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On to the Next One

The Increasing Importance of Destination in Tax Regimes

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Michele Borens
Randy Buchanan
Daniel Nicholas

Background

- Historically source has been of primary importance in determining the income tax consequences of transactions

  - Many countries have fully territorial systems that tax only locally sourced income

  - Sourcing principles generally determine the amount of income properly allocated to a tax presence in a country

  - Sourcing principles generally determine to what extent a country can impose a withholding tax on cross border payments

Background

- With the expansion of cross border flows and the digital economy, tax authorities are increasingly considering and implementing destination based concepts, rather than sourcing principles, to determine the tax consequences of transaction

  - The hybrid mixture of sourcing and destination principles may result in further mismatches that result in increased double taxation of the same income for which there may not be adequate remedies

  - Today we will walk through how these new destination principles are developing in a number of contexts

Background

- VAT – a brief overview of key VAT concepts
  - Destination principle has been the preferred approach
  - May provide a conceptual framework or toolkit for considering destination principles for income tax purposes
  - Increasing importance of direct and indirect coordination
- FDII – Implementation of destination principles in US Tax Reform
- Digital Initiatives in Europe and elsewhere
- US State tax developments, including the Wayfair decision

Value Added Tax

Background

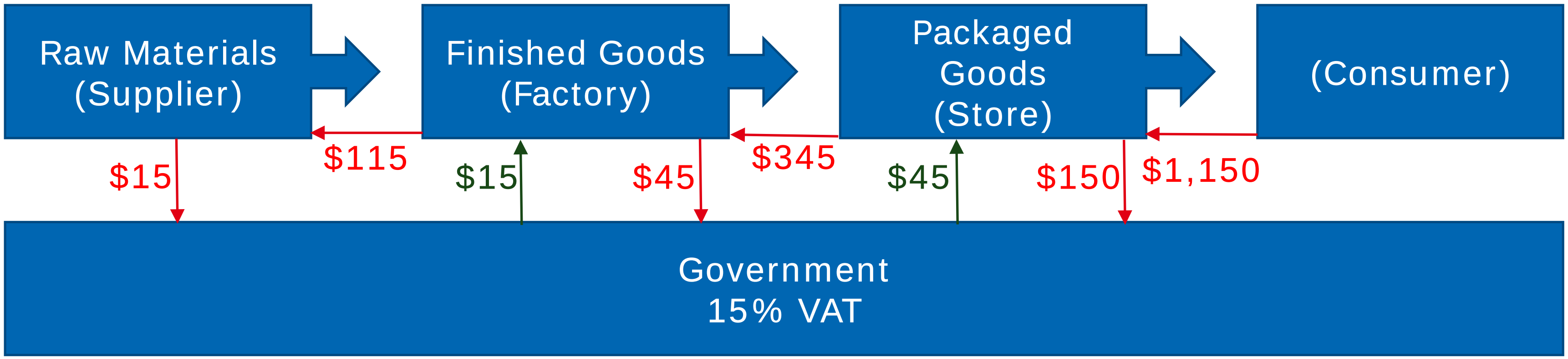
Background

Introduction to VAT

- The value added tax (VAT) is an indirect tax on final consumption collected from, but in principle not borne by, businesses through a staged collection process.
- The overarching purpose of a VAT is to impose a broad-based tax on consumption, which is generally understood to mean final consumption by households.
- VAT is charged on sales of goods and services (output VAT) and paid on purchases of the same (input VAT). In principle, the VAT is collected on the "value added" at each stage of production and distribution.
  - This staged collection process distinguishes a VAT from a retail sales tax, which taxes consumption through a single stage at the point of sale.
  - As discussed herein, VAT is also often applied on the importation of goods under the Destination Principle in the cross-border context.
- A VAT registered business collects the output VAT from customers and pays the VAT to the government; input VAT is paid to the supplier of goods/services and can be claimed back from the government. The ability to reclaim input VAT prevents businesses from bearing the economic burden of the VAT, which is ultimately borne by the final consumer.

