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12 October 2017

Task Force on the Digital Economy
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
Paris, France

Via email: TFDE@oecd.org

RE: Input on the Tax Challenges of the Digitalized Economy

Dear Sir or Madam:

The Organisation for Economic Co-Operation and Development (OECD) published final reports pursuant to its base erosion and profit shifting (BEPS) project on 5 October 2015. The reports were the culmination of the OECD's *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Plan) published in 2013. The Plan set forth 15 actions the OECD would undertake to address a series of issues that contribute to the perception of tax bases being eroded or profits shifted improperly. Included in the October 2015 final reports was the report under Action 1 of the Plan, *Addressing the Tax Challenges of the Digital Economy* (the Final Report).

On 22 September 2017, the OECD released a request for input from interested stakeholders regarding the OECD's work on the tax challenges of the digitalization of the economy (the Request), including the development of an interim report to be presented to the G20 Finance Ministers at their upcoming meeting. I am pleased to respond to the OECD's request for input on behalf of Tax Executives Institute, Inc. (TEI).

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies in the world.[1]

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[1] TEI is a corporation organized in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

TEI Comments

General Comments

TEI commends the OECD for providing stakeholders the opportunity to comment on the important and often misunderstood area of the impact of digitalization and high technology on various business models and multi-national enterprises. As an initial matter, TEI agrees with the Final Report, which found that "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] We also agree with the Final Report that "The collection of VAT/GST on cross-border transactions, particularly those between businesses and consumers, is an important issue. Countries are thus recommended to apply the principles of the International VAT/GST Guidelines and consider the introduction of the collection mechanisms included therein."[3]

Before answering the specific questions posed in the Request, however, as a threshold matter, it is unclear to TEI what underlying fundamental tax issue or problem the OECD is addressing in the Request's various proposed approaches to international taxation with respect to the digitalization of the economy. Is the issue that income from the changes wrought by digitalization is not taxed at all, or is the issue that the income is not taxed in the market country, *i.e.*, the country of the consumer? If the income is actually taxed somewhere, should the market country be able to tax that income in addition to, or instead of, the country where the functions, assets, and risks that create value are located? The solution to prevent double non-taxation is different than the solution to ameliorate non-taxation in the source country (if the latter is even an issue when the PE threshold is not met). Thus, TEI recommends further clarity on the problem the Request is intended to address, which will then inform the potential solutions.

Responses to Questions

Question 3.A.1 – This question concerns the impact of digitalization on business models. In TEI's view, digitalization does not change the fundamental concepts of business models, it merely makes logistics cheaper and faster, enabling even start-up businesses to reach global markets to grow and prosper. A business still needs someone developing, identifying, procuring, storing, pricing, and shipping the goods and services to be sold or provided. Even in pure digital cloud businesses, an enterprise still needs to develop and write the software to provide the service, acquire servers and transmission capacity, accept the orders, handle customer complaints, *etc*. The servers, software developers, and warehouses all have locations. Thus, "internet scale" physically happens somewhere in the world that can be determined and then appropriately taxed.

Question 3.A.2 – This question asks about the role intellectual property (IP) plays in highly digitalized business models and the important IP relevant to those models. IP includes

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2 Final Report at 11 & 54.
3 *Id*. at 13.

copyrights, patents, brands, algorithms, business methods, and anything else that differentiates one seller from another, including brand loyalty generated from treating customers better than the competition. We note that all IP is created and developed somewhere by the activities of real people.

Question 3.A.3 – This question enquires about the impact of digitalization on sales operations and activities. Digitalization does not materially change sales organizations in TEI's opinion. If a particular business' sales require face-to-face interaction, then the business will have a local sales and/or marketing organization. If sales are concluded because of name recognition or distance marketing, then there will not be a local sales and/or marketing organization.

Question 3.A.4 – This question concerns the role of data collection and analysis in highly digitalized business models. Again, in TEI's view, digitalization has not changed the role of data, it has simply increased the volume of data and the ability to analyze larger amounts of data at lower costs, benefiting both small and large businesses alike. Businesses have been analyzing purchasing trends for hundreds of years and this current business practice is no different.

Question 3.A.5 – This question asks about the active participation of customers / users in a business via online platforms and whether this is a new phenomenon and specific to highly digitalized business models. TEI notes that automobile companies have had "fan clubs" for their products since they were first produced. So have fountain pen companies, football clubs, record companies and movie producers. Online platforms again merely make the logistics of the communications faster and easier, which drives higher volumes.

Question 3.A.6 – This question asks stakeholders to describe how they view business models evolving in the future due to advances in information and communications. While obviously impossible to predict with any accuracy across the economy, in TEI's view intermediation services will become easier and cheaper, continuing to reduce many of the frictional costs that presently make intermediation unsuitable for high volume, low value transactions. As noted above, digital resources will enable small businesses in developing countries to scale and compete globally.

Question 3.D.1 – This question provides three potential options for addressing the broader direct tax challenges driven by digitalization: (i) a tax nexus concept of "significant economic presence"; (ii) a withholding tax on certain types of digital transactions; and (iii) a digital equalization levy. The question then asks for input on the advantages and disadvantages of the three options from an administrative and economic perspective.

