UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

February 28, 2019

Corporate Tax Team
1 Yellow
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ
VIA EMAIL: dstconsultation@hmtreasury.gov.uk

RE: USCIB Comments on the Digital Services Tax Consultation ("consultation document")

Dear Corporate Tax Team:

USCIB[1] is pleased to provide comments on the Digital Services Tax Consultation ("consultation document").

General Comments

Unilateral measures

USCIB believes that any fundamental changes to the international tax rules should be achieved through a consensus-based process. The best place to conduct that process is at the OECD where over 120 countries are participating in a project to attempt to achieve consensus on possible new rules applicable to the broad digitalized economy.

User participation

The consultation document is premised on the controversial idea that the sustained and active engagement of users creates value and that value is not properly reflected under the current international tax rules. Thus, too little income is attributed to the user's jurisdiction. The UK continues to support the general principle that profits should be taxed where **the enterprise**

[1] The United States Council for International Business (USCIB) advances the global interests of American business both at home and abroad. It is the American affiliate of the International Chamber of Commerce (ICC), the Business and Industry Advisory Committee (BIAC) to the OECD, and the International Organization of Employers (IOE). As such, it officially represents U.S. business positions both in the main intergovernmental bodies and vis-à-vis foreign business communities and their governments. USCIB addresses a broad range of policy issues with the objective of promoting an open system of world trade, finance and investment in which business can flourish and contribute to economic growth, human welfare and protection of the environment. USCIB formulates its positions in numerous committees and other working bodies composed of business experts drawn from its membership of 300 global corporations, professional firms and industry associations. It advocates these positions to the U.S. government and to intergovernmental organizations such as the OECD, the WTO, the ILO and other bodies of the U.N. system with which its international affiliates have official consultative status on behalf of world business.

creates value. To USCIB, these principles seem to be in conflict and the notion that users create value is not supported by empirical analysis.

The consultation document arbitrarily suggests that user participation is limited in scope to specific business activities such as the provision of a social media platform, the provision of a search engine, and the provision of an online marketplace.

A primary goal of some major technology companies is to connect all people on the planet to the network. The UK paper focuses on the connections among users and attributes most of the value to the existence of the users, rather than the business processes, investment and technology that enables those users to connect. The consultation document states that businesses invest heavily in engaging users[2], but there is no indication what that means, or what it means relative to investments in other parts of the business. The businesses processes and technology that create the means by which users can connect, search, connect with vendors, or shop online require significant investments by businesses in both physical infrastructure[3] and technology[4]. The physical infrastructure includes not just servers, but network infrastructure.[5] Without these significant investments in infrastructure and technology, the participation of users would not be possible.

The consultation document also identifies the collection and use of user data as source of value created by user participation.[6] USCIB believes that raw data has little or no intrinsic value. Value is created by the aggregation of data and the application of analytics, which is achieved through investment in people and technological resources. For example, a simple internet search might provide a bit of data on the user, but answering that inquiry requires enormous computing power and infrastructure that the businesses provide. Search engines continuously "crawl" the web to analyze web pages and build an index that can respond to inquiries. In order to be of value, the answers to inquiries need to be appropriate. To put in perspective the value of the user data vs. the business investment consider that:

- In 1999, it took Google one month to crawl and build an index of about 50 million pages. In 2012, the same task was accomplished in less than one minute.
- 16% to 20% of queries that get asked every day have never been asked before.

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[2] Consultation Document, Chapter 2 paragraph 2.6, page 6.

[3] https://www.datacenterknowledge.com/cloud/hyper-scale-data-center-spend-was-20-percent-2017-analysts-say For 2017, approximately 75 billion dollars of capex was spent on data centers. This number is anticipated to grow. Forty-four percent of the hyper-data centers are in the U.S.

[4] https://www.visualcapitalist.com/global-leaders-r-d-spending/ This chart shows the top 20 global companies and their R&D expenditures for 2017. The numbers for the top six companies are: Amazon 17.4; VW 15.18; Alphabet 14.5; Intel 12.8; Samsung 12.8; and Microsoft 12.7.

[5] https://www.datacenterknowledge.com/google-alphabet/three-new-submarine-cables-link-google-cloud-data-centers. Companies are building submarine cables that will connect Asia, Europe, North America and South America.

[6] Consultation Document, Chapter 2, paragraph 2.6, page 6.

