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USA's Investigation into Digital Taxes – Virtual War or Janus Like Policy?

Date: June 08,2020

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Background

The Office of the United States Trade Representative has recently issued a notice indicating initiation of investigation under Section 301 of the Trade Act of 1974. The notice has also invited comments regarding the same before the 15th of July, 2020. The investigation is initiated against various nations 'who have adopted taxes on revenues that certain companies generate from providing certain digital services to, or aimed at, users in those jurisdictions.'

The investigation has been initiated under Section 302(b)(1)(A) of the Trade Act of 1974, as amended. The investigation initially focuses on the alleged

(i) Discrimination against U.S. Companies

(ii) Retroactivity

(iii) Unreasonable tax policy

In relation to the tax policy, the investigation may also include extraterritoriality, taxing revenue not income; purpose of penalising particular technology companies for their commercial success.

The comments are sought from the public on whether the DST is unreasonable or discriminatory; the extent to which one or more of the covered DSTs burdens or restricts U.S. commerce; whether one or more of the covered DSTs is inconsistent with obligations under the WTO Agreement or any other international agreement; determinations required under Section 304 of the Trade Act, including what action, if any, should be taken. The United States has initiated investigation against Austria, Brazil, The Czech Republic, the European Union, India, Indonesia, Italy, Spain, Turkey and the United Kingdom.

India - Equalisation Levy 2.0

With regard to India, the Supplementary Information provided elaborates on the *Digital Service Tax (Equalisation Levy) of 2% initiated in March, 2020. According to the notice, the tax only applies only to non-resident companies, and covers online sale of goods and services to, or aimed at, persons in India. The tax applies only to companies with annual revenues in excess of approximately Rs. 20 million (approximately US $ 267,000) and the tax is in effect from April 2020.*

India introduced Equalisation Levy in the year 2016 at the rate of 6% on digital/online advertisement and related services. Through the Finance Act, 2020, India has widened the scope of equalisation levy to include e-commerce supply or services under the purview of equalisation levy. In terms of new Section 165A w.e.f. 01.04.2020 there will be a new levy known as the equalisation levy at the rate of *2% on the amount of consideration received or receivable by an e-commerce operator from e-commerce supply or services made or provided or facilitated by it to a person resident in India, to a non-resident under specified circumstances, to a person who buys such goods or services or both using IP address located in India.*

However, the equalisation levy is not charged if the e-commerce player has a permanent establishment in India and such e-commerce supply or services is effectively connected with such permanent establishment, where the equalisation levy is leviable under Section 165 or sales, turnover or gross receipts as the case may be, is less than Rs. 2 crores during the previous year.

This is similar to the Digital Service Tax introduced by France. It is contemplated that the tax treaty benefits will not be applicable to equalisation levy.

European Union - Paving the path for DST

The EU is planning to introduce Digital Service Tax on revenues generated from online advertising and digital

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interface services for companies generating more that 750 million Euros per year globally through covered digital services and at least 50 million Euros in EU-wide revenues. The DST was first introduced by France effective from 01.01.2020, the tax being popularly known as the GAFA Tax (Google, Apple, Facebook, Amazon) Tax.

Vodafone Ruling - European Court of Justice

The European Court of Justice in the case of ***Vodafone Magyarország Mobil Távközlési Zrt. Vs. Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatósága***[1] examined a special tax paid by Vodafone, which is a turnover based special tax for undertakings operating in certain sectors. The Hungarian Court referred a question to the ECJ for a preliminary ruling which reads as under:

Must Article 401 of the VAT directive be interpreted as precluding legislation for a Member State that gives rise to discrimination between foreign-owned taxable persons and national taxable persons? Must the special tax be considered a tax on turnover? In other words, is this tax compatible or not with the VAT Directive?

The Court observed that under Article 401 of the VAT Directive, the provisions of that directive do not prevent a Member State from maintaining or introducing taxes on insurance contracts, taxes on betting and gambling, excise duties, stamp duties, or more generally, any taxes, duties or charges which cannot be characterised as turnover taxes, provided that the collecting of those taxes, duties or charges does not give rise, in trade between Member states, to formalities connected with crossing of frontiers.

