The taxman cometh… for the internet

BY ROGER J. COCHETTI, OPINION CONTRIBUTOR - 04/16/22 4:00 PM ET

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A dramatic struggle is playing out over future taxation of — and on — the internet. Few subjects are more complex than tax rules, but internet tax policy multiplies the complexity because so much of it involves activities taking place in cyberspace without regard to borders.

Since ancient times, basic international tax principles have evolved, including that governments only tax people in their own territory at whatever rates each government decides. These concepts were complicated last century when international mail, telephone, data and jet travel emerged, resulting in complex efforts to define exactly what it means to "be in" a country and subject to its taxes. The relative financial stakes in cross-border, non-trade, economic activity during the last century, however, were modest compared to today.

As the 20the century drew to a close, things began to change, as the combination of the digitization of property (like software), globalization, and the easy transmission of anything anywhere through the internet began both to complicate and to increase the economic importance of cross-border economic activity — and thus taxation. Governments were left confused and concerned over the possible erosion of their tax base.

The first major internet tax policy move in the U.S. came in 1998 with the passage of the Internet Tax Freedom Act, which prohibited U.S. state and local governments from imposing taxes on things sold over the internet when such things were not taxed in the material world and from imposing taxes on internet access, since such access was already taxed at the telecommunications layer. (Full disclosure: at that time, I was the IBM executive responsible for directing their policy on internet tax, and the main theme was to protect an infant industry from discriminatory treatment.)

This "leave the internet alone" philosophy combined with late-20th Century tax rules that enabled countries to attract investment by offering low tax rates for multinational enterprises, regardless of where most of their actual business was conducted (so called "tax havens.") The old rules of tax sovereignty and the new technology combined to make it possible to sell to customers around the world via the internet and yet pay taxes only in a "tax haven." But something perhaps more important was happening. Services (from banking to entertainment) and merchant advertising began migrating away from physical buildings to the internet. By the 2010s, a huge percentage of services had abandoned the streets, where governments could easily impose taxes, and migrated to cyberspace, where locations and tax liabilities were difficult to establish or enforce.

Making matters even more complicated, many of these internet services were not even “sold” to local “consumers” (in the sense that the local consumer actually makes a payment to the service provider.) Instead, many internet-based services were technically “sold” to multinational advertisers, who were the real “customers,” and then provided “for free” to local consumers. In this case, the actual “sale” by the internet service to the merchant advertiser could occur in cyberspace or “in” any attractive jurisdiction. (This is, of course, where internet tax and privacy policies intersect: For advertisers, cyberspace advertising could be more attractive than broadcast or publisher advertising, since by carefully monitoring the activities of end users, the online service providers could target exactly the customer the advertiser wanted to reach, with no wasted ad dollars.)

The combination of these forces led to internet tax upheavals in recent years. The Supreme Court in 2018 threw out one of the principal 20th Century tax tenets that sellers had to have physical “nexus” in a territory for that territory’s government to impose taxes on them. Earlier, an intergovernmental organization, the Paris-based OECD (home of most international tax dialogues for the past half century) got pulled into the internet tax vortex. This was partly because some EU members realized that in an era of digital property and seamless online sales, they could serve as tax havens for major businesses seeking to effortlessly reach EU markets and in doing so attract employment, new tax revenues and investments in their countries — which in turn led to major pressures from within Europe to rewrite the old tax rules.

In Europe, the first major shot came in 2019 from France. Within the United States, in 2021 from Maryland. Both jurisdictions put forth the previously revolutionary proposition which I would paraphrase as “I don’t care where you’re headquartered/located or whether you’re charging my consumers fees … if you’re very large and doing a lot of online business to people in my territory, you owe taxes here.”

A dozen European countries joined France, and even more outside of Europe did so. The U.S. response was to accuse European and other countries of trying to change accepted tax rules to retaliate against successful American companies, and the U.S. threatened to retaliate.

The emerging 2020 tax confrontation between Europe and the U.S. supercharged the OECD effort (which grew to over 130 countries) to find a compromise and create new international tax paradigms, which the OECD process did in 2021.

Even the most cursory summary of the OECD's tax deal would take volumes, but to oversimplify grossly, in my view, its core is for nations to drop their plans to impose internet-specific taxes on large companies and instead agree to a global minimum 15 percent tax rate on all large multinational businesses (eliminating the narrow internet target and reducing the threat of tax havens) and allow nations to tax all large multinationals based on where they proportionately generate income instead of where the company is "located."

Both concepts are revolutionary: Taxes would be based on where a large company sells to — not from — and no country can impose less than a 15 percent rate. Perhaps most important, a confrontation between the U.S. and Europe and other taxing countries would be avoided (for now.)

But this compromise remains in its final stage of preliminary approval. So, while we pay our taxes, the world waits to see if the taxman cometh for the internet — or not.

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