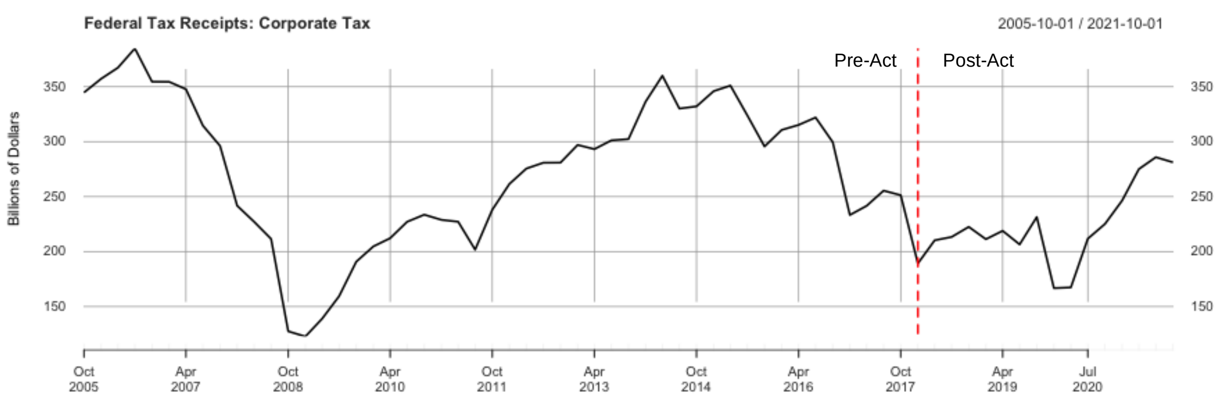
INDIANA REVENUE THEORY, LLC

1315 10th St, Room A203
Bloomington, IN 47401

TO: ZACHARY Q. JACKSON, INDIANA STATE BUDGET DIRECTOR
FROM: JACOB ALDER, TAX ANALYST
DATE: APRIL 10, 2022
RE: CORPORATE INCOME TAX: IMPACTS OF DIGITALIZATION

Digitalization of the global economy has had, and will continue to have a significant impact on taxation worldwide. This memorandum summarizes various effects of digitization on the corporate income tax (CIT). For brevity, I focus only on the United States. After a review of current corporate tax policy, I cover two brief sections: (1) positive effects and (2) negative effects, then conclude with a reflection on possible tax strategies to improve corporate taxation in a digital era.

For nearly three decades prior to 2018, the United States had a CIT rate of 35 percent. The passage of P.L.115-97[1] in late December 2017 restructured U.S. corporate and international tax policy. Among other major modifications, it permanently cut the CIT rate to 21 percent. This reduced the effective CIT rate by nearly half and was projected to reduce tax revenue by $1.5 trillion (Gravelle and Marples, 2017). The following figure, adapted from a report on federal tax receipts by the U.S. Bureau of Economic Analysis, shows the Act's impact on tax collection. The figure shows quarterly data, plotted at six-month intervals on the federal fiscal year calendar.



Note: Federal U.S. corporate income tax receipts from FY 2006 Q1 (selected for pre-Great Recession trend) to FY 2022 Q1; dashed vertical line indicates tax receipts in the first full quarter after the passage of P.L. 115-97. Figure adapted from public tax data from the U.S. Bureau of Economic Analysis. B075RC. Retrieved from FRED, Federal Reserve Bank of St. Louis, April 8, 2022.

POSITIVE EFFECTS OF DIGITALIZATION

Digital services encompass an increasing share of corporate revenue. Concurrent with policymakers' effort to tax corporations at a lower rate, corporations have accelerated digital strategies. Over the past decade, hundreds of corporations engaged primarily in durable-goods exchange have migrated entire sectors online, while thousands of new businesses have cropped up with successful tech-first approaches. Most agree that digitalization is a net-positive in both the U.S. and the global economic landscape; for example, robust digital services enabled whole sectors of the U.S. workforce to move remote during the COVID-19 pandemic, a major component of the

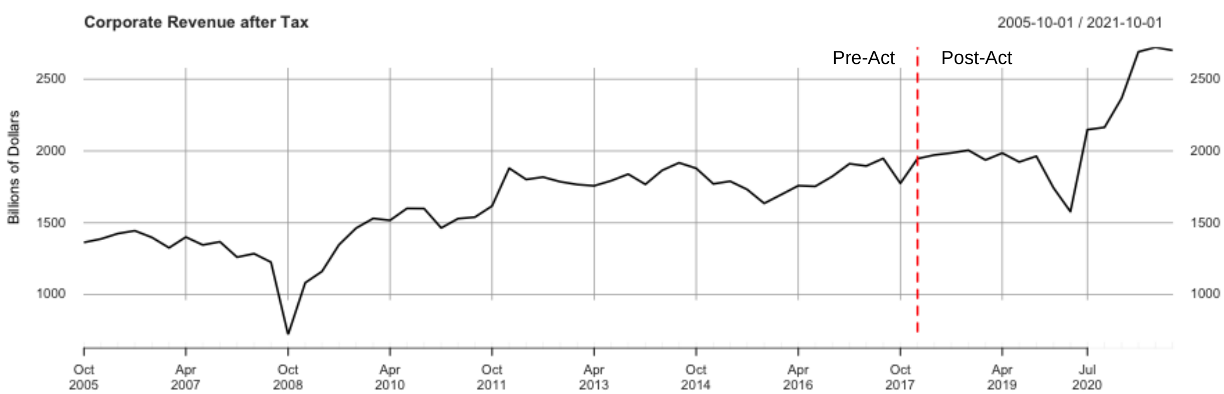
[1] Variously known as the "Tax Cuts and Jobs Act" and "Trump Tax Cuts." Hereinafter referred to as the "Act."

nation's speedy economic recovery. Advanced digital services are a practically non-negotiable function of corporate success in the 21st century.

