



UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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**VIA EMAIL**

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**Re: USCIB Comment Letter on the OECD's request for input on work regarding the tax challenges of the digitalized economy**

Dear Mr. Bradbury,

USCIB<sup>1</sup> appreciates the opportunity to comment of the OECD's request for input on work regarding the tax challenges of the digitalized economy (hereinafter "RFI"). USCIB requests the opportunity to present comments at the public consultation on November 1, 2017.

**General Comments**

USCIB is cognizant of the tremendous political pressure to move forward on taxing the digitalized economy. We recognize the concern that as remote sales activities increase, countries may consider re-evaluating the traditional rules splitting income between the so-called "source" and "residence" countries. It needs to be clearly understood that there is only one "pie" and if countries take a larger share of the "pie" on the basis of the market, they also must agree to relinquishing some of the "pie" previously allocated to other functions, assets and risks. The newly revised Transfer Pricing Guidelines<sup>2</sup> (hereinafter "2017 TPG's") continue to base transfer pricing between related parties on an analysis of functions, assets, and risks. If

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<sup>1</sup> USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

<sup>2</sup> [OECD 2017 Transfer Pricing Guidelines](#)

anything, the 2017 TPGs emphasize the performance of people functions over other aspects of the FAR analysis. Chapter 6 of the 2017 TPGs provides:

This Section B confirms that the ultimate allocation of the returns derived by the MNE group from the exploitation of intangibles, and the ultimate allocation of costs and other burdens related to intangibles among members of the MNE group, is accomplished by compensating members of the MNE group for functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles according to the principles described in Chapters I - III.<sup>3</sup>

To the extent that any new method of allocating profits is inconsistent with the 2017 TPGs, countries that are negatively affected would need to agree that the new rules would be coordinated with the 2017 TPGs and how this coordination would occur.<sup>4</sup> This is why unilateral measures would be so destructive; the inconsistency would not to be resolved, some countries would be applying the 2017 TPGs with their emphasis on the place of performance of income producing activities while other countries – those adopting unilateral measures – would be using a different standard to determine tax nexus and returns for enterprises delivering digital goods or services.

Consistent with the OECD's conclusion that the digital economy is the economy, we understand that this re-evaluation will impact the total economy, not just the current digital economy. Some countries and trading blocks are already implementing or considering unilateral measures. In our view, unilateral measures will be extremely damaging and, because they will increase costs to supply those markets, may adversely impact economic development and increase costs to consumers. Unilateral measures would likely result in double taxation, decreased trade, and reduced global growth. If a new global consensus is to be reached on the general allocation of taxing rights, it will require sustained effort over a number of years to balance the interests of both countries and businesses. In our view, it is also likely to require considerable additional thinking on taxation principles since the proposals that have been considered previously (as discussed in detail below) are deeply flawed.

As the Action 1 Final Report (hereinafter "Final Report") points out, the broader tax challenges of the digital economy intersect with several other BEPS action items.<sup>5</sup> The Final Report<sup>6</sup> further points out "it is expected that the implementation of the BEPS measures will substantially address the BEPS issues previously identified with respect to the digital economy." The Final Report identifies specific aspects of other BEPS measures that may have an impact on the digital economy, including changes to the definition of a permanent establishment, and

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<sup>3</sup> IBID, Chapter VI.B.6.32, page 258.

<sup>4</sup> The guidance on intangibles is so important because the goal of this re-evaluation of the split between so-called "source" and "residence" countries is to allow a country a claim to tax the excess rents generated by MNEs.

<sup>5</sup> [Action 1 Final Report](#), Chapter 9.4, paragraph 352, page 135.

<sup>6</sup> IBID, at Chapter 9.4, paragraph 353, page 135.

concludes that: “As a result, the expected impact of the tax BEPS measures needs to be taken into account when evaluating the extent of the broader tax challenges and the options to address them.”<sup>7</sup>

The multilateral instrument that would implement key portions of the BEPS package – including all the PE measures -- has only just been signed and is not yet in effect. Although the Transfer Pricing Guidelines have been updated, there remain important pieces of that work that are still being debated. Countries and companies are changing their tax laws and tax reporting as a result of the other BEPS action items. Therefore, it is not now possible to take into account the impact of the BEPS measures in evaluating the broader tax challenges and the options to address them.

Further, the Final Report<sup>8</sup> recommended improvements to the collection of VAT as an important part of addressing tax challenges of the digital economy. Working Party 9, in conjunction with the technical advisory group (hereinafter the “VAT/TAG”), has been addressing these challenges and is beginning to address the practical difficulties associated with the collection of VAT in the context of digital platforms. This work is likely to substantially increase collection of VAT that is due under current law. Many countries have enacted or are considering extra-territorial VAT registration and collection obligations for nonresidents and business is making the significant investments required to comply with these obligations. Many of the VAT issues, including the platform issues, may be replicated by a tax – whether a turnover tax, a withholding tax or an equalization levy – that imposes a gross basis tax.<sup>9</sup> Beginning a separate process to evaluate the same issues is not likely to speed up the work and may result in inconsistent outcomes, which would only create multiple levels of taxation, additional costs and complexity.

While RFI cites the G7 and G20’s support for the work of the TFDE, the RFI does not point out that the primary economic goal of the G7 and G20 is encouraging global growth.<sup>10</sup> USCIB is concerned that the proposals -- particularly those that impose gross basis taxes and therefore do not account for significant costs that may be imposed in the absence of any profits – may have a significant negative impact on growth. This would particularly be the case if the gross basis taxes did not provide credit refunds similar to VAT and, therefore, would actually be cascading at every level. Significant unilateral shifts in net basis taxation will also increase controversy, require more resources devoted to dispute resolution, and increase double tax costs (if disputes cannot be resolved due to the lack of agreed upon standards), resulting in a

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<sup>7</sup> IBID, at Chapter 9.4, paragraph 355, page 136.

<sup>8</sup> IBID at Chapter 8.2, paragraph 321, page 122.

<sup>9</sup> USCIB believes that proposals that are designed to impose a gross basis tax in lieu of a corporate income tax look like VATs with a different name. We understand that in theory the VAT is supposed to be a final tax on household consumption and therefore is it politically extremely difficult to simply increase the VAT. Nevertheless, gross basis taxes, regardless of the name, may be passed onto the final consumer (and if they are not, they may reduce the trade and global growth).

<sup>10</sup> [G20 Leaders Declaration](#), third paragraph.

profound negative impact on growth. Smaller markets will suffer most because the additional costs will be a higher percentage of the revenue opportunity. The imposition of taxes in a manner inconsistent with the existing international framework, in the absence of a new broad-based consensus, will result in double taxation and reduced trade and investment.

### Detailed comments

Section D of the RFI requests comments on the potential options outlined in the Final Report.<sup>11</sup> These options are: imposing net taxation based on a tax nexus that relies on a significant economic presence rather than the traditional concept of permanent establishment; a withholding tax on certain digital transactions; and an equalization levy on certain digital transactions. The questions in this section presume that each of these taxes can be made to work in a principled manner – which would require significant additional changes to all the options or to the historical tax policy principles. We believe that the principles enunciated in the Final Report ought to be applied to determine whether such an approach is appropriate.

The Final Report set forth an agreed upon framework starting from the basic tax principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, and proportionality. These are the longstanding (from 1998) Ottawa principles with the addition of sustainability and proportionality. We do not repeat the definitions of these terms here, they can be found in the Action 1 Final Report Chapter 9.3 Framework to Evaluate the Options, paragraph 351, page 134.

USCIB believes that each of the enumerated options should be analyzed under these principles to determine whether taxation under these options meets these principles. In our view, the identified options do not satisfy these principles and therefore should not be adopted, particularly since the impact of the BEPS measures cannot yet be effectively measured.

### Neutrality

As the Final Report points out “attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not.”<sup>12</sup> The questions with respect to each of the options starts with a question asking where this line should be drawn. USCIB agrees with the Final Report; wherever the line is drawn will be arbitrary and that arbitrary line will create different results for similarly situated taxpayers. Thus, the neutrality principle will be violated for all the options because of the necessity of drawing arbitrary lines. The significant economic presence option starts with a revenue factor that would apply the new nexus test to taxpayers above a certain revenue threshold. This

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<sup>11</sup> Chapter 7.6 of the Final Report lays out the three different options. The EU is apparently considering a turnover tax, which is not one of the options set forth in the Final Report. So far, no details are available with respect to the EU proposal, so we do not analyze it here.

<sup>12</sup> Chapter 10.1 paragraph 364, page 42. This is also consistent with the fundamental conclusion of the Final Report, that the digital economy cannot be ring-fenced. USCIB strongly supports this conclusion.

would effectively function as a cliff, with very different results for those just below or above the threshold (which would itself be arbitrary) and therefore not neutral.

A new nexus test that determines significant economic presence test based on factors other than the location of functions, assets and risks of the taxpayer will require a new model for attributing income. Such a new model would also violate the neutrality principle unless the new factors were also applied broadly to all businesses and not just digitalized businesses. As more companies become digitalized the new model would will expand to eventually cover the entire economy, which may reduce the neutrality issue but effect a complete change in the taxation of all multinational corporations.

### Efficiency

Under the efficiency factor, the benefits of the proposal should outweigh the costs of its adoption including transitional and implementation costs.<sup>13</sup> It is difficult to evaluate the efficiency factor with respect to the significant economic presence and equalization levy given the high-level nature of the proposals and the lack of a definition of the benefits of the proposal. Presumably the “benefit” of the proposal is the increased tax collected by the market jurisdiction. Can this be considered a “benefit” if the tax is imposed unilaterally such that the transaction is potentially subject to double taxation? On the cost side, it is difficult to estimate even the cost of designing new systems to comply with new obligations when there is so little detail. Using current transfer pricing principles, it is difficult to understand how tax nexus based solely on revenue will significantly increase tax collections, resulting in little benefit from a significant disruption in the current tax system.

With respect to the withholding tax, the efficiency principle is likely to be violated. In many cases, the withholding tax might be imposed on business to consumer transactions. Collection would be unlikely at best and if individuals did withhold these taxes the cost of collection could easily exceed the amount of tax due.

### Certainty and Simplicity

As to certainty and simplicity factors, again there is very little detail, so these factors are difficult to evaluate under the circumstances. However, under the significant economic presence option there would probably need to be either some form of formulary apportionment that includes a sales factor or another deemed profit measure. These are unlikely to be simple and without agreement among countries on how profits would be apportioned, there is likely to be both double taxation and gaps. For example, a country that has a small market and wishes to attract manufacturing might give sales a disproportionate weight to shift income away from the manufacturing activities that it hopes to attract. Without agreement among its trading partners, this might result in untaxed income. Conversely, a country with a large market might also disproportionately weigh sales in a way that might

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<sup>13</sup> Final Report, Chapter 9.3, paragraph 351, page 134.

double tax manufacturing that is occurring outside of its borders. This might be a disguised restraint on trade, that is an attempt to require manufacturers to manufacture locally goods for the local market to avoid double taxation of the company's manufacturing income. Current formulary apportionment systems illustrate the issues with consistent and fair application of the general apportionment framework, often resulting in double taxation.

Deemed profit measures would also be likely to require detailed analysis of the activities of a particular industry and agreement among countries to achieve results that avoid double taxation and double non-taxation. This is unlikely to produce either certainty or simplicity.

With respect to withholding taxes, the Final Report<sup>14</sup> does a good job of identifying some of the difficulties associated with imposing a withholding tax. The transactions to which it applies must be clear and the scope defined as simply as possible (multiple rates for different types of transactions should be avoided). The Final Report<sup>15</sup>, however, suggests that because of the possibility of imposing the tax when there is no income that withholding rates might be determined based on typical profit margins in domestic industries and the withholding rate could be adjusted to reflect those profit margins. This would likely lead to varying rates and perhaps the need to change rates over time – not a prescription for either certainty or simplicity.

The most difficult issue with a withholding tax – particularly one which is intended to address direct sales to consumers by non-residents of the market jurisdiction – is the absence of an appropriate person on which to impose the withholding and remittance obligation. Consumers are unlikely to be able or willing to comply, so tax collection would be very uncertain. It would also be very difficult to require a financial intermediary to withhold because the intermediary is unlikely to have the information available to determine whether withholding is required. Therefore, imposing a withholding tax on an intermediary would likely violate the certainty principle.

These questions are being addressed in the context of the work of Working Party 9 and the VAT/TAG, which is considering how platforms operate and whether a combination of information reporting and simplified registration and payment of the tax due can achieve the desired outcome of correct imposition of destination based VAT without overpayments and negative impacts on cross-border trade.

With respect to the equalization levy, the Final Report<sup>16</sup> suggests that a significant business presence would be necessary before the equalization levy would apply and further suggests different additional tests that could be adopted depending on the policy goals of the country implementing the equalization levy. Two additional tests that are mentioned are one based on monthly active users and the volume of data collected. The Final Report acknowledges that the

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<sup>14</sup> Chapter 7.6.3, paragraph 292 et seq., page 113.

<sup>15</sup> Chapter 7.6.4.1 paragraph 303 et seq., page 116.

<sup>16</sup> Chapter 7.6.4, paragraph 302 et seq., page 115.

suggested additional tests would be difficult to apply in practice because measuring either of these items may be challenging. Thus, the equalization levy is unlikely to be certain or simple in its application.

### Effectiveness and Fairness

The standard for effectiveness and fairness provides that “taxes imposed should produce the right amount of tax at the right time.” That “who may bear the ultimate burden of the tax and in what proportion” is important in assessing fairness. An ineffective tax (one that is difficult to enforce) “is unlikely to be either equitable or neutral and may undermine the public perceptions of the whole system in the long term.”<sup>17</sup>

Unilateral changes to fundamental tax principles are unlikely to produce the “right amount of tax at the right time”. Rather such unilateral taxes are likely to produce inconsistent results that will be damaging to trade among countries. Annex E of the Final Report (which analyzes the incidence of taxation) “assumes that a significant number of countries impose these changes in a global coordinated step.”<sup>18</sup> Incidence might be more difficult to determine if countries act unilaterally. Thus, it might be very difficult to determine who bears the ultimate liability for the tax and whether that burden is fair or proportionate.

The difficulties associated with the proposed taxes have been discussed in the efficiency section of this letter.

### Flexibility and Sustainability

USCIB believes that to the extent that the changes rely on defining a significant business presence (which both the changes to the PE rules and the equalization levy do), the changes may become obsolete. The evolution of the permanent establishment rules is evidence that business is constantly changing. Designing a new standard for business presence based on the way business is done today may similarly become obsolete in the relatively short term.

The withholding tax is less subject to obsolescence, but the difficulties with imposing tax when there is no profit and collecting tax on sales to consumers would remain substantial obstacles.

### Proportionality

USCIB strongly agrees with the conclusion of the Final Report that the digital economy cannot be ring-fenced. As a corollary, any rules designed to address the tax challenges of the digitalized economy should apply broadly.

The BEPS project was intended to align taxation with value creation. USCIB believes that, although information and communications technology has allowed all businesses to become more efficient and has provided enormous benefits to society, the fundamental aspects of

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<sup>17</sup> These quotations are from Chapter 9.3, paragraph 351, page 134.

<sup>18</sup> Annex E.4.1.1, paragraph 15, page 278.

running a business have not changed. Most businesses fail. Businesses that do succeed do so because they do certain things well. They identify a business opportunity, develop (including R&D and manufacturing) a product or service that fills that need, market that product or service, and deliver it to customers.

A retailer of LPs once shipped LPs to consumers using the postal service. An online provider of song downloads now uses ICT to deliver songs to consumers over the internet. The fundamental business model of finding and developing artistic talent, marketing, and delivering musical content to consumers remains the same. Similarly, a software developer and manufacturer once shipped software on disk or CD directly to consumers or retailers. This same developer and manufacturer may now provide access to this software online. The fundamental business model of developing, delivering and supporting software for use by consumers remains the same. While the “Cloud” may sound intangible, Cloud services are supported by tens of \$billions in annual physical investments by Cloud businesses in network infrastructure, datacenters, servers and all the support requirements. These investments are funded by business and provide incredible low-cost economic development opportunities to developing economies, small business, start-ups and governments.

### Conclusion

USCIB understands concerns about eroding tax bases and the political pressure to address those concerns. We believe, however, as explained above, that the measures proposed in the Final Report are all deeply flawed, which was why none of the proposals was recommended by the Task Force on the Digital Economy. As the economy becomes more digitalized, enabling more small business and start-ups to compete in the global market, these proposals will effectively represent fundamental changes in all business taxation and create significant impediments to growth for companies unable to afford the related administrative and tax costs. If the Task Force is to move forward with a proposal, we believe that it must start fresh with new ideas for comprehensive reform.

Sincerely,

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