- Every query has to travel on average 1,500 miles to a data center and back to return the answer to the user.
- A single Google query uses 1,000 computers in 0.2 seconds to retrieve an answer.[7]

It is the view of USCIB members that the vast majority of the profits of these businesses 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.

It is inappropriate to proceed to a reallocation of taxing rights without a proper analysis of the value chain. The consultation document does not indicate that HMT has conducted this analysis. This topic will be covered in more detail in our specific comments, but the UK approach seems to allocate most of the profits (perhaps as much as 80%) to the location of the user. This is inconsistent with any reasonable allocation based on a value chain analysis.

Although the user participation model is based on revenues, not profits, the likelihood is that a 2% tax on gross revenues will effectively allocate a share of profits to the user's jurisdiction that is significantly disproportionate to any actual value generated in that jurisdiction. This point is elaborated on in the discussion of the safe harbor proposal.

Administrability

The consultation document assumes that implementing the DST by affected businesses will be straightforward[8] and that determinations may be made on a "just and reasonable basis"[9]. These two assumptions are in conflict; straightforward application of the rules would not require taxpayers (or the UK government) to make determinations based on what is just and reasonable. The determinations that must be made on a just and reasonable basis include the boundary between in-scope and out-of-scope activities, the attribution of revenues to in-scope activities, and the location of users – none of which are straightforward. This very fuzzy standard will lead to significant uncertainty, controversy and double/multiple taxation.

Additionally, determining who is a "UK user" will require substantial effort and will not be straightforward. The consultation document states HMT intends to capture revenue associated with UK users, but there is no specific definition of UK user and different businesses will be permitted to use different methods of determination.[10] If this term captures non-UK residents who visit the UK and view advertisements or use digital services while in the UK, then the tax could be levied on anyone regardless of their relationship with the UK. Furthermore, users of many digital services do not provide information on their address or national residency and

[7] http://www.internetlivestats.com/google-search-statistics/
[8] Consultation Document, Chapter 3 paragraph 3.24, page 12
[9] Consultation Document, Chapter 3 paragraph 3.50, page 15, Chapter 4, paragraphs 4.9 and 4.16, pages 16 and 17; Chapter 5, paragraph 5.16 and 5.21, pages 19 and 20.
[10] Consultation Document, Chapter 5, paragraphs 5.12 and 5.13.

therefore digital service providers would be required to make such determinations. While some businesses may be able to approximate the location of a user for purposes of marketing or advertising, an approximate location may not be sufficient for tax purposes.

It is unclear what requirements would be necessary to substantiate the proposed tax for audit purposes. Presumably, the companies affected would need to maintain the data of all users, their location, and the advertisements viewed or engaged with as substantiation of what revenue was or was not associated with the UK. The definition of users under the proposal would also capture residents of other countries visiting the UK, meaning UK law would be requiring the collection and maintenance of data from non-UK residents to potentially make such data available to the revenue authorities. Much of the data in question would be personal data like search engine searches and online purchases made while in country. As this proposal represents a significant departure from fundamental tax principles, it is unclear whether businesses would be able to comply with such collections under other legal obligations. [11]

<u>Revenue based taxes are regressive, create double taxation, and may be passed on to customers</u>

USCIB strongly believes that businesses should be subject to tax on profits, not revenues.[12] While the consultation document attempts to address the harm caused by a tax on gross revenue to lower profit margin or loss-making businesses, the tax is still generally structured as a tax on revenues with all the flaws and economic harm that flow from that.[13] These flaws include the potential for multiple taxation – even within the same country – because the tax is only deductible and non-creditable against income tax liability. This is even before considering that other countries may claim the right to tax the same revenue – either under existing income tax principles or separate unilateral measures covering digital services taxes.[14] Thus, the consultation document accepts potential double gross basis taxation, unless there is a bilateral agreement relieving that double taxation. Because this tax would create an additional cost to the affected businesses, there will be an incentive for businesses to pass along the these costs on to small business users and ultimate consumers, especially in low-margin businesses. This incentive may be increased because of the lack of clarity surrounding the proposal.

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[11] For example, it is not clear how these rules would interact with the recently adopted General Data Protection Regulation. Companies may be required to keep information for tax purposes that the GDPR would require them to delete. It is also not clear how companies would comply with other jurisdictions privacy laws if the UK required a company keep information on another country's resident that the country would require the company to delete.

