The case for multilateral agreement on digital taxation

The growing virtual economy is encouraging countries to introduce digital services taxes and similar mechanisms that are discriminatory, intentionally or otherwise. They distort economic outcomes, reduce growth and generate uncertainty. They provoke trade retaliation, and destabilize tax and trade regimes. A multilateral solution to digital taxation is urgently needed.

Digital technology is a wellspring of immense opportunity. But the transformational impact of digitalization generates pressures for change, including in relation to digital taxation policy. As large digital tech companies extend their commercial reach across borders, some argue that these multinational enterprises (MNEs) are not paying their fair share of taxes. A related but separate issue is whether they are paying taxes in the jurisdictions where they generate their profits.

Analyses of effective corporation tax rates at the global level reveal that digital tech companies are in fact paying taxes in the same value range as MNEs in the real economy. As to where the taxes are paid, a possible response to this concern is to create a new tax nexus. This would be between consumers in a given jurisdiction and the MNEs who supply them without having a physical presence in the relevant market.

While efforts are underway among more than 130 countries at the Organization for Economic Cooperation and Development (OECD) to fashion a multilateral approach to digital taxation, a growing number of governments are choosing to go their own way. In some instances unilaterally designed tax arrangements are touted as temporary, pending an outcome from the OECD-led multilateral process. Temporary or not, they complicate the quest for a cooperative outcome.

Dangers of unilateral digital services taxation

In the absence of international accommodation, unilateral digital service taxes (DSTs) and similar measures risk sparking trade conflict. A number of their design features may well render them inconsistent with World Trade Organization (WTO) rules. But responding to them in the same unilateral coin undermines an already fragile multilateral trading system.

The negative-sum economic and political consequences of destabilizing two pillars of multilateral cooperation – on taxation and on trade – should concentrate the minds of governments.

A DST incorporating the new nexus between consumers in one jurisdiction and companies from another was first designed by the EU in 2018. The scheme was shelved because of discord among member states. Several EU members, however, as well as a number of other countries – 9 in total as of mid-2020 – have implemented DSTs based on the EU design. A further 12 are contemplating or actively preparing to do so. The DSTs vary in detail, but they are taxes levied on the gross revenues of affected enterprises. A few countries have adopted a gross-based withholding tax designed to achieve much the same as a DST.

These taxes levied on sales are proxies for a profits tax. But they do not provide for any of the customary deductible allowances or consideration of differing profit rates among companies. The coverage of DSTs is typically circumscribed by enterprise size thresholds and by type of digital activity. This results in discrimination among directly competitive enterprises and product lines. Applied unilaterally, they also result in double taxation of the kinds that tax treaties are supposed to prevent. Indeed, the hybrid design of DSTs linking a direct tax to an indirect tax base may be partly intended precisely to circumvent existing tax treaty obligations.

Multilateral approaches: OECD and WTO

The OECD's proposals on digital taxes seek to eliminate DSTs but do recognize the new tax nexus. The initiative contemplates the payment of some corporation taxes in the jurisdiction where sales revenue is generated, with the amount adjusted for relative profitability among in-scope enterprises. The proposal also seeks to establish a broad base in terms of companies and activities within scope in order to avoid ringfencing the digital economy and discriminating against particular companies or their products.

Another feature of the OECD initiative is the establishment of an international minimum corporation tax rate. This is to reduce the incentive for companies to use intra-firm pricing structures so as to declare their profits in low-tax jurisdictions.

Whether the OECD initiative will offer a workable multilateral solution for digital taxation remains to be seen. But if it does not evolve into a consensus outcome, the picture looks bleak. United States tariff increases are already in the works to retaliate against France's DST, which is aimed at a few large digital tech companies. More of the same will follow, involving more countries, in the absence of an international agreement.

Where do WTO rules stand on the legality of unilateral DSTs and similar measures? This can only be known for certain in the context of a challenge. Two non-discrimination requirements – the most-favored-nation (MFN) principle and national treatment – are the yardsticks for determining legal consistency. MFN prohibits discrimination among countries and national treatment addresses discrimination within a market once the terms of foreign access to that market have been specified. The WTO's General Agreement on Trade in Services (GATS) is the key agreement in the digital taxation field, and outcomes depend in part on the specific national treatment commitments assumed by the parties concerned.

Possible grounds for a finding of discrimination against unilateral DSTs include: i) the absence of deductibility rules; ii) a lack of benchmarks linking taxes to different levels of profitability among taxable enterprises; iii) double taxation outcomes; and iv) distinctions based on criteria such as firm size, product mix, or the means of delivery of a service. Another possible finding of inconsistency might arise under the GATT's (General Agreement on Tariffs and Trade) subsidy rules, where a physical product benefits from subsidized services inputs.

The WTO, and in particular the GATS, is not as well equipped as it could be to deal with trade in the digital world. In recognition of this, some WTO members are engaged in negotiations on e-commerce that seek to address many of the relevant issues. Negotiators might use the initiative to strengthen and deepen their GATS commitments, including on national treatment.

The OECD and the WTO should work together with national governments to avoid the costly and rancorous chaos that the digital tax issue will otherwise provoke.

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