italy, Spain, Turkey, and the United Kingdom. The notice states that these proposed or implemented DSTs will likely target large, U.S.-based tech companies and the USTR is exercising its powers to open investigations into whether these implemented or proposed DSTs unfairly discriminate against U.S. companies, whether the retroactive nature of the DSTs is problematic and whether it is an unreasonable tax policy. As of early January 2021, the results of the investigations had not been released.

How Should U.S. Importers Prepare for the Potential Increase in Tariffs?

The result of the USTR's notice raise serious concerns about the possibility of increased trade tensions with EU member countries and any other country contemplating imposition of DSTs, even with a new U.S. administration in office in 2021. Understanding the mitigation opportunities available to importers is essential to prepare for potential retaliatory tariffs. First, while the USTR's investigation was brought pursuant to Section 302(b)(1)(A) of the Trade Act of 1974, and retaliatory tariffs would be actionable under Sections 301(b) and 304(a) (similar to the Section 301 tariffs imposed on some Chinese-origin goods), an exclusion process will not likely be available as it was for certain Chinese goods given that the purpose and goals of any retaliatory tariffs differ. Regardless, duty mitigation opportunities may still be available to help offset the tariff's impact.

Duty Drawback

Section 301 duties may be eligible for duty drawback where goods imported into the U.S. are subsequently exported either (1) as incorporated into products manufactured in the U.S. (i.e., manufacturing drawback); or (2) in the same condition as originally imported (i.e., unused merchandise or same condition drawback). The drawback rules permit the recovery of 99% of the duties originally paid on the imported merchandise when exported, subject to the requirements of the customs regulations at 19 C.F.R. Part 191. Drawback is becoming an increasingly popular duty mitigation program because of the substantial savings it offers.

First Sale for Export

In a multi-tiered transaction (e.g., where the U.S. importer purchases goods from a foreign middleman, who in turn purchases goods from a foreign manufacturer), the First Sale for Export (FSFE) principle establishes the dutiable value of merchandise based on the ''first sale'' between the foreign middleman and the foreign manufacturer rather than on the sale between the U.S. importer and foreign middleman. As a result, duties paid by the U.S. importer exclude ad valorem duties on the foreign middleman's markup as the duties are only applied on the foreign manufacturer's price, thereby decreasing the duties payable. Thus, if the U.S. were to impose retaliatory tariffs, those tariffs would similarly only apply to the ''first sale'' transaction.

In order to qualify, a U.S. importer must prove (generally with documentary evidence) that the purported FSFE transaction is a *bona fide* sale, that the goods are *clearly destined* for export to the U.S., and that the price paid to the foreign manufacturer by the foreign middleman is at *arm's-length*. Historically this program has been used among retail and apparel importers who faced steep duties but is now becoming more popular in other industries due to the high-tariff environment. While the requirements to apply the FSFE principle are stringent and reasonable care must be exercised, U.S. importers have experienced significant savings through the implementation of this strategy.

Foreign Trade Zone

Foreign Trade Zones (FTZ) are physical locations within the U.S. that are considered outside of customs territory. Upon arrival at the port, goods are admitted to an FTZ and duty is not paid until they are withdrawn. While an FTZ does not eliminate Section 301 tariffs, it enables importers to plan for and manage duty payments—an opportunity that may be crucial to achieving other strategic goals. Further, unlike a customs bonded warehouse where goods are permitted to be stored for no longer than five years, goods may remain in an FTZ indefinitely. Additionally, expanding an FTZ's square footage to meet business need is relatively easy, which is increasingly important as more companies move to an on-line presence. Many importers also realize significant fee and customs broker savings because only one entry a week is made instead of every time a shipment arrives. As part of a long-term cost-management strategy, an FTZ can be a powerful tool.

De Minimis Value

Customs rules also provide for a duty exemption for imported goods valued at less than $800 fair retail value in the country of shipment if imported by one person on one day. Use of this exemption has increased the volume of direct-to-consumer e-commerce transactions, which has further accelerated as more consumers shop from home due to Covid-19.

Importers should be aware, however, that CBP recently submitted a proposal to the Office of Management and Budget that would eliminate the $800 *de minimis* exception for goods subject to Section 301 tariffs. Thus, importers planning around the use of the *de minimis* exception should keep this in mind.

Conclusion

DSTs threaten to substantially raise the cost of business for many companies while also creating confusion about the services triggering the tax. The first step for many companies is to understand in which jurisdictions they will likely be affected and when the tax will become effective. For U.S. importers facing an array of potentially steep tariffs, understanding the company's trade profile is instrumental in identifying the right savings strategies. Although it is possible that the U.S. will have a position on DSTs by March 2021, it is likely that tariff actions will continue to be part of the political toolbox. Importers should develop a short, medium, and long-term tariff management plan that provides flexibility as tariffs are imposed. Higher taxes and increased tariffs may be here to stay but proper planning can help companies control costs.

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Author Information

Amie Ahanchian is a principal in Trade and Customs at KPMG. Donald Hok is a senior manager in the trade and customs services group of the Washington National Tax practice of KPMG LLP. Philippe Stephanny is a Senior Manager, WNT-SALT at KPMG LLP. Elizabeth Shingler is a manager in the Trade and Customs practice of KPMG LLP.

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