Background

A Simple Example of a 15% VAT on Consumer Goods



- Supplier sells raw materials to Factory for $100, plus a $15 VAT. Other than administrative costs, Supplier bears no economic burden of the 15% VAT.
- Factory pays $15 input VAT to Supplier on its purchase of raw materials, which Supplier remits to the government. Upon its sale of finished goods to Store, Factory can reclaim its $15 of input VAT paid to Supplier. Other than administrative costs, Factory bears no economic burden of the 15% VAT.
- Store purchases finished goods from Factory for $300 and pays a $45 input VAT to Factory, which Factory remits to the government. Upon its sale of packaged goods to Consumer, Store can reclaim its $45 of input VAT paid to Factory. Other than administrative costs, Store bears no economic burden of the 15% VAT.
- Consumer purchases packaged goods from Store for $1,000 and pays $150 VAT to Store, which Store remits to the government. Because Consumer is the household consumer of the finished product, it bears the full economic burden of the 15% VAT.

Value Added Tax

Cross-Border Transactions

Cross-Border Transactions

The OECD Guidelines

- VAT is a major source of revenue for governments around the world. Although the US does not employ a VAT, approximately 165 other countries do, a number which has more than doubled in the last 25 years.
- The prevalence of VAT systems, coupled with the growing importance of international trade, has generated the need for a more unified and consistent application of VAT to avoid uncertainly and the risks of double taxation and unintended non-taxation.
- The Organisation for Economic Co-operation and Development (OECD) has set forth VAT guidelines, which establish internationally agreed principles and standards for the VAT treatment of common types of international transactions, with a particular focus on trade in services and intangibles (the OECD Guidelines).
- The OECD Guidelines identify two mechanisms by which to achieve the overarching purpose of VAT (to impose a broad-based tax on consumption by households) in the cross-border context – the “Destination Principle” and the “Origin Principle.”

Cross-Border Transactions

The Destination Principle Compared to the Origin Principle

- According to the OECD Guidelines: "The fundamental issue of economic policy in relation to the international application of the VAT is whether the levy should be imposed by the jurisdiction of origin or destination."
- The Destination Principle provides that tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction (i.e., only the jurisdiction of final consumption has the right to levy a VAT).
- The Origin Principle, on the other hand, provides that tax is levied in the various jurisdictions in which value was added in the supply chain.
- The Destination Principle places all firms competing in a given jurisdiction on an even footing, whereas the Origin Principle places consumers in different jurisdictions on even footing.
- Only the Destination Principle, however, achieves neutrality in international trade; it is therefore favored in most jurisdictions and is lobbied for in the OECD Guidelines and by the World Trade Organization.