[12] USCIB also believes that if jurisdictions are seeking to tax consumption, the appropriate tax is a destination-based VAT. USCIB has been actively participating in the OECD's VAT TAG that is seeking to address collection of VAT in the digitalizing economy.

[13] USCIB identified these same issues in a letter to the European Commission on the Digital Services Tax. https://www.uscib.org/uscib-content/uploads/2018/07/EU_letter_on_digital_directives_July_26_2018_final.pdf

[14] Consultation Document, Chapter 5, paragraph 5.28, page 21. This seems to be a rather cavalier acceptance of potential double taxation of gross revenues.

Effective date

As noted above, USCIB strongly supports the consensus-based OECD process to review and achieve consensus on proposed revisions to the post-BEPS international tax rules in light of changes occurring as the result of the digitalization of the economy. This process is scheduled to produce a solution by the end of 2020. The consultation document proposes to implement a new unilateral rule that would require substantial changes to the way businesses compute tax liabilities beginning in April of 2020.[15] This deadline is a little over a year away, the new tax is still being reviewed, and might be abandoned if the OECD reaches consensus on an international solution. There would be significant costs incurred in building a system to comply with this unilateral tax. These costs include not only the actual costs associated with building the system, but also opportunity costs. This early effective date undercuts the OECD process and imposes unnecessary administrative burdens on taxpayers. Therefore, the UK should defer the effective date of any measures to no earlier than April 2021 and those measures should only be implemented if there is no agreement at the OECD in 2020. If consensus is reached at OECD in 2020, then additional time should be allowed to implement the agreed consensus.

USCIB believes that a sunset clause, rather than a formal review would be preferable to ensure that the tax is truly temporary and would lapse unless positive action is taken by Parliament to extend the tax. Such a clause should have effect as early as possible and no later than 2025.

Specific Comments

In scope and out of scope activities and revenues

USCIB believes that singling out specific industries is arbitrary and may be subject to claims of discrimination. If the UK nevertheless proceeds in this direction, the definition of in-scope activities must be very clear. The use of the “activities” standard is particularly problematic because “activities” is, as a fundamental matter, less clear than revenue. As the consultation document points out there are boundary issues and unless an activity is clearly on one-side or the other the administrative burden associated with determining whether an activity is in scope of out of scope will be significant.

While the consultation document may intend to have a narrow definition of in-scope activities, USCIB believes that the definitions are over-broad and have identified some of these cases:

- The definition of a search engine is so broad that it could include any website with a search function that links to third party sites. A majority of websites provide this functionality, including UK Government websites. This is not a workable definition.

- The definition of a search engine should be much narrower and refer only to those businesses where the operation of the search engine is the core revenue generating

[15] USCIB would like an opportunity to make available system design personnel who could explain the necessary steps and the time required to implement a new system.

function of the business, rather than an ancillary part of a broader website. This is much clearer than a broad definition with exceptions, because the exceptions would never capture all cases that ought to be excluded.

- o The revenues associated with the provision of an online marketplace should be narrowed to only refer to revenues that are connected to user value participation on that marketplace. For example, in the context of an online goods marketplace, delivery and logistics fees are not connected with user value contribution in any way and should not be in scope.

- o Where customers purchase subscriptions that include a mixture of in and out-of-scope activities, the entire amount of subscription fees should not be treated as in-scope.

- o Advertising revenues earned through the in-scope business models are overly broad and capture advertising that does not generate any actual revenue or advertising that is not related to any specific user.

USCIB supports the identification of out-of-scope activities including financial services, sale of own goods online, provision of online content, cloud computing, and the collection of data from data gathered from sensors on industrial equipment (among others) and believes that there should be a list of exempt activities. While an approximately narrow and clear definition of what is included is extremely important, it is also important to have clarity as to the excluded activities.

Safe harbor

USCIB welcomes the UK government's acknowledgement that DST should "remain proportionate for businesses with very low profit margins".[16] We have concerns that the design of the safe harbour does not meet this objective.

- In order to fall within the safe harbour, a group must have a profit margin of below 2.5%. We consider this to be too low, and even groups within the safe harbour face hugely disproportionate impacts from DST. See the table in Appendix 1 which shows that a group with a profit margin up to 2.5% pays an effective tax rate of 100% under the UK's proposal. This is clearly not proportionate.
- The economic effect of imposing DST on low margin businesses is that this tax will be in whole or in part passed on to individual consumers or companies within the supply chain, many of whom will be SMEs who are not the target of DST and who themselves are unlikely to be able to absorb the cost. This will therefore produce distortive effects.
- The outcome of the safe harbour is a function of two factors: (1) "X" (the multiplier), and (2) calculation of the profit margin. We address each of these below.

