UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

August 31, 2020

VIA EMAIL
UN Subcommittee on Tax Challenges Related to the Digitalization of the Economy

Dear Subcommittee Members:

USCIB is pleased to have the opportunity to comment on the recently released draft of Article 12B covering the taxation of automated digital services (although we understand this is not an official discussion draft). USCIB members are very concerned about the possibility of multiple inconsistent approaches to the issue of the taxation of the digitalizing economy. USCIB has objected to the proliferation of digital services taxes (DSTs) globally. Multiple inconsistent approaches to the same tax issue will result in double (or multiple) taxation which will discourage foreign investment especially in smaller jurisdictions where the return on investment will be less and therefore the impact of additional costs and taxes will be greater. We, therefore, urge caution in proceeding with a new approach to taxing the digitalizing economy while a multilateral approach is under discussion at the OECD through the ongoing work of the Inclusive Framework.

Policy concerns

Rationale for the proposal

USCIB is concerned that the stated policy rationale of the proposal does not appear to be aligned with its structure. Paragraph 1 of the proposed commentary provides:

> [A]n enterprise of one Contracting State can provide substantial services to customers in the other Contracting State and therefore maintain a significant economic presence in that State without having any fixed place of business in that State and without being present in that State for any substantial period.

This implies that the provision of the substantial services to customers should be the source of the right to tax. Draft Article 12B, however, determines the source of the services based on the residence of the payor.[1] Thus, for example, the source of the payment for digital advertising services would be the residence of the payor regardless of where the service was performed or where the market for the advertising was located.

The OECD is taking a different approach to sourcing Amount A under Pillar 1. The OECD looks to the location of the consumer of the service (in the case of advertising, the person to whom the

[1] The source rule is more complex than this but for this purpose, we focus on the main part of the rule.

advertising is directed). These differing rules reflect different goals and could ultimately result in double taxation as different countries source the same income to different locations.

Alternatively, the rationale for this tax could be that it prevents base erosion, in which case it should not apply to non-deductible payments (those made by individuals for personal services). Further, not every deductible payment made to a nonresident of the payor jurisdiction is base eroding. If a deductible payment is made for services that enhance a company's ability to sell its goods and services, then as long as the payment is arm's length (which it should be when services are provided between unrelated parties), that payment is not base eroding. In fact, such payments are "base enhancing" because the company should be more profitable as a result of the payments for services. For example, the company may be able to sell its goods and services to a wider audience or use external computing services that it could not afford, or would exceed the expected additional revenue, if it had to develop IT resources in-house.

A fundamental disconnect on source rules between the UN and OECD proposals will result in the same income being potentially subject to tax in different jurisdictions, with no means of eliminating double taxation because there is no agreement on which jurisdiction has the primary right to tax. The UN approach should be consistent with the work of the OECD Inclusive Framework wherever possible, especially on sourcing rules, as any disconnect is likely to result in multi-layer taxation, excessive compliance costs on businesses, and significant intercountry disputes. This highlights the need for these challenging international tax issues to be addressed on a multilateral basis, instead of through bilateral treaties, where many unintended consequences will result.

<u>Gross basis taxes</u>

Gross basis taxes have an adverse impact on lower profit margin/loss businesses. A gross basis withholding tax is the primary mechanism for imposition of this tax. While the draft provides an election to apply an approximation of net basis taxation, it is not clear how that operates. USCIB believes that the draft indicates that there would be withholding in all cases and that the person subject to the tax would bear a difficult burden of proof with respect to a net basis taxation filing to request a refund.

Given that withholding tax would apply to businesses with very different profit margins, it will in practice, be impossible to set the rate in a way that can translate a tax on revenues as being equivalent to a tax on profits. Multinational enterprises ("MNEs"), especially small and mid-size enterprises ("SMEs") that are either loss making or generating relatively low margins, likely could not support a gross basis withholding tax, even at a very low rate that potentially approximates the amount that would be collected if applied to profits. Due to cash flow constraints, it is likely that application of a withholding tax could push an otherwise profitable transaction into an economically unviable one that could require SMEs to severely curtail their global business activity. For example, a withholding tax of three percent on gross revenues may exceed the entire net profit from some of the taxed activities – even for the larger enterprises. This is the case for some of our members that receive commissions for acting as an intermediary or incur a loss on in-scope revenue activities. If the company cannot afford to bear the cost upfront and cannot pass along the cost to customers, then the only other option would be to cease doing the business that is incurring the withholding tax. Obtaining refunds of overpaid tax, especially requiring a successfully substantiated net basis filing, can be a long-term, difficult exercise, so companies may be reluctant to rely on obtaining a refund in the case of a low-margin business. In many countries, obtaining a refund can be a multiyear process requiring significant amounts of documentation and detailed information. This arduous process is likely to lead many businesses to instead choose to reduce or cease their investment in countries adopting these rules.

