UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

New Zealand Ministry of Finance and Ministry of Revenue
July 16, 2019
By email: policy.webmaster@ird.govt.nz

Re: Options for taxing the digital economy

The United States Council of International Business[1] is pleased to have the opportunity to provide comments on the discussion document on options for taxing the digital economy. As requested, we summarize our major points and recommendations and thereafter include a more detailed discussion.

Summary of Major Points and Recommendations

USCIB strongly supports pursuing an internationally agreed solution at the OECD. The discussion document solicits comments on the OECD proposals based on the February 2019 consultation document. USCIB submitted a comment letter to the OECD in response to those proposals.

The digital economy cannot be ring-fenced. As the OECD concluded in its Action 1 Final Report: "Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes."[2] Therefore, any solution to agreed-upon issues must apply to the economy broadly, not to narrow segments of the economy.

Decisions should be based on careful impact assessment. Much of the debate on this issue has been based on faulty data which asserts that the digital multinationals pay taxes at lower rates than other multinational enterprises. New Zealand, the OECD and other countries, should, to the extent possible, ensure that data that informs the impact assessment is accurate and current.

New international tax rules should be based on sound tax policy principles.

[1] 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.

[2] Action 1, Final Report, page 11.

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USCIB supports the principles recently articulated by Business at the OECD.[3] USCIB believes that that any sustainable solution should:

a. Comply with treaty obligations (both tax and trade);

b. Reflect long-standing income tax principles

c. Minimize double or multi-layer taxation;

d. Include strong dispute resolution mechanisms;

e. Minimize uncertainty; and

f. Provide for consistent, simplified administrative mechanisms.

For many companies higher than average returns are generally attributable to investment in research and development and the risks inherent in these investments, rather than marketing or markets and income taxes ought to reflect that premium returns accrue to those investments. Even though a tax of 2% to 3% of gross revenues may seem low, the effect of such a tax may be to effectively allocate all or virtually all of the enterprise's system profit to the market jurisdiction. It is the view of USCIB members that the vast majority of the profits of businesses that would be subject to a DST are attributable to the investments made by the companies in their products – that is the means of generating the connections among users and enabling their interactions – rather than the inputs by users.

The Digital Services Tax is not based on sound tax principles and its supposed virtues are illusory. Digital Services Taxes have been marketed as simple, targeted solutions that can be easily implemented. As we explain in more detail below and as we explained in our letters to the European Commission and the United Kingdom, these assertions are generally untrue.

The DSTs that have been proposed generally require global calculations of particular income streams, identification of global users and users within New Zealand (or the other country proposing to adopt a unilateral measure). To the extent that these proposals require companies to gather new data globally, they will require extensive new systems to be implemented. Implementing such new systems would be both time consuming and expensive – not simple or easily implemented -- and would divert company resources from useful profit-making activities. User-related data would have to be collected and retained for many years.

Because the Digital Services Tax is not based on sound tax principles, it may have a negative impact on investment and growth. As described in more detail below, the DST may misallocate revenue based on inappropriate formulas, result in unrelieved double taxation, and, therefore, may harm growth and trade and investment. It is essential that the effects on economic growth,

[3] http://biac.org/wp-content/uploads/2019/02/FINAL-2019-01-31-Business-at-OECD-Digital-Principles-Position-Paper2.pdf

particularly from enterprise IT technologies, be taken into account before pursuing additional levels of tax.

