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International Tax Considerations in Light of South Dakota v. Wayfair, Inc.

By Leonard D. Levin, JD, Partner

U.S. sales and use tax is governed on a state and local level. Compliance with rules and regulations has always been a challenge for multinational companies. A Supreme Court decision from last year has had a massive impact on internal processes and even business models of multinational companies operating in the U.S. The impact is the result of new rules and regulations introduced by state legislatures following the Supreme Court decision.

Overview

On June 21, 2018, the U.S. Supreme Court in the case of South Dakota v. Wayfair, Inc., 585 U.S. (2018) significantly expanded the taxing authority of states of the United States with regard to sales and use taxes. The Supreme Court in the Wayfair case created the concept of “Virtual Presence” to describe the connection of large retailers to a state, especially online retailers who engage in a significant amount of business with a state in which the retailer does not have a physical presence.

The question was never whether the sale of goods or the provision of services to the purchaser was subject to sales/use taxes in the purchaser’s state, it was solely a question of which party to the transaction — the seller or the purchaser — was required to remit the tax on the transaction to the state. Prior to the Wayfair decision, if the seller was not obligated to collect and pay the sales tax because it had no physical presence in the state, the buyer was expected to remit the tax to the state.

International View

From an international perspective, the Wayfair decision, intended to stop revenue loss to states on interstate transactions, is another consequence of the “Cyber Age.”

Even if a Double Tax Agreement (DTA) would apply to preclude a foreign seller from having a U.S. taxable presence for Federal and state corporate tax purposes — because inventory by itself, used only to fulfill orders, does not create a permanent establishment — this would not prevent a state from demanding the seller to collect sales tax on both instate sales and out-of-state sales.

The Role of Double Tax Treaties

For non-U.S. vendors selling to customers in the United States, the Wayfair decision is merely another example of the fact that DTAs between the United States and other countries do not cover or protect against many aspects of U.S. tax law; in particular, the array of tax laws enacted and applied by the individual states and local jurisdictions within the states. Taxes levied by the states include corporate income taxes, corporate franchise taxes, personal property taxes, and sales and use taxes. A significant problem with the sales tax regimes is that they are creatures of the states, thus the large number of such regimes (45 states impose sales taxes) each with its own rules, definitions and rates.

In many if not most states, registering to collect sales tax will automatically bring a request from the state’s Secretary of State or Tax and Revenue Department that the entity register or qualify to conduct business in the state. This will bring with it the obligation to file corporate tax returns and appoint a registered agent in the state for service of process. The source of this problem is the concept that if an entity is collecting sales tax in a state it must have a physical presence in the state.

How nexus for corporate taxation will be determined after the Wayfair decision is an open question. Although annual sales of $100,000 and/or 200 separate sales transactions may seem to be reasonable thresholds, even the Chief Justice of the Supreme Court thought these sales levels would create an undue burden on small business. Nevertheless, lacking any other guidelines, more than 30 states have adopted the $100,000/200 standard or one similar to it.

Key Takeaway

Multinational companies selling tangible property or providing services into a state without having physical presence need to monitor very closely state activities in the wake of the Wayfair decision and will have to implement internal processes which track all kinds of sales into different states. If thresholds are exceeded, sellers will not only have to register to collect sales tax, they may also have to fulfill requests from state Secretaries of State and/or Tax and Revenue Departments to register or qualify to conduct business in the state.

IRS Issues Final Transition Tax Regulations

By Ralf Ruedenburg. Principal and Kelly Lin, Senior Manager

The proposed transition tax regulations were finalized and made available on the IRS website on January 15, 2019. The finalized regulations are effective with the publication in the Federal Register on February 5, 2019.

The final regulations are generally consistent with the proposed regulations published on August 9, 2018, but there are some helpful changes made in several key areas, including but not limited to, the following:

- A consolidated group will be treated as a single U.S. shareholder of a specified foreign corporation (SFC) when determining the aggregate foreign cash position of a consolidated group.
- Introduction of an exception to exclude certain assets from the calculation of the cash position. Exceptions include the fair market value of commodities (e.g., oil, lumber, coffee beans, lead) held by an SFC as stock in trade included in inventory or as property held in the ordinary course of its trade or business as well as certain privately negotiated contracts to buy or sell such assets. This rule does not apply to specified foreign corporations that are traders or dealers.
- A U.S. shareholder has to include in gross income its pro rata share of a SFC transition tax amount at any point during the inclusion year, even if the SFC ceases to be such corporation during the transition year.
- U.S. shareholders are allowed to elect to not disregard payments between specified foreign corporations that occurred between earnings and profits measurement dates.

The final regulations are retroactive and, in some cases, the revisions may materially affect a taxpayer's transition tax net liability. Taxpayers have to determine the effects of the revisions made from the proposed to the final regulations.

Is the Arm's Length Standard in Danger?

By David Slemmer, Principal

A few months ago, the European Commission released a statement which could signal the beginning of the end for the Organisation for Economic Co-operation and Development's (OECD) international tax rules, and the arm's length standard on which they are based. The current rules, which date to decisions taken many decades ago, are based on the assumption that the "right" price for a transaction between different companies within the same multinational group is the price which would apply for the same transaction between unrelated parties. This "arm's length" price is, therefore, taken as the basis to evaluate all such intercompany transactions (i.e., transfer pricing).

There is a chance that countries working to achieve consensus on new rules to govern by which a country can tax multinational group profits will agree to a proposal such as formulary apportionment and abandon the arm's length standard.

Many are advocating the formulary apportionment which would split the entire profits of a multinational enterprise group (MNE) among all its subsidiaries, regardless of their location. Proponents of such alternatives not only have to show that their proposals are theoretically "better," but that they are capable of winning international agreement. Not easy, since the very act of building a formula makes it clear what the outcome is intended to be and who the winners and losers will be for a given set of factors. The tax authorities would naturally want the inputs to reflect their assessment of profit. Questions like how to apportion intellectual capital and R&D between jurisdictions would become very argumentative to say the least.

Rather, it is more likely that consensus will build around a proposal for a modest increase in market jurisdiction taxing rights coupled with a global minimum tax. The OECD policy note released January 29, 2019 by the Inclusive Framework on *Base Erosion and Profit Shifting* (*BEPS*) — an OECD-led coalition of 127 countries — states that the international community is fundamentally reassessing how to allocate taxing rights over MNE profits between countries. It is expected that the U.S will soon release its own paper discussing the two items mentioned in the OECD policy note.

Such problems would make it very difficult to reach agreement on the inputs to the formula, particularly between parent companies in wealthy countries and subsidiaries in poorer ones. The arm's length standard avoids these pitfalls as it is based on real markets. It is tried and tested, offering MNEs and governments a single international standard for agreements that give different governments a fair share of the tax base of MNEs in their jurisdiction while avoiding double taxation problems. At this point in time, it's much better to update and modify the existing arm's length standard than start from scratch with something new.

Taxation of the Digitalized Economy in the Future

By Ralf Ruedenburg, Principal

The Organisation for Economic Co-operation and Development (OECD) identified the tax challenges of the digitalization of the economy years ago. That lead to the Base Erosion and Profit Shifting (BEPS) Action 1 Report in 2015. That report observed that the digitalization of the economy raised a number of broader direct tax challenges chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.

A Task Force on the Digital Economy (TFDE) was deployed, delivered an interim report in 2018 and is now working on proposals which could form the basis for consensus among over 115 countries and jurisdictions on how to address the tax challenges of the digitalized economy.

The potential solutions could update fundamental tax principles for a twenty-first century economy involving the following two pillars.

- The first pillar would focus on the allocation of taxing rights including nexus issues. Taxing rights could be allocated to market or user jurisdictions in situations where value is created by a business activity through participation in the user or market jurisdiction without having physical presence.

- Under the second pillar, basis taxing rights would be explored that would strengthen the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective rate of tax to those profits. These rules could resemble the U.S. global intangible low-taxed income (GILTI) enacted under the Tax Cuts and Jobs Act.

Despite these efforts from the OECD, countries have already enacted new rules for taxing the digitalized economy or are planning to do so in the near future:

- Hungary, India, Israel and South Korea enacted various digital taxes in 2016 or earlier.

- The Italian Budget Law 2019 introduced a new tax on digital services (DST), initially enacted in 2016. The DST will apply with respect to digital transactions performed, individually or at the group level. The tax applies to businesses (companies and groups) which, during the fiscal year, jointly realize:

  - Annual revenues, wherever arising, not lower than EUR 750m
  - Annual revenues derived from digital services supplied in the Italian territory not lower than EUR 5.5m.

- The UK and Singapore are planning to introduce tax on digital services in 2020.

It remains to be seen if a worldwide system can be introduced based on OECD proposals.

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