The Court observed that circumstance is sufficient ground to conclude that the special tax does not display all the essential characteristics of VAT and is, consequently, not subject to the prohibition laid down in Article 401 of the VAT Directive.

The Court therefore, held that Article 401 of the VAT Directive must be interpreted as not precluding the introduction of a tax which is based on the overall turnover of the taxable person and which is levied periodically, and not at each stage of the production and distribution process, there being no right to deduct tax paid at an earlier stage of that process. This judgment paves way to the introduction of the Digital Service Tax for the benefit of the Member States of EU.

Uniform Standards and United States - Hypocrisy at its best

The United States declined from signing the Multi-Lateral Instrument, an initiative taken by the OECD to harmonise the taxing system for the world. Many of the large business conglomerates transacting in the digital businesses are present in the United States and therefore, irrespective of whether there is a uniform system of taxation introduced in the nearest future by OECD, USA not being part of the same will serve as a deterrent to a globally consensual mode of taxation. Therefore, irrespective of whether the countries arrive at a uniform solution for taxing digital services through taxation of Income, the terms of taxing digital services will still have to be arrived at for United States independently.

Wayfair Ruling - US Supreme Court

While nations are debating on taxing rights with reference to business profits, which is in the direct tax arena, loss of sales tax revenue to a State on account of archaic laws linked with physical presence prompted States in the US to examine different solutions. The decision of the US Supreme Court in the case of **Quill**[2] held the field for a long time till the recent decision in the case of **South Dakota Vs. Wayfair Inc**.[3].The concept of a nexus without a physical presence in the digital world was examined by the US Supreme Court. South Dakota imposes taxes on retail sales of goods and services. However, if a business does not have a physical presence in that state, the consumers were required to pay the use tax at the same rates. Consumer compliance was notoriously low which prompted the South Dakota legislature to enact a law requiring out of state sellers to collect and remit the sales tax as if the seller had a physical presence in the State. The Act covered only sellers who delivered more than $100,000 of goods and services into the State or engaged in 200 or more separate transactions for the delivery of goods or services into the State. The Respondent, a top online retailer met the requirements of the law but did not collect the sales tax. In the litigation that ensued, the State Supreme Court considered the Act as unconstitutional based on the earlier precedent of Quill.

The US Supreme Court held that-

(i) The physical presence rule has long been criticised as giving an out of state seller an advantage. Each year it becomes further removed from economic reality and results in significant revenue losses to the State. Quill[4] creates market distortions as it is a judicially created tax shelter for businesses that limit their physical presence in a State but sell their goods and services to the State's consumers, something that has

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become easier and more prevalent as technology has advanced.

(ii) Modern e-commerce does not align analytically with the test that relies on the sort of physical presence defined in Quill.

(iii) The internet revolution has made Quill's original error all the more egregious and harmful. The Quill Court did not have before it the present realities of the inter-State market space where the internet prevalence and power have changed the dynamics of the national economy. The expansion of e-commerce has also increased the revenue shortfall faced by States seeking to collect their sales and use taxes.

(iv) While nexus rules are clearly necessary, the Court "should focus on rules that are appropriate to the twenty-first century, not the nineteenth."

Many States in the United States have identified a monetary threshold to establish nexus with the State in relation to remote sellers. For example, in Louisiana, sale into the state in excess of $100,000 or separate transactions of 200 or more sold for delivery into the State attracts nexus into the State of Louisiana for the purpose of taxation. Washington, Texas, Virginia, Ohio, New York, etc. all have similar conditions.

A peculiar issue arose in the context of the retrospective impact of the decision on account of the fact that many States had provisions similar to South Dakota effective from different dates. In order to ensure that there is no retroactive collection of taxes, a Bill has been introduced in the House of Representatives of the US which has now been referred to the Committee of the Judiciary. This law is called as 'Protecting Businesses from Burdensome Compliance Cost Act, 2019' and it provides that a State may not require a remote seller to collect tax or fee owed by a purchaser then located in such State where the seller does not have a physical presence. The Act does not apply to purchases that occur after the effective date of the Act.