Detailed Response

Any change of this magnitude should be based on good data and sound economic analysis. The discussion draft leads off with the assertion that digital multinationals are undertaxed.[4] The discussion draft supports this assertion by citing the European Commission's Impact Assessment that the traditional business model has an average tax rate of 23.2%, while the average tax rate for a digital company is only 9.5%. These figures were based on a study conducted by the Zentrum fur Europaische Wirtschaftsforschung Gmbh ("ZEW"). Some of the many problems with these numbers are described in a recent Tax Management International article[5] excerpted below:

> First, the staff itself reported in the Impact Assessment that the average effective tax rate of digital companies operating only domestically was even lower than that of multinational groups, which hardly supports the proposition that multinationals enjoy the benefits of uneven playing field. Further, the Impact Assessment notes that the lowest effective rates are created through utilization of patent boxes, which as noted are completely creatures of domestic law and are particularly prevalent in the EU.
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> Second, subsequent academic research carefully examined the reported financial statements of many digital and traditional enterprises, and concluded that the actual average corporate tax rates of highly digitalized enterprises considerably exceeds those estimated by the EC staff, and don't differ materially from those of traditional enterprises[6].
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> Finally, and most remarkably, shortly after the Impact Assessment was released, the ZEW study lead author contradicted the staff's conclusions, stating in an interview that the digital sector was not undertaxed, and that the staff had misapplied his work.[7]

Further, even if these numbers were conceptually valid, they have no relevance for determining whether it is appropriate for New Zealand to adopt a DST. That is, these numbers were intended to compare traditional European companies to multinational digital companies operating in Europe and therefore are irrelevant to the taxation of multinational enterprises operating in New Zealand. The discussion draft notes that a New Zealand DST is likely to raise between 30 million and 80 million New Zealand dollars, depending on design features,[8] and that this is not a

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[4] Discussion draft, paragraph 1.2.

[5] A Critical Look at the European Commission Staff Impact Assessment Relating to the Proposed EU Directives on Taxation of the Digital Economy, Gary D. Sprague, Baker & McKenzie, Tax Management International Journal, Vol. 47, p. 468, 07/13/2018. Internal citations to the Impact Assessment omitted.

[6] Dr. Matthias Bauer, *Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions, European Centre for International Political Economy,* ECIPE Occasional Paper (Mar. 2018). (Citation in the original.)

[7] Jack Schickler, *EU Study's Author Doubts Digital Transactions Undertaxed,* Law360 (Mar. 6, 2018). (Citation in the original.)

[8] Discussion draft paragraph 3.69.

significant amount of revenue.[9] To impose a short-term measure that is not based on the tax situation in New Zealand, will not raise significant revenue, and may impose significant implementation costs for the Tax Authority and companies is a poor choice.

The OECD is intending to include an impact analysis as part of its work program.

> Assessing the impact of the proposals will involve an in-depth consideration of how they would be expected to affect the incentives faced by taxpayers and governments, their impact on the levels and distribution of tax revenues and their overall economic effects, including their effects on investment, innovation and growth. The impact assessment will also need to consider how these effects vary across different kinds of MNEs, sectors and economies.[10]

This is the sort of analysis that is needed to support fundamental changes to the international tax system and new laws should not be adopted without the support of such analysis.

The incidence of the burden of the DST is unclear. The discussion draft considers whether the burden of the tax will be passed on to New Zealand consumers or borne by companies (and therefore presumably corporate shareholders or employees). The discussion draft analysis looks at studies showing the pass-through rate of increases in VAT. Before critiquing this discussion, it is worth noting that the discussion draft cites studies indicating only one-third of a VAT change is passed on to consumer prices,[11] although the economic burden of the VAT is supposed to borne by final consumers.

One of the justifications for the DST is to reach the income of multinational corporations rather than, increasing the tax burden on final consumers (through increasing the VAT). If, however, the economic analysis shows that the pass-through rates would be similar, then there is no benefit to adopting an entirely new system – other than the political benefit of being able to claim that the countries are doing something to tax foreign multinational enterprises. However, establishing an entire new tax system will impose significant burdens on taxpayers as well as revenue authorities in attempting to administer the new tax.

The discussion draft also speculates that any pass-through would not be to final consumers but to the businesses paying for the digital services (advertising).[12] This would certainly be true, however, if the DST were passed on to the advertiser, that business would then have to decide whether to pass its costs onto the purchaser of its products and/or services, which is not analyzed by the discussion draft. This is discussed further in our letter to the European Commission (linked above).

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[9] Discussion draft paragraph 3.94

[10] http://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm (hereinafter "work program").

[11] Discussion draft paragraph 3.84. Internal citations omitted.

[12] Discussion draft paragraph 3.81.

A low rate on turnover is not necessarily a low rate. USCIB strongly believes that businesses should be subject to tax on profits, not revenues. Even a low rate of tax on turnover can exceed the entire profit being earned by a company and can significantly over-allocate total enterprise returns to the destination or market jurisdiction. Assuming a corporate tax rate of 25%, a three percent rate would essentially attribute all of the profit to the jurisdiction of the location of the user in cases when total operating profit measures as the return on sales equals approximately 12 percent.[13] This is a very high allocation of profit to the country of users and effectively allocates little or no profit to the jurisdictions where production, management, and innovation take place.[14] Production, management, and innovation are key to value creation by all business and ignoring those functions is grossly distortive.

Furthermore, outside of a new multilateral consensus achieved through the OECD Inclusive Framework process, the jurisdictions where production and innovation take place are unlikely to cede taxing jurisdiction to the location of the user. Thus, the DST inevitably will result in unrelieved economic double taxation. To avoid this result, it is likely that, even if profits exceed 3%, companies subject to the DST will be inclined to pass along this cost to their customers. Thus, advertisers on digital media (which may be SMEs trying to expand their markets) will likely have the choice between passing on their increased costs (the DST that is passed along to them) to their customers, absorbing the cost of the DST, or not advertising on digital media. All of these options are likely to decrease business activity, job creation, and harm SME competitiveness.

The DST may also result in cascading application of the tax to gross revenue, depending on how revenue is characterized. One case where this may be possible is the case of traffic acquisition costs (or "TAC"). Search engines improve the more searches they conduct. Companies, therefore, pay TAC, calculated as a percentage of ad revenue related to the search, to acquire searches for their search engines from other websites. If the TAC is considered ad revenue, then the DST could cascade and USCIB is aware of cases in which TAC exceeds 90% of the total revenue received. Even if TAC is not considered ad revenue, because TAC can be so high, it is very likely that a tax of 3% of gross revenue would exceed net profits in many cases.

Because of the possibility of cascading taxes, it may be more important and more likely that the DST would be passed on to consumers of digital services.

The DST would not be simple to implement. The discussion draft draws heavily from the European DST proposal, although the discussion draft is less detailed than the EC proposal. As

[13] If an MNE earned 100 of gross revenue and paid the 3% DST, that would equate to a 25% tax on 12 of income. As noted above this is a very high overall rate of return and effectively attributes 100% of the profit to the jurisdiction of the user, a result that does not bear any relationship to actual value creation by the company.

[14] The European Commission's Impact Assessment reports surveying 12 large digital MNEs and finding a median profit margin of 15%.

noted and linked above, USCIB submitted detailed comments on the EC proposal.[15] We summarize the comments relating to the difficult implementation issues here:

- Looking at global revenues is distortive – prices are not uniform even within jurisdictions, let alone across the globe.
- Users are extremely difficult to define and difficult to identify by location.
- Allocating profits based on total users undercuts the rationale that users are different from customers – there is no attempt to distinguish users that are "influencers" or create value from users that do not add significant value.
- The proposals may violate privacy protections since companies may be required to track users' locations and other data and keep that information for years.
- The proposal does not recognize that data may have a very short-shelf life.
- The proposal fails to recognize the importance of data analytics. It is rare for companies to sell data.

USCIB appreciates the opportunity to provide these comments and would be pleased to discuss them further.

Sincerely,

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Chair, Taxation Committee
United States Council for International Business (USCIB)

[15] The discussion of technical problems with the DST is at pages 6 through 11.