INSIGHT: Will The U.S. Wayfair Decision Impact the International Digital Taxation Debate?

By Will Morris

Will Morris considers what implications of the U.S. Supreme Court decision in Wayfair may have beyond sales taxes, and, in particular, for the current international discussion on taxation of digital businesses.

On June 22, the U.S. Supreme Court handed down a much-anticipated decision in Wayfair—a state sales tax case. The issue in Wayfair was whether South Dakota could require Wayfair to collect sales tax on Wayfair’s sales into the state, even though Wayfair had no physical presence in the state (no so-called ‘nexus’ or connection justifying taxation). The decision is one that companies will need to consider from several angles in the coming months.

**Digital Permanent Establishment?**

At the heart of the digital tax issue for many countries is their ability to tax the profits of large technology companies based on the location in the country of the companies’ users/consumers—even though the companies themselves have little or no physical presence in the countries.

Some commentators have noted that the United States, which historically has opposed taxation without physical presence, has now provided the perfect precedent for the rest of the world to tax U.S. digital companies. Some of the language in Wayfair, they argue, could be read broadly to also cover international corporate income taxation and provide support for a so-called ‘Digital Permanent Establishment.’ This would allow countries to assert enough (virtual) presence of a company in a country to allow income taxation of the business’ corporate profits in that country.
Wayfair is a Sales Tax Case

But hang on a second. Let’s think about that. Wayfair is a sales tax case, not a profits tax case. The sales tax is a tax on consumption imposed on the consumer.

It is well-established in jurisdictions around the globe (including since 2015 in the EU under the Electronically Supplied Services rules) that sales taxes are levied where the consumer is located, rather than where the seller is located.

At issue in Wayfair was the obligation of the seller to collect the sales tax from the consumer for the jurisdiction in which that consumer is located, even if the seller has no physical presence there.

Income Tax Point?

So how can there be an income tax point?

Well, U.S. state corporate income taxes are very different from most national level income taxes—and are, in many ways, much closer to sales taxes.

At the state level, a number of states have corporate income tax legislation that provides that nexus (that right to tax) is established not by physical presence but by a certain level of sales. And once the right to tax exists, the amount to be taxed is determined by a formula (traditionally three factors: payroll, property, and sales in the state—but these days more often on a single factor of sales).

Although taxpayers have disputed the point, this income tax nexus rule generally has been upheld by the courts. In that sense, state income tax nexus (for non-tangible personal property) actually preceded the change to the nexus rules that Wayfair has brought to state sales taxes. However, as I’ll try to explain, that doesn’t mean that either the state income tax precedent or Wayfair is relevant to the international corporate income tax discussion.

Place of Consumption

So let’s look at that a bit more closely. First, we need to separate the two crucial elements in the discussion: ‘nexus’ on the one hand, and ‘attribution of profits’ (or what and how much of those profits a country is actually entitled to tax) on the other.
In relation to ‘nexus,’ Wayfair may give support to the theory that you don’t need to be present in a country to be taxable there, but that doesn’t necessarily impact the ‘attribution of profits’ leg of the digital discussion under international tax rules.

To repeat: consumption taxes are levied at the place of consumption, i.e., the location of the consumer. That’s logical because the tax is (almost always) on the consumer, not the business—even if the business is required to act as tax collector. But under most international rules, the taxation of profits—which are a tax on the business and not on the consumer—depends on where the profits are generated. Putting that slightly differently, the question under international corporate income tax rules is not where the sale took place, but how and where the business undertook the activities that created the profits of that business.

**Generation of Profit**

Now it is true that there is a growing discussion about whether the place of consumption (or ‘market’ or ‘destination’) plays a part in generating profit. But, so far, it is just that—a discussion. There have been a number of suggested justifications for this.

- One is that the activities of the user in another country (especially on social media sites) help to create value, even though the business that runs the platform with which those users interact is not physically present there.
- Another is the so-called ‘scale without mass’ argument, which basically argues digital has made it possible to create and extract profit from a country with very little, if any physical presence. Under this theory, a significant digital presence—over the internet but enabled by the infrastructure of the country (broadband, legal protection, etc.)—is what creates value there. Thus, the argument continues, the rules need to be rewritten to take that into account.
- A third argument is made by those who have argued for years that the ‘market’ (its size, its educated consumers, its ‘uniqueness’) should automatically result in some profit being allocated to it.

**Profits Tax**

To be clear, all of these may warrant a discussion—and should be part of the OECD discussion that is just beginning to gear up.

But while it’s pretty clear in the sales tax context (including the EU, see above) that for physically and digitally delivered products it is the jurisdiction of the consumer where the transaction takes place that should be able to collect sales tax on that sale, the same is not true for profits tax. Why? Because it’s not currently clear how much—if any—value the market
jurisdiction creates. And we are a very long way from any—even emerging—international consensus on this.

To be sure you need to be able to sell your goods and services to generate any profit at all, but over and above the tax on the transaction (i.e., sales tax) should there be an automatic profit allocation to the jurisdiction of the consumer?

It is well established that putting capital at risk, creating intellectual property, providing legal protection, and directing the activities of the business all play a significant role in creating value and generating profit. And it seems only fair that the jurisdictions that encourage that activity, and sometimes support it with incentives such as the Research and Development Credit, should be able to tax the profit created by those activities.

To be clear, I am assuming BEPS measures (and GILTI) have led (or will lead) to a much closer alignment of taxation with where value-creating activities take place.

So while the OECD discussions on digital may result in a new consensus on value creation and/or the allocation of jurisdiction to tax profits, the Wayfair case is not a good guidepost on the question of where, and how much, profit (whether earned by a ‘digital’ or ‘traditional’ business) should be taxed under international corporate income tax rules.

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