These changes bring noticeable benefits to government revenue collection. Digitalization enables vastly improved tax filing and processing speed, compared to antiquated paper filing. Automation, too, on both the IRS and corporate side reduces human errors that can delay both tax revenue and returns. Generally, digitalization reduces the overhead costs associated with tax compliance that might have prevented small, capital-strapped businesses from filing error-free and on-time twenty years ago (Agrawal and Fox, 2021). All of this contributes to the IRS's improved ability to provide forecasting agencies with higher quality data to develop more accurate revenue and budget predictions.

NEGATIVE EFFECTS OF DIGITALIZATION

On the other hand, digitalization has outpaced new tax policy. By lowering barriers for corporations to enter the global e-commerce marketplace, widespread digitalization has accelerated globalization and corporate revenues. This conundrum raises a major hurdle for tax administrators: should taxes be applied based on transactional destination or the transaction's origin? The following figure illustrates increasing year-over-year corporate revenue (with a dashed line denoting pre- and post- passage of P.L. 115-97). In the absence of unified taxes on digital services, corporate profits have soared.



Note: Corporate income after-tax from FY 2006 Q1 (selected for pre-recession trend) to FY 2022 Q1; dashed vertical line indicates tax receipts in the first full quarter after the passage of P.L. 115-97. Figure adapted from public tax data from the U.S. Bureau of Economic Analysis. A055RC. Retrieved from FRED, Federal Reserve Bank of St. Louis, April 8, 2022.

The U.S. Supreme Court ruled on this issue in *South Dakota v. Wayfair* in 2019. Following the Court's ruling, each state must determine its own interpretation of the threshold over which a company meets "economic nexus" (Bengali, 2021). Once met, the company must pay the CIT. However, state definitions vary widely (Agrawal and Fox, 2021).[2] Many corporations have taken advantages of such implementation loopholes and are able to largely skirt the corporate income tax by incorporating in different states or shifting transactions through a low-tax state.[3] Other corporations flood the IRS with erroneous tax filings, capitalizing on anonymity due to the sheer

[2] Four states (Delaware, Montana, New Hampshire, Oregon) have no threshold. Otherwise, each state established a minimum transaction threshold between $100,000, with several allowing up to $500,000 in sales before establishing economic nexus.

[3] Denning, S. "Why Amazon Pays no Corporate Taxes." February 22, 2019, *Forbes.* https://www.forbes.com/sites/stephaniedenning/2019/02/22/why-amazon-pays-no-corporate-taxes/?sh=7256736f54d5

breadth and volume of returns the IRS has to process. Indeed, digitalization enables billions of dollars of tax evasion each year (Alm, 2021; Kitsios et al., 2022).

Developing Robust Taxation in the Digital Era

Scholars, tax experts, and policymakers in most European countries, as well as Russia, China, and many emerging countries are working to develop effective corporate taxes on digital services. One particularly intriguing policy from a joint committee on taxation at Oxford, comes in the form of a Destination Based Cash Flow Tax (DBCFT). The DBCFT reduces origin distortion by taxing cash flow through border adjustments (Auerbach et al., 2017). Similarly, several scholars propose a uniform, global digital services tax (Bach, 2020; Cui, 2019; Hanrahan, 2021; Kitsios et al., 2022).

Conclusion

Tax administrators in the U.S. need to define corporate taxes in a way to capture increased profits and transactions from digitalization. Many countries find themselves similarly stretched to catch up with the pace of digitalization which fuels growing corporate profits. Recent declines in corporate tax revenue stem from both lenient tax policy and increased digitalization. This combination makes corporate revenue simultaneously harder to track and the tax easier to evade.

References

Agrawal, D.R., Fox, W.F., 2021. Taxing Goods and Services in a Digital Era. Natl. Tax J. 74, 257–301. https://doi.org/10.1086/712913

Alm, J., 2021. Tax evasion, technology, and inequality. Econ. Gov. 22, 321–343. https://doi.org/10.1007/s10101-021-00247-w

Auerbach, A.J., Devereux, M.P., Keen, M., Vella, J., 2017. Destination-Based Cash Flow Taxation (SSRN Scholarly Paper No. 2908158). Social Science Research Network, Rochester, NY. https://doi.org/10.2139/ssrn.2908158

Bach, J., 2020. International Taxation of Digital Economies: Impact of Digital Business Models on Existing Conventional International Taxation Approaches 79.

Bengali, L., 2021. How Does Changing the Statutory Incidence of Sales Tax Affect Reporting and Tax Collection? The Wayfair Decision and AB 147 8.

Cui, W., 2019. The superiority of the digital services tax over significant digital presence proposals. Natl. Tax J. 72, 839–856. https://doi.org/10.17310/ntj.2019.4.09

Gravelle, J.G., Marples, D.J., 2017. The Economic Effects of the 2017 Tax Revision: Preliminary Observations 22.

Hanrahan, D., 2021. Digitalization as a Determinant of Tax Revenues in OECD Countries: A Static and Dynamic Panel Data Analysis. Athens J. Bus. Econ. 7, 321–348. https://doi.org/10.30958/ajbe.7-4-2

Kitsios, E., Jalles, J.T., Verdier, G., 2022. Tax evasion from cross-border fraud: does digitalization make a difference? Appl. Econ. Lett. 0, 1–7. https://doi.org/10.1080/13504851.2022.2056566