Digital Goods and Services Tax Act, 2019 - USA

In the US Senate a new Bill (Federal Law) has been introduced in March 2019 to promote neutrality, simplicity, and fairness in the taxation of digital goods and digital services. This Legislation is titled as Digital Goods and Services Tax Fairness Act of 2019. This Bill is yet to be enacted. The object of this legislation is to ensure that no State or local jurisdiction imposes multiple taxes on the sale or use of a covered electronic good or service. Similarly, a State or local jurisdiction cannot impose discriminatory taxes. Only a State or local jurisdiction whose territorial limits encompass the customer tax address can impose the tax.

This law is very interesting since it seeks to clearly define as to which State will have the right to levy the sales tax on digital goods and services and the nexus is determined through the customer tax address. The responsibility is on the seller to identify the customer tax address and remitting the correct amount of tax in the State having jurisdiction.

Identical Nexus

What is interesting at this juncture is that the nature of the nexus created is similar to the nature of equalisation levy in India and DST in France. This type of nexus and the tax is definitely applicable to the companies in the United States itself. One may argue that it is only States that impose such taxes and they are not in the nature of Federal taxes. But the fact of the matter is that States operate like countries within the United States in the context of laws and taxes. The new Digital Goods and Services Tax Fairness Act of 2019 is not very different from some of the DST levies by other countries which also focus on the customer address or IP address being the nexus for the levy

The US Supreme Court in the case of ***Scripto Inc. Vs. Carson***[5] has held that solicitation of customers for the retailers by instate sales representative counts as physical presence even where the sales representatives are independent contractors. Concept of *minimum size in terms of necessary human and technical resources may not be equally viable in modern context as due to technological advancements physical presence is no longer an inevitable factor for supply of services. An entity may now have a profound impact upon other jurisdiction solely through its virtual projection.*

Digital World

Digital economy is clearly the way forward. With market disruptors like Artificial Intelligence, cryptocurrencies and pandemics redirecting the way the world functions, the need for physical presence for the purpose of accrual of income and consequentially, the taxation of the accrued income is becoming obsolete. The judgment of the United States Supreme Court in the case of **Wayfair** and the judgment of the European Court of Justice in the case of **Vodafone** is indicative of the fact that the market trends are changing and along with it, the methods of taxation.

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Therefore, it is incumbent upon the world to come up with a new method of taxation to cope with the change in the realms of the marketplace. One must understand that the digital taxes are for the services provided/ products bought and sold/ businesses transacted digitally/ online without establishing physical presence in that territory. There is a vast difference between extra-territorial legislation and extra-territorial operations. The validity or otherwise of digital taxes or equalization levy needs to be seen only from the respective country laws and their Constitution and their Courts.

But not wanting to conform to MLI, a globally advocated, widely accepted method to revisit principles of international taxation and redefining taxing rights for jurisdictions; not willing to participate in the global journey for understanding and taxing digital economy and at the same time introduce taxes such as Base Erosion Anti Abuse Tax (BEAT) and Global Intangible Low Tax Income (GILTI) seems to suggest some element of double standards. Can DST be a hindrance to trade, when threshold-based taxation sans physical presence has been upheld in the ***Wayfair?***

The digital taxes are irrespective of United States bearing the largest market players such as Google, Amazon, Facebook and Apple in relation to digital economy presently. The tax is based on the very nature and the mode of service and not the country or its service providers It is not targeted towards a particular country. It is a matter of irony that a nation which firmly believes in innovation, new ideas, good old fashioned ingenuity, technology driven digital revolution still wants to hold on to the archaic physical presence theory for taxation which clearly is woefully inadequate for digital business. While Countries would respond to the 301 action in their own way one cannot but quote Victor Hugo who said "*Nothing is more powerful than an idea whose time has come*."

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[1] Case C-75/18

[2] (1992) SCC Online US SC 59; 504 US 298 (1992)

[3] (2018) SCC Online US SC 79; 585 US ___ (2018)

[4] (1992) SCC Online US SC 59; 504 US 298 (1992)

[5] (1960) SCC Online US SC 39