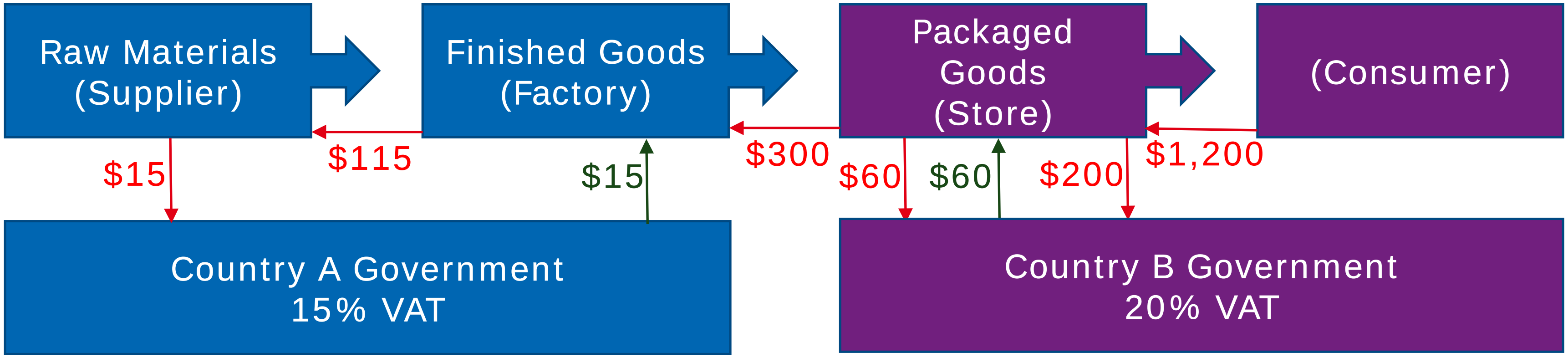
Cross-Border Transactions

The Destination Principle, Generally

- Under the Destination Principle, exports are not subject to VAT, and suppliers are allowed a refund of input VAT (i.e., exports are free of VAT or zero-rated), while imports are taxed on the same basis and at the same rates as domestic supplies.
- Therefore, the total tax paid in relation to a supply is determined by the laws of the jurisdiction of consumption, and all revenue accrues to the jurisdiction where the supply to the final consumer occurs.
- When a transaction involves goods being moved from one jurisdiction to another, the goods are generally taxed where they are delivered. As noted above, exported goods are free of VAT in the seller's jurisdiction (and suppliers are entitled to an input VAT refund), while imports are subject to the same VAT as equivalent domestic goods in the purchaser's jurisdiction.
- The VAT on imports is generally collected at the same time as customs duties; although in some jurisdictions, collection is postponed until declared on the importer's VAT return. Allowing deduction of the VAT incurred at importation in the same way as an input VAT deduction on a domestic supply ensures neutrality and limits distortions in international trade.

Cross-Border Transactions

A Destination Principle Example: Cross-Border Sale of Goods



- Factory purchases raw materials from Supplier for $100 and pays $15 input VAT to Supplier, which Supplier remits to the government of Country A. Upon its export of finished goods to Store, Factory can reclaim its $15 of input VAT paid to Supplier. Other than administrative costs, Supplier and Factory bear no economic burden of Country A's 15% VAT.
- The export of the finished goods from Country A to Country B is free of VAT under the Destination Principle. However, Store must pay VAT based on Country B's laws on the importation of the finished goods (i.e., 20% of $300). Upon its sale of packaged goods to Consumer, Store can reclaim its $60 of VAT paid on importation. Other than administrative costs, Store bears no economic burden of Country B's 20% VAT.
- Consumer purchases packaged goods from Store for $1,000 and pays $200 VAT to Store, which Store remits to the government of Country B. Because Consumer is the household consumer of the finished product, it bears the full economic burden of the 20% VAT.

Cross-Border Transactions

The Destination Principle: Services and Intangibles

- Implementing the Destination Principle for international trade in services and intangibles is more difficult than for goods; services and intangibles are not subject to border controls in the same manner as goods.
- The Destination Principle ensures that tax on cross-border supplies is charged only in the jurisdiction in which the final consumption occurs – this principle applies equally to goods, services and intangibles. However, determining the jurisdiction of the final consumer is less clear with respect to the provision of services and intangibles.
- The rules for determining the jurisdiction of consumption depend on whether the supply is a business-to-business (B2B) supply or a business-to-consumer (B2C) supply.
- This distinction is attributable to the different objectives of taxing B2B and B2C supplies: taxation of B2C supplies involves the imposition of a final tax burden, while taxation of B2B supplies is merely a means of achieving the ultimate objective of the tax, which is to tax final consumption.

Cross-Border Transactions

Services and Intangibles: Business-to-Business Supplies

- The OECD Guidelines provide: “For business-to-business supplies, the jurisdiction in which the customer is located has the taxing rights over internationally traded services or intangibles.”
- The supplier provides services or intangibles free of VAT in its jurisdiction but retains the right to full input VAT credit. Only in exceptional and clearly specified circumstances should the place of taxation vary from this general rule.
- The customer, in this instance, is not the household consumer, but is the business receiving the services or intangibles. The identity of the customer is normally determined by reference to the business agreement for the provision of services or intangibles.
- Where the customer only has a single location, the application of this principle is straight-forward. However, where the customer has establishments in multiple jurisdictions, the OECD Guidelines require an analysis to determine which of the jurisdictions has the taxing rights, with the goal being to ensure taxation accrues to the jurisdiction where the customer’s establishment actually using the service or intangible is located.