[16] Chapter 7, paragraph 7.5 page 24.

(1) "X" (the multiplier)

- Considering the objective of the measure, i.e. to reflect the value of user participation in certain business models, X should be representative of that user value contribution.
- We do not understand how a 0.8 multiplier has been derived or why 2.5% is considered as the level of profit which is considered to be sufficiently low.
- Based on the UK proposal, we have prepared a table and graph (Appendix 1) that shows how groups with lower profit margins bear a much higher tax burden than groups with higher profit margins. As it shows, for a company with an operating profit margin between 10% and 15%, and paying corporate income tax at 20%, a 2% rate of DST would suggest that 67%-100% of the profit is attributable to user value, which is clearly unrealistic.
- In this context, the DST contemplated in the consultation document would more than double the tax borne by groups with profit margins of 10% or below. The tax would not be proportionate.
- In order to reduce the distortions, we would propose setting the multiplier at a much lower level that reflects a more realistic value of user participation.
- Alternatively, the safe harbour could be adapted to be a gateway test to fully scope out loss making and low margin businesses from DST. The rationale for this would be that these businesses do not benefit from any material user value because they are loss-making or making small margins.

(2) Calculation of profit margin

- The financial information used for DST should be financial data that is readily accessible for both taxpayer and tax authority rather than something that needs to be prepared specifically to implement these rules.
    - Taxpayers subject to these rules should be allowed to use either of the following audited financial statements as a basis for any required computations:
        - (1) published and audited global consolidated financial statements (under U.S. GAAP/IFRS per the taxpayer's parent company accounting standards), or
        - (2) published and audited financial statements by segments (under U.S. GAAP/IFRS per the parent company's accounting standards).
- The consultation document suggests taxpayers will be required to produce a UK-only in-scope P&L. Aside from the additional work for both sides in creating bespoke financials solely for these purposes (which should not be underestimated, especially for complex integrated business models), we do not support this approach for the following reasons:
    - The financial information would not be audited (unless a separate audit was undertaken solely for this purpose, which would add unjustifiable incremental time and cost). Without a 3rd party auditor to express an opinion on the financials, there is a risk of disagreement between taxpayer and tax authority, as well as

between different tax authorities in cross-border scenarios (i.e. with other countries who implement a DST).

- Given this increased risk of dispute, there would be an increase in controversy/litigation activity in order to reach a mutually agreed position.
- A full value chain analysis would need to be performed in order to carve out a country-only or business-only P&L where this is not already in place. This would be a highly complex exercise that would not be justified for DST only.
- For integrated businesses with a mixture of in-scope and out-of-scope activities, this presents a number of highly challenging issues. For example, a single website with in- and out-of-scope services, integrated customer offerings covering both in and out-of-scope activity, central costs such as technology, R&D, marketing, IP development, etc that are not tracked by business, and non-geo-gated websites with advertising (UK customers on non-UK websites and vice versa), etc. Consideration would need to be given to how to allocate a relevant portion of these costs to the in-scope P&L, which is extremely complex.

Sincerely,

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Appendix 1 – Distortive effects of UK proposal

Revenue	Operating profit	Foreign/UK CIT charge @ 20% (A)	DST rate (based on UK proposal)	DST charge @ 2% (B)	Total UK tax burden	Deemed user value contribution to profit (B/A)	Total tax ETR	DST as % of total UK tax burden
100	0	0	0.0%	0	0	0	N/A	N/A
100	1	0.2	0.8%	0.8	1	400%	100%	80%
100	2.5	0.5	2.0%	2	2.5	400%	100%	80%
100	5	1	2.0%	2	3	200%	60%	67%
100	10	2	2.0%	2	4	100%	40%	50%
100	15	3	2.0%	2	5	67%	33%	40%
100	20	4	2.0%	2	6	50%	30%	33%
100	25	5	2.0%	2	7	40%	28%	29%
100	30	6	2.0%	2	8	33%	27%	25%
100	35	7	2.0%	2	9	29%	26%	22%
100	40	8	2.0%	2	10	25%	25%	20%