Because there are no thresholds, the gross basis withholding tax would apply to the first dollar of income. For companies that might be incurring start-up losses or operating on small margins this would discourage entry into new markets and therefore might discourage competition with existing service providers. The option to elect a proxy for net basis taxation might not be feasible for small service providers because the costs associated with determining and substantiating net taxation for small amounts of revenue might be too high.

<u>Amount of profit allocated to “source” jurisdiction is inappropriate</u>

The draft proposal would allocate 30% of the profits to the market or “source” jurisdiction, on the basis of a profitability ratio. While the technical issues with this proposal are discussed below, USCIB has two policy concerns with this proposal. First, the 30% allocation is too high. Second, routine profits would be attributed to the “source” jurisdiction, inconsistent with the work of the Inclusive Framework on Amount A for automated digital services.

As discussed above, the stated purpose for this proposal is to allow taxing rights to the “source” jurisdiction when there is no fixed place of business or other physical presence for any substantial period of time. Thus, activities generating the reallocated profits must be taking place elsewhere. Even “digital services” have a footprint in the real world. They require software and algorithms that are written, maintained, and operated by engineers outside the “source” jurisdiction. MNEs incur high costs in the form of owning and operating server farms and network infrastructure. Allocating routine returns to the “source” jurisdiction when these activities and assets that contribute to the generation of such profits are elsewhere inappropriately shifts taxing jurisdiction and ignores the high costs of such investments made outside the source jurisdiction. Profit reallocations to “source” jurisdictions on top of existing transfer pricing also create circumstances where results may be inconsistent with the arm’s length standard under the OECD guidelines. Furthermore, fractional profit split or formulary apportionment moves further away from the arm’s length standard and decreases the ability to amend existing transfer pricing legislation to get relief in the “surrender” country.

When there are few activities in the “source” jurisdiction, there is simply no justification for allocating 30% of the deemed profit to that jurisdiction. In such a case, a 30% allocation of the profit to the market seems to be a tax on market access since it bears no relation to activities or investments by the taxpayer in the "source" jurisdiction. This allocation also ignores the fact that deductible services will generate income in the country of the service recipient. That is, the service recipient is only purchasing services with the expectation of furthering its business activities and the income from those incremental business activities will be taxable in the country of residence. So, the 30% number suggested by the draft proposal would be on top of income earned by the service recipient as a result of the services that were provided. This is clearly an over allocation to the "source" jurisdiction.

<u>Impact on nexus for other purposes</u>

USCIB members are also concerned that allowing taxation in circumstances where there is little to connect the service provider to the "source" jurisdiction may lead to other assertions of jurisdiction. For example, countries may seek to impose other legal obligations on businesses subject to these rules, such as the creation of nexus for VAT purposes or product liability with respect to goods sold through an intermediary service. If the UN Tax Committee adopts provisions along these lines, then they should explicitly prohibit extensions of jurisdiction to any other tax or non-tax regulatory requirements outside of the narrow focus of the rules under Article 12B. Furthermore, the UN should make clear to countries that any reallocated profits do not create any deemed payment transaction to which VAT, withholding taxes, or other taxes apply.

Technical concerns

Although USCIB has concerns with the tax policy approach articulated in Article 12B and the accompanying proposed Commentary, we have provided some technical comments on the specific draft provisions. The below comments are not an endorsement of draft Article 12B. The below list of technical concerns is necessarily incomplete. More issues would be identified with further study. One overarching issue is the application of multiple bilateral negotiated agreements to tax a single global business. In particular because the profitability ratio is a group-wide ratio, if different countries reach different agreements as to the definition of the profitability ratio or the definition of the group, which is near certain given the bilateral nature of the agreement, then double taxation is likely. This problem is made worse because the profit allocation is so high.

<u>Paragraph 3</u>

- It is not clear whether the election can be made in advance of withholding, so that the taxpayer will only pay net taxes or whether there would be withholding in all cases followed by a request for a refund. One way to address this would be to permit taxpayers to elect the net basis approach in advance.
- Thirty percent of qualified profits would be allocated to the "source" state. Qualified profits are determined using a profitability ratio. The commentary indicates that the

profitability ratio is total annual profits divided by total annual revenue. It is not clear what level of profits (profits before taxes as the OECD is proposing as part of Pillar 1 or some other measure) would be used or whether adjustments would be required or permitted.

- Since there is no threshold for application of these rules, some smaller groups that are subject to the rules might not have consolidated financials. What would be the starting point in these cases? The application of a withholding tax mechanism (which taxes discrete transactions as they occur) on the basis of historical financial information is also problematic.
- Even though this proposal is supposed to avoid the need to make adjustments in other jurisdictions, because this is a group wide profitability ratio, it may be that income is allocated to the "source" state from third countries and there is no mechanism for relieving double taxation. That is, if the service provider that transacts with the service recipient/payor is a routine service provider, then it may not earn enough income to support the 30% allocation to the service recipient/payor. The allocated income would then need to come from another jurisdiction and there is no mechanism for making that adjustment and no mechanism for relieving double taxation.
- The profitability ratio is supposed to be determined on a segmented basis if those numbers are available. There is no indication of what that means. The financial information used to implement any changes 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.
- There is no definition of multinational group although the commentary indicates that this is supposed to be consistent with the standard for applying transfer pricing rules to related party transactions. This may be too broad a definition for purposes of determining profitability levels on a group basis.

<u>Paragraph 4</u>

- The draft proposes to adopt the OECD definition of automated digital services including the positive and negative lists; however, there is no early resolution contemplated for gray areas. Any definitions should be as comprehensive as possible to ensure a level playing field between competitors. For example, if cloud is considered to be ADS then this should apply to all cloud providers, not just a subset of providers.
- Also, the definition applies to services supplied to individuals. In such cases withholding is extremely unlikely to occur. (See para 41) Applying this tax to payments by individuals for personal services also undercuts what we understand to be a possible policy rationale for Article 12B because payments by individuals are unlikely to be deductible and therefore do not "erode the tax base."
- Paragraph 42 of the proposed Commentary raises the possibility of financial intermediary involvement in tax collection, although the mechanism is unclear. In the VAT context,

business has raised the difficulties of financial intermediaries being involved in tax collection because they are unlikely to know what the individual is purchasing (e.g., how will they know whether the transaction involves a good or service and if a service what kind of service) and therefore are not able to appropriately determine particular transactions that are subject to tax.

- Paragraph 44 of the proposed Commentary acknowledges the lack of a definition of the term "services" and suggests that "the term "services" should be understood to have a broad meaning in accordance with ordinary usage to generally include activities carried on by one person for the benefit of another person in consideration for a fee." This definition is potentially flawed in that many ADS are not provided for a fee.

<u>Paragraph 5</u>

- This paragraph provides a priority rule that prioritizes taxation of business profits under Article 7 (or Article 14) over Article 12B. On its face this does not raise technical issues but paragraph 47 of the proposed Commentary contains a force of attraction rule that may be difficult to apply.

<u>Paragraph 6</u>

- This paragraph provides the source rule, which diverges from the proposed OECD rule. The rule provides: "income from automated digital services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the income, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment … in connection which the obligation to make the payment was incurred, and such payments are borne by the permanent establishment…" The proposed OECD rule, on the other hand, is trying to locate the marketplace and source the payment based on the location of the marketplace and the residence of the payor is explicitly not used to determine source. The conflict that this creates might be most obvious in the case of advertising. If a company resident in State A pays for digital advertising that is displayed to and consumed by someone in State B, then this rule would source the payment to State A, while the OECD would treat the revenue from the advertising as sourced to State B. This inconsistency could result in significant double taxation.
- USCIB is concerned that this source rule is tied to the decision to withhold on the payment. If the source were determined differently, then withholding would be extremely difficult if not impossible because the location of the consumer of the advertising may not be known when the payment is made.

<u>Paragraph 7</u>

- This paragraph provides an exception to the above source rule based on the residence of the payor if the payor has a PE in the other Contracting State and the expenses are borne by that PE. This rule is too narrow. If the payment is borne by a PE in any other jurisdiction, then there would seem to be no rationale for the country of the residence of the payor to have the primary right to tax. The country of residence would not necessarily be the marketplace and there would be no base erosion since the payment is borne by a PE located elsewhere. Applying this narrow rule is likely to increase double taxation since other jurisdictions have a better claim to taxing this income.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

Washington Office
1400 K Street, N.W., Suite 525
Washington, DC 20005
202.371.1316 tel
202.371.8249 fax
www.uscib.org