Cross-Border Transactions

Services and Intangibles: Business-to-Consumer Supplies

- In the B2C context, the objective is to tax the final consumption in the jurisdiction where it occurs, with the tax burden resting on the final consumer.
- The OECD Guidelines recommend two general rules for determining the place of taxation:
  - First, for supplies that are physically performed at a readily identifiable location and that are ordinarily consumed at the same time and place where they are physically performed in the presence of supplier and customer ("on-the-spot supplies"), the OECD Guidelines recommend a place of taxation rule based on the place of performance. Examples may include auto repair or personal services.
  - Second, for other supplies, the OECD Guidelines recommend a place of taxation rule based on the customer's usual residence. Examples may include the provision of software or technical support.

FDII

Implementation of destination principles in US Tax Reform

FDII

Background

- New section 250(a)(1)(A) provides a deduction for “foreign derived intangible income” (“FDII”)
  - Reduced tax rate achieved through a 37.5% deduction for FDII for tax years beginning 2018 through 2025 (for taxable years beginning after 2025, the FDII deduction is reduced to 21.875%)
- Results in an effective tax rate on FDII of 13.125% (increased effective tax rate of ~16.4% for taxable years beginning after 2025)
- Deduction is limited to there being positive taxable income

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign-Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

FDII

Foreign-Derived Deduction Eligible Income

– A key component of the FDII calculation, Foreign-Derived Deduction Eligible Income, is determined based upon destination principles.

– Specifically, Foreign-Derived Deduction Eligible Income
  - Income derived in connection with property sold by the taxpayer to a foreign person <u>for foreign use</u>, and
  - Income derived in connection with services provided by the taxpayer to any person, or with respect to property, <u>not located in the U.S</u>.

FDII

Foreign Derived Deduction Eligible Income – Sales

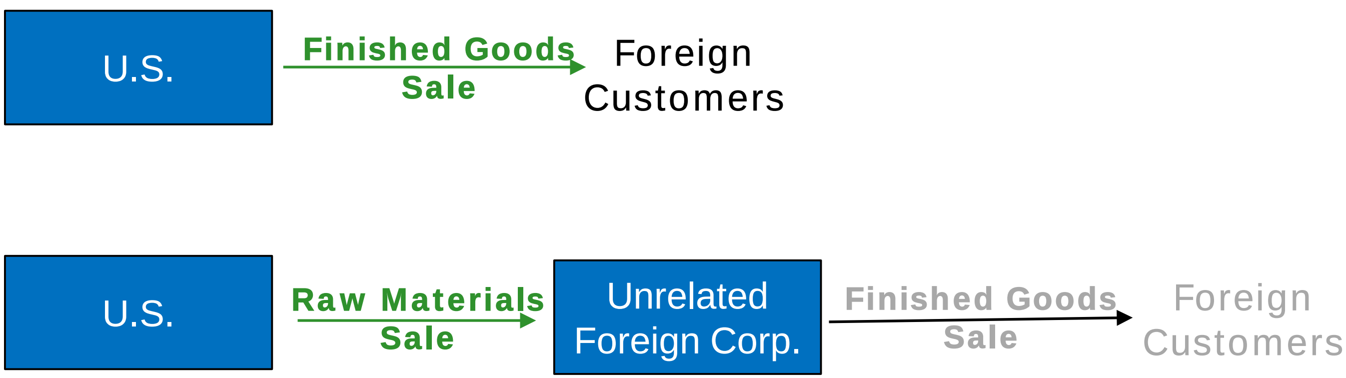
- “Sale” defined broadly
  - Includes income from a lease, license, or exchange
- Foreign Use
  - “Foreign use” means any use, consumption, or disposition which is not within the United States
  - Sales of property to a non-US person must be for foreign use
  - Services must be provided to any person, or with respect to property, not within the United States
  - Foreign use must be shown to the “satisfaction of the Secretary”

FDII

Foreign Derived Deduction Eligible Income – Sales

– What is foreign use?