These options were referenced in the Final Report, as well as a recent European Commission communication (the Communication).[4] In TEI's view, none of the three options are

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[4] The communication is available at https://ec.europa.eu/taxation_customs/sites/taxation/files/1_en_act_part1_v10_en.pdf.

viable.[5] The withholding tax and equalization levy are each forms of a gross revenue levy and proposed as a proxy or substitute for a corporate income tax. The Request asks how the negative impacts of gross basis taxation and the threat of double taxation could be mitigated. In TEI's view, it is difficult to conceive of any system or process that (i) would be effective in mitigating the impact of gross basis taxation, and (ii) is capable of being efficiently and effectively implemented in practice while also being a viable substitute for a corporate income tax. Indeed, the Communication refers to these options as "quick fixes" and yet does not include any recommended practical solutions, merely stating that "further work is needed . . . ." Gross basis taxation will significantly increase costs for business, creating an additional barrier to entry into smaller markets, and for small to medium sized entities, as well as start-ups.

A recent paper from the European Presidency discussed at the ECOFIN meeting in Estonia in September 2017 reaches the same conclusion with respect to the withholding tax or equalization levy (the EU Paper).[6] The paper noted that

> connecting the taxation of the digital economy with the source of income (e.g. online advertisements, digital services from non-residents) through 'quick fixes' may not be a reliable solution in the long-run . . . . The most likely outcome of such approach would be under-, over- or non-taxation. The latter deriving from an expectation that after enacting new rules, the tax base would cease to exist although the digital presence and value created in the jurisdiction would remain the same: the businesses would for instance abandon the sources of income that led to taxation and reorient to non-taxed sources (e.g. substituting advertisement revenue with client fees).

The EU Paper then suggests that a modification of the tax nexus concept, *i.e.*, changing the definition of a permanent establishment (PE), to address a digital presence, is the most appropriate way forward for a long-term solution. In TEI's view, changing PE thresholds so soon after the BEPS project creates even greater uncertainty for businesses. Moreover, in the absence of any useful guidance on the attribution of profits to a PE – the OECD still has not agreed on a profit attribution for the limited changes to the PE definition recommended in BEPS Action 7 – the concept of a digital tax nexus is problematic. In addition, it is difficult to contemplate how any extension of the PE definition can be limited to the digitalized economy, especially considering that the OECD and other bodies have not been able to describe, define, or explain what is meant by the phrase.

An equalization levy also appears similar to a VAT. If this analogy is correct, why not use a VAT rather than setting up a parallel tax system for "digital" transactions, as recommended in the Final Report? Most of the tax costs of these proposals will be passed on to local country customers. Thus, such proposals will have failed to generate tax revenue from non-resident

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[5] The OECD appears to agree as the Final Report stated it was not possible to ring-fence the digital economy for tax purposes.

[6] The EU Paper is available at https://www.eu2017.ee/sites/default/files/2017-09/Ecofin%20Informal_WS%20II_digital%20economy_15-16.Sept_.17.pdf.

suppliers to the extent that is the intended goal of the proposals. In addition, these proposals actually protect harm small and medium size businesses, as well as startups, who cannot afford to either absorb the costs or pass them on to customers. Further, increasing the cost of accessing non-resident cloud service providers via these proposals will negatively impact economic growth and hinder the development of local enterprises that utilize these cost efficient and empowering cloud based services in their business.

Fundamentally, what is needed is a way to tax net income. If the seller has a branch or local selling subsidiary in country, would that avoid the tax issue or will the country attempt to tax the income twice by imposing a digital economy tax (or withholding tax) on the intercompany transactions between the local selling entity and regional service suppliers? The approach of the proposal appears to be an attempt to change the focus of corporate income taxation in general from (i) where goods and services are produced (consuming government services in the production location) and/or (ii) where the IP was created, to where the goods and services are consumed. If this is correct, then the proposed solution seems to be replacing an income tax with a consumption tax, or worse an additional consumption tax regime layered over current income and/or consumption taxes. This goal could be achieved without increasing taxpayers' compliance burden by increasing the rates of, or adapting, the current consumption tax regime as recommended by the Final Report.

To the extent countries (unwisely) attempt to develop a specialized tax system in this area, businesses that report all local customer revenue in the local jurisdiction should be exempt from such a special tax regime. In addition, it is critical to make it easy for non-resident businesses to comply, particularly considering language barriers, accounting differences, and lack of local resources for the non-resident sellers. Simplified reporting mechanisms should be established that do not require creating separate accounting systems and duplicate transaction reporting. Moreover and as noted above, these challenges are more difficult for small and medium sized businesses to overcome, which is a barrier to innovation in the marketplace. Further, care should be taken to ensure a specialized tax system does not discriminate against non-resident sellers and multi-national enterprises in favor of local businesses. Such discrimination would obviously raise trade issues that may run afoul of WTO rules and raise the specter of possible retaliation by countries who feel their taxpayers are targeted by such taxes.[7] Finally, taxes solely on imported goods would also increase prices for consumers purchasing such goods.

Question 3.D.2 – This question addresses the tax measures proposed or introduced by various countries to address the direct tax challenