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VIA EMAIL

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**Re: USCIB Comments on HM Treasury's position paper on Corporate Tax and the Digital Economy**

Dear Mr. Power,

USCIB<sup>1</sup> is pleased to have the opportunity to comment on HM Treasury's position paper on Corporate Tax and the Digital Economy (hereinafter "position paper or paper").

USCIB believes that the most important goal of the international tax system should be to encourage global growth, trade, and investment. USCIB also believes that this goal is furthered by a multilateral approach to dealing with the international tax challenges posed by the digitalized economy.<sup>2</sup> USCIB, therefore, opposes unilateral international tax measures that attempt to target the digital economy as such measures will create impediments to growth, trade and investment.

USCIB supports the position paper's focus on taxing the income of multinational enterprises based on where value creating activities take place. We also welcome the (related) acknowledgment that "countries should have the right to tax business profits derived from productive activities, enterprise and human innovation in their jurisdiction, irrespective of where shareholders and customers are located."<sup>3</sup>

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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> USCIB strongly agrees with the conclusion of the Action 1 Final Report that the "digital economy" cannot be ring-fenced; that the entire economy has been digitalized.

<sup>3</sup> Position paper, paragraph 2.7. Although this strong statement is undercut by the proposals relating to "royalties". USCIB will address our concerns with this topic in a separate letter in response to the consultation on royalties withholding taxes.

We are concerned, however, that the position paper sets forth a long-term solution based on the value created by users that creates the impression that it is fixed in its general contours<sup>4</sup>, even though it not the result of a multilateral process. The position paper may give businesses and other countries the impression of rigidity when it is important to move forward in a multilateral fashion. Multiple sets of rules may reduce global growth, trade and investment because of friction between different systems; alternatively, multiple sets of rules may create new opportunities for BEPS as the different responses to the tax challenges create new gaps that may be exploited.

The proposed solution also appears to target digitalized business models. The recommended approach assumes that user participation is limited to digitalized business models when, like many digitalized practices, it may be primarily a digital evolution of legacy business objectives of forming relationships with their customers. Attributing significant value to user participation, based on business models that are only a few years old and undergoing constant evolution, seems premature and such a policy decision should benefit from additional analysis and history.

### The International Tax Framework -- Transfer Pricing, Profit Splits, and Formulary Apportionment

In describing the international tax framework, the position paper begins with this question:

The important question when applying corporation tax to a multinational group is what amount of profit should be taxed in the UK compared with other countries in which the group operates.<sup>5</sup>

The position paper then states that under the current international tax framework:

“a multinational group’s profit is divided between its constituent companies in accordance with those companies’ contributions to the generation of profit.”<sup>6</sup>

These statements imply a computation of global profit, and an allocation of that profit based on relative contributions. In most cases, this is not an accurate description of how transfer prices (and therefore profits) are currently determined. Transfer prices are determined on the separate entity principle and the application of the arm’s length standard. Individual companies may have profits (or losses) while the overall group has losses (or profits); the global profit of the group is not relevant to the determination of the appropriate transfer price or the income of a company within the group. Even where profit split is the appropriate method, the profit to be split is transactional and not global, so the comparing the profit in the UK to other countries in which the group operates is not relevant. Profit split computations often look first

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<sup>4</sup> The general contours are: reward the value of generated by user participation, give countries a right to tax such material participation even in the absence of a permanent establishment, and allocate an amount of profit among market countries based on a metric such as monthly active users.

<sup>5</sup> Position paper, paragraph 2.1.

<sup>6</sup> Position paper, paragraph 2.3. The statement concerning the allocation of profits under the permanent establishment rules is more in line with the current framework because it limits the division of profits to the profits of the head office and the permanent establishment.

to exclude routine profits, calculated using traditional one-sided transfer pricing methods, from the residual pool of profits to be split only between those entities qualifying for a share of the residual profits because they contribute unique and valuable intangibles to the transaction. Looking at global profit of the group and apportioning that profit among countries would move the international tax framework to global formulary apportionment, which countries have repeatedly rejected.

USCIB believes this mischaracterization of the current framework distorts the analysis throughout the rest of the position paper.

### Challenges to the Current Framework

#### *Continued Risk of Base Erosion and Profit Shifting*

The position paper acknowledges the significance of the BEPS project.<sup>7</sup> USCIB members agree that the changes are significant and have had an impact on tax planning, including group structures, IP location, and transfer pricing. We also note that the BEPS Final Reports were issued at the end of 2015; that the Multilateral Instrument, which will make significant changes to the operation of tax treaties is not yet in effect; that the first country-by-country reports have only just been filed; and that generally the BEPS implementation process is still in the early stages and is ongoing. It is therefore difficult to gauge at this stage what “important weaknesses”<sup>8</sup> remain.

The position paper identifies a number of challenges that remain including: applying the arm’s length standard where no comparable arrangements exist between unrelated parties; whether the BEPS changes are being administered in a way that prevents profits from being realized in low-tax jurisdictions in the absence of “true economic substance”; the extent to which tax authorities have the requisite information on the global value chain; the extent to which countries are exposed to risks of “manufactured tax outcomes” such as the attribution of a large amount of profit that is determined by the location of a small number of mobile and replaceable individuals taking decisions regarding the deployment of capital or the management of risk within a group.”<sup>9</sup>

The position paper points out that these issues are not unique to the digital economy, but posits that digitalization exacerbates these issues.<sup>10</sup>

USCIB is concerned that the position paper would like to revisit issues that were decided in the context of the BEPS framework. The BEPS action items reports include both minimum standard and optional actions for country implementation to address these issues. There are two concerns with revisiting these issues at this stage. First, because implementation of the BEPS

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<sup>7</sup> Position paper 3.3.

<sup>8</sup> Position paper 3.4.

<sup>9</sup> Position paper 3.5. All the issues mentioned are identified in paragraph 3.5.

<sup>10</sup> Position paper 3.7.

outcomes is still in the early stages, it is not and cannot be clear what the outcome of those decisions is and whether there are unacceptable “manufactured tax outcomes” remaining and if so what they are. Much of the BEPS work was directed at ensuring that taxing rights followed value creation. To the extent that these additional concerns relate to the administration of the BEPS standards, it is necessary to give countries the time to implement these standards and options and to give the rules time to work. The BEPS information reporting standards – including the country-by-country reports<sup>11</sup> and the automatic exchange of tax rulings – should lead to identifying problem areas, including those related to lack of implementation and improper administration by countries.

Second, some of these points seem to seek to reverse clear decisions made in the OECD/G20 BEPS process. Like any process involving a large multilateral group, all of the participants in that process have made compromises to reach agreement. Quickly reversing those decisions, especially if done unilaterally by one or more of the participants, will undercut the ability to work in a multilateral setting going forward. The transfer pricing guidance provided new and complex rules concerning returns for intangibles, cost-sharing and risk. This guidance was developed with full recognition of the digitalization of the economy and many of the rules significantly impact digitalized business models. The position paper seems to question the suitability of these rules, by suggesting that intangibles and risks can be located in low-tax countries without “true economic substance”. The BEPS standards were intended to define the substance necessary for a party to be treated as being entitled to the return on an intangible (the DEMPE functions) and which party or parties are entitled to the risk related return based on control of the risk and the economic capacity to bear the risk. These standards are intended to define “true economic substance”. If these activities take place in a low-tax jurisdiction, then those parties are entitled to the return, regardless of the tax rate. BEPS participants recognized that many activities do take place in low-tax jurisdictions and those investments may increase as a result of the DEMPE and other rules. Retreating from the BEPS standards and adopting more onerous rules unilaterally, will increase the likelihood of double taxation as different standards proliferate.

### *User Participation in Digital Business*

The position paper states that users in a digital business may “create material value for a business through their sustained engagement and active participation.”<sup>12</sup> The position paper posits a social media platform that provides a free online platform to users and monetizes the value of that user base through directing advertising at those users. This does not seem any

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<sup>11</sup> The country-by-country reports are not to be used to determine transfer prices, but are to be used for high-level risk assessment. The OECD pilot ICAP project may provide a way to address some of the concerns mentioned in the position paper. In particular, adopting multilateral audit procedures may result in countries evaluating transfer pricing (and other cross-border issues) in ways that ensures appropriate outcomes and not “manufactured tax outcomes”.

<sup>12</sup> Position paper, paragraph 3.16.

different from television networks or print media selling advertising because they have access to an audience. Television and print media have used tools (e.g. Nielsen surveys) for decades to measure audience participation for purposes of targeting advertising.

The position paper also argues that an online marketplace that generates commission revenues through matching suppliers and purchasers of goods is reliant on the active involvement of users to generate revenue. While this is true, it does not necessarily follow that it is appropriate to attribute income of the online marketplace to the country in which the suppliers and purchasers reside. The availability of the online marketplace may have already increased the income subject to tax in the country of the supplier/purchaser because the online marketplace may both increase the demand for goods and services being offered on the marketplace and as the result of the increased demand, increase the price of those goods or services. This increase in sales and sales prices may reflect the value attributable to the active involvement of the local participants. Many of these transactions would not take place in the absence of the online marketplace, regardless of the presence of buyers and sellers.

The position paper also seems to downplay investments and risks that companies must make to create user participation. Companies must anticipate technological developments, develop products, provide customer service, in the face of significant competition for users. To compete effectively, companies invest billions in research and development, seek out acquisition targets, incur significant traffic acquisition and other costs. The position paper cites low marginal costs that are associated with running a platform<sup>13</sup>, while marginal costs may be low, the investment required to design and maintain an online platform are significant and ongoing. User participation should not be elevated with respect to other value creation components without more analysis and observation of how digitalized economy businesses create value.

The position paper glosses over the difficulty of distinguishing active participants from mere users. The position paper seems to take the position that merely streaming movies or music would not make one an “active user”, but how would that line be drawn? Assuming that distinction can be made, it would then be necessary to define a test for comparing active users across borders. Companies do try to determine their active users, but different companies use different standards and even within one company, different standards are used for different lines of businesses. In order to determine a valid number, it would be necessary to screen out multiple accounts for the same user and accounts that are not legitimate accounts.<sup>14</sup> Users can also browse the internet anonymously through use of virtual private networks, which would make identifying a user’s location very difficult. Measured at this level, countries may find that user/participants in other jurisdictions would require an outbound profit allocation to other

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<sup>13</sup> Position paper, paragraph 3.20.

<sup>14</sup> There might even be concern that some might attempt to manipulate these accounts to shift income into one country or another. The attached article, while not related to taxes, discusses the use of bots to inflate the appearance of followers. See [NY Times reporting](#) on fake social media accounts.

jurisdictions. The digitalization of the economy, requiring significant investment in additional networks, computing power, and Cloud services will enable increased user participation for digitalized businesses in all countries. This analysis will be highly subjective, complex and increase the probability of double taxation. The principles of reciprocity that underlie the historical compromises made to create the current international corporate income tax system will soon apply to the digitalized economy as well.

## The Government's Approach

### *Long-term Reform*

USCIB supports the paper's call for "broad international acceptance"<sup>15</sup> of the need for international reform, and agreement on a process and timetable for international reform. Especially given the early stages of this debate, it is important to avoid the appearance of a pre-ordained result. That is, while the impact of user participation may be considered, a unilateral approach whether based on user participation (or any other approach) should be avoided. USCIB agrees that the historical multilateral approach remains necessary for the digitalized economy. The UK needs to consider the views of the international community, including business if an appropriate result is to be reached.

### *Interim Digital Solutions*

The position paper expresses the UK government's support for an interim solution<sup>16</sup>. The focus is again on user participation<sup>17</sup> but the design elements, while sketched out, lack detail. USCIB appreciates that the UK government is looking to a multilateral process led by the OECD for guidance.<sup>18</sup> We strongly prefer a multilateral approach, nevertheless designing an effective and fair interim solution may require significant time and resources, such that it would make more sense to devote those resources to designing an appropriate long-term solution. We are also concerned that interim solutions have an unfortunate tendency to become permanent, so the long-term solution becomes in addition to rather than in lieu of the interim solution.

USCIB is also concerned that the interim solution, although lacking detail, contemplates a gross-basis tax of some sort. We strongly object to gross basis taxes which may tax companies when there are no profits and which may violate nondiscrimination principles and therefore may raise concerns that they violate both tax and trade agreements.

We would strongly urge the UK to avoid interim solutions.

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<sup>15</sup> Position paper, paragraph 4.1.

<sup>16</sup> Position paper, paragraph 4.9.

<sup>17</sup> Position paper, paragraph 4.10.

<sup>18</sup> Position paper, paragraph 4.12.

### *Preventing under Taxation*

USCIB will address concerns with these proposals in the context of the separate consultation on Royalties Withholding Tax.

### VAT

The position paper discusses some VAT changes that have already been adopted<sup>19</sup> and others that are being considered to deter fraud and improve collection of VAT with respect to sales via online marketplaces.<sup>20</sup> USCIB has been working with the OECD Technical Advisory Group for many years to improve the operation of the VAT, which benefits both governments and businesses. Business remains an active participant in countries' implementation of extraterritorial VAT registration, collection, and remittance as recommended by the OECD's report on Action 1 - The Tax Challenges of the Digital Economy. We support steps that reduce fraud and improve collection, while taking into account the limitations of business in a complex value chain.

The discussion of VAT also raises the possibility of imposing VAT on value-for-value barter transactions, if an appropriate interim solution cannot be worked out.<sup>21</sup> USCIB believes attempting to impose VAT on what is now free use of the internet, would create significant disruption to the operation of the internet and should not be used as leverage to achieve another goal.

We look forward to continuing dialogue on this important topic.

Sincerely,

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United States Council for International Business (USCIB)

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