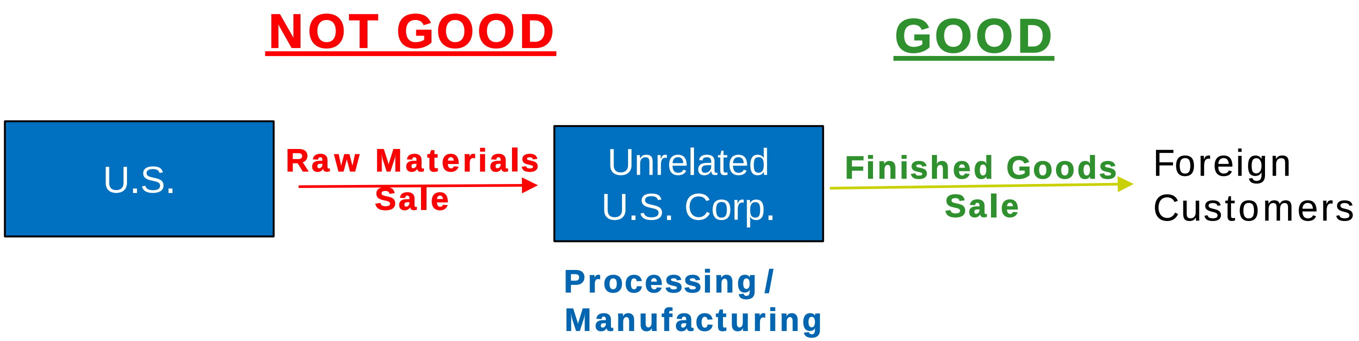
GOOD



FDII

Foreign Derived Deduction Eligible Income – Sales

– What is a Foreign Use?
  - Sales to a non-related person (whether U.S. or foreign) are not for foreign use if subject to further manufacture or modification within the U.S. prior to foreign use



FDII

Foreign Derived Deduction Eligible Income – Sales

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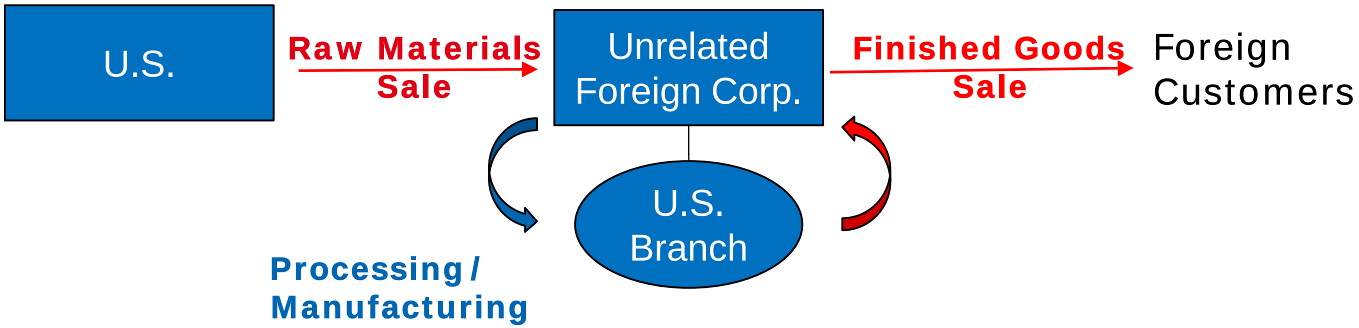
ALSO NOT GOOD



FDII

Foreign Derived Deduction Eligible Income – Services

- Persons or Property not “located” in the United States
  - Services is focused not on use, but instead whether the services are performed for persons, or with respect to property, not located in the U.S.

GOOD

FDII

Foreign Derived Deduction Eligible Income – Services

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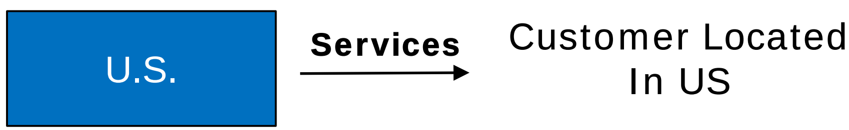
NOT GOOD



FDII

Foreign Derived Deduction Eligible Income – Sales and Services

– Sales of Property to Related Foreign Parties
  - Property must be for foreign use (to the satisfaction of the Secretary) **and** either:
    1. Ultimately sold by a related party to an unrelated foreign person

- OR -

2. Used by a related party in connection with property that is sold to an unrelated foreign person, or

3. Used by a related party in connection with services that are performed for an unrelated foreign person

FDII

Foreign Derived Deduction Eligible Income – Services to Related Parties

- Services Provided to Related Foreign Parties
  - Services provided to a related party are not for foreign use unless the taxpayer establishes to the satisfaction of the Secretary that such service is not substantially similar to services provided by the related party to persons located within the United States

Taxation of Digital Services

The OECD Report and European Commission Proposals

Taxation of Digital Services

Background

- In addition to VAT, businesses involved in cross-border transactions are liable for income or gross payment taxes. Establishing to which jurisdiction such taxes are to be paid, however, is often unclear – especially upon the provision of digital services.

- Taxation of businesses that use digital technology has been high on the international political agenda in recent months and years.
  - On March 16, 2018, the OECD published its interim report regarding taxation of the digital economy under the title "Tax Challenges Arising from Digitalisation", which follows-up on the work performed in 2015 under Action 1 of the Base Erosion and Profit Shifting (BEPS) Project.
  - On March 21, 2018, the European Commission issued several proposals to "ensure that digital business activities are taxed in a fair and growth-friendly way in the EU."

- While the European Commission has recommended that European Union (EU) member states assert their right to tax certain profits generated from the provision of digital services, the OECD has proposed a two-year, detailed review of the issues with the goal of achieving a consensus-based solution to digital tax challenges in 2020.

Taxation of Digital Services

OECD Report

- In 2015, the OECD acknowledged that the digitalization of the economy poses broader tax challenges than simply exacerbating the existing BEPS concerns that the OECD was seeking to address at the time.
- The 2018 OECD report identifies digitalization-specific challenges as data, nexus, and characterization. These challenges largely relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.
- The 2018 OECD report reflects a consensus between more than 110 member countries whereby members agreed to undertake a coherent and concurrent review of “nexus” and “profit allocation” rules - fundamental concepts relating to the allocation of taxing rights between jurisdictions; such concepts are currently strongly rooted in physical presence.
- While identifying a number of options to address these concerns, none were ultimately recommended by the 2018 OECD report. Although there are several countries opposed to change, the OECD’s stated goal is to have a consensus-based solution by 2020.

Taxation of Digital Services

European Commission Proposal

- In lieu of waiting for the OECD's consensus-based solution, the European Commission presented a series of localized proposals to ensure fair and efficient taxation of digital businesses operating within the EU. The proposals include both interim measures, in the form of a 3% "Digital Services Tax" (DST) on certain gross revenues, and a long-term solution that introduces the concept of virtual permanent establishment.
- The DST would only apply as an interim measure until comprehensive reform can be implemented and would apply only to revenues created from activities where users play a major role in value creation, such as those revenues created from:
  - selling online advertising space;
  - digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them; and
  - the sale of data generated from user-provided information.
- DST revenues would be collected by the EU member states where the users are located and will only apply to companies with total annual worldwide revenues of €750 million and EU revenues of €50 million.

Taxation of Digital Services

European Commission Proposal (continued)

- The European Commission's proposal is designed to eventually introduce a taxable nexus for digital businesses operating within the EU with "significant digital presence" within a member state, even if such businesses have little to no physical presence in such state. This proposal is scheduled to go into effect January 1, 2020.
- A digital platform will be deemed to have a taxable "digital presence" or a virtual permanent establishment in a member state if it satisfies one of the following criteria:
  - It exceeds a threshold of €7 million in annual revenues in a member state;
  - It has more than 100,000 users in a member state in a taxable year; or
  - Over 3,000 business contracts for digital services are created between the company and business users in a taxable year.
- The new rules will also change how profits are allocated to member states in a way which better reflects how companies create value. The attribution of profits will take into account the market values of:
  - Profits from user data (e.g., placement of advertising);
  - Services connecting users (e.g., online market places, platforms for "sharing economy"); and
  - Other digital services (e.g., subscriptions to streaming services).

Taxation of Digital Services

Digital Tax Initiatives: Australia and India

Taxation of Digital Services

Australia's Multinational Anti-Avoidance Law

- Australia's Multinational Anti-Avoidance Law (MAAL) works as a permanent establishment (PE) anti-avoidance rule limited in scope to non-resident enterprises that belong to large multinationals.
  - MAAL is designed to target the use of an overseas company, supported by locally based personnel, with the aim of remotely supplying goods and services to final customers located in Australia – a common structure for businesses providing digital goods and services.
  - If applicable, MAAL results in the cancellation of any structure-based tax benefit obtained by the multinational. Typically, this results in income being allocated to a deemed PE of the foreign entity.
- As of the date of the 2018 OECD report, no MAAL-based assessment has been issued, but local tax authorities have reported that approximately 38 taxpayers have restructured or are restructuring their trade arrangements in response to this measure (e.g., by moving to a local sales structure).

Taxation of Digital Services

Australia’s Diverted Profits Tax

- Australia’s Diverted Profits Tax (DPT) Act was adopted in April 2017 as a complement to existing income tax anti-abuse rules.
  - The DST operates as an alternative provision rule limited in scope to large multinationals and certain intra-group cross-border transactions, which typically involve licensing or transfer of intellectual property, leasing of equipment, loans, and management services.
  - The alternative provision may apply to excessive deductions (e.g., base eroding payments) and understated income (e.g., transfer of assets for an undervalued price, charging of unduly low service fees), provided that the arrangement was set-up for the "principal purpose of, or for more than one principal purpose of" securing a tax benefit.
- The tax base corresponds to the tax benefit of the arrangement, relative to the alternate arrangement had tax not been a motivating factor.
- This tax base may, at the discretion of the tax authorities, be subject to a punitive tax rate of 40% (instead of the 30% standard corporate tax rate).

Taxation of Digital Services

India's Significant Economic Presence Standard

- Several amendments to domestic nexus rules for corporate income tax were recently introduced in India and are expected to become effective April 1, 2019.
- One such amendment expands the definition of nexus for business income by incorporating the concept of significant economic presence (SEP). A non-resident enterprise has a SEP if either of the follow thresholds are satisfied:
  - A threshold based on local revenue: "any transaction in respect of any goods, services, or property carried out by a non-resident in India, including the provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed", or
  - A threshold based on number of local users: "systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India, through digital means."
- Satisfying one of these thresholds creates a direct tax liability in India irrespective of the location and/or residence of the taxpayer.

Taxation of Digital Services

India’s Equalization Levy

- India’s Equalisation Levy (EL) is a separate tax that was introduced in 2016, which works as a 6% charge deducted from the gross amount of consideration paid for the provision of online advertisement services by non-residents.
  - The EL only applies to certain listed cross-border B2B transactions, including online advertising and any provision of digital advertisement space (although India’s central government has the authority to expand upon these listed transactions).
  - Exemptions are available if (i) the total consideration paid by the payer over a year does not exceed approximately USD 1,500 or (ii) the specified services are effectively connected to a PE of the payee in India.
- The EL liability is imposed on the non-resident payee; however, the EL is collected by the payer (i.e., the local business in India), who is responsible for remitting the tax to the central government.

Impact of *Wayfair*

South Dakota v. Wayfair

- The U.S. Supreme Court issued its decision in Wayfair on June 21, 2018 overturning *Quill* and prior U.S. Supreme Court precedent.
- The Court considered whether South Dakota's S.B. 106 established nexus against remote sellers with $100,000 in annual gross revenue from sales delivered to the State or 200 separate transactions delivered to the State violated *Quill* and the Commerce Clause.
- In its decision, the Court held:
  - *Quill* was "unsound and incorrect"
  - It established a new test that is more or less parallel to the Due Process Clause.
  - New test for sales and use tax nexus is "**economic or virtual**" presence.

South Dakota v. Wayfair, cont.

– The Court's decision "appears" to indicate that South Dakota's law minimized the burdens on interstate commerce because it has at least these three features:
  1) Includes a safe harbor for sellers with "limited business" in SD
     – Is "considerable amount of business" required?
  2) Does not apply retroactively
  3) South Dakota is a full member of the Streamlined Sales and Use Tax Agreement (SSUTA)

Reactions to *Wayfair* – 11/05/2018

Adoption of South Dakota-Style Thresholds*

- **AL** – 10/1/2018 -- $250,000 plus an activity in Ala. Code § 40-23-68(b)
- **AR** – TBD (proposal approved by tax reform comm'n)
- **AZ** – None**
- **CA** – TBD (bill intro'd)
- **CO** – 12/1/2018
- **CT** – 12/1/2018 -- $250,000/200 (pre-12/1/2018, CRS may seek to enforce 100 or more retail sales threshold)
- **DC** – TBD (bill pending)**
- **GA** – 12/1/2019 - $250,000/200
- **FL** – Under review**
- **HI** – 7/1/2018
- **ID** – Under review**
- **IL** – 10/1/2018
- **IN** – 10/1/2018
- **IA** – 1/1/2019
- **KS** – Under review**
- **KY** – 10/1/2018
- **LA** – 1/1/2019 (est. by DOR)
- **MD** – 10/1/18
- **MA –** 9/22/17 - $500,000/100 – regulation being challenged.
- **ME** – 7/1/18
- **MI** – 10/1/2018
- **MN** – 10/1/2018 – 10 more transactions over $100,000/100 transactions
- **MO** – None**
- **MS** – 9/1/2018 -- $250,000 plus systematic solicitation
- **NE** – 1/1/2019
- **NJ** – 11/1/2018
- **NC** – 11/1/2018
- **ND** – 10/1/2018
- **NM** – Under review**
- **NV** – 10/1/2018 (proposed reg.)
- **NY** – Under review**
- **OH –** 1/1/18 - $500,000 and software or CDN
- **OK –** 7/1/18 - $10,000
- **PA –** 3/1/18 - $10,000
- **SC** – 11/1/2018 -- $100,000 (includes marketplace sales)
- **SD** – 11/1/2018
- **TN** – TBD (enjoined, legislative of regulation approval needed) -- $500,000 plus systematic solicitation
- **TX** – 10/1/2019 (proposed reg.) – $500,000**
- **UT** – 1/1/2019
- **VA** – Under review**
- **VT** – 7/1/2018
- **WA** – 10/1/2018
- **WI** – 10/1/2018
- **WV** – None (Gov. opposes)**
- **WY** – 2/1/19

***Unless otherwise noted, states adopt SD-style threshold of $100,000/200**

****State "doing business" statute applies to the extent allowed under the U.S. Constitution.**

Foreign Sellers – U.S. Destination Sales

- There has been a lot of discussion about how the new *Wayfair* standard applies to foreign sellers selling into the U.S.
- The Commerce Clause has been interpreted as providing two additional protections for foreign sellers whether: (1) there is a substantial risk of international multiple taxation and (2) the tax prevents the Federal Government from speaking with one voice when regulating commercial relations with foreign governments. *See Japan Line, Ltd.*
- In applying these two additional prongs in the tax context, Courts have not viewed these additional protections as significantly limiting taxation of foreign entities.

Foreign Sellers – U.S. Destination Sales

- U.S. sales taxes apply to physical goods that are sent to a purchased located in the state –destination sourcing.
- For foreign sellers selling to the U.S., this likely means that these sales will be subject to sales tax if the foreign seller exceeds the dollar or transaction threshold to establish nexus.
- Practically, the question will be how the states seek to enforce sales tax economic nexus laws against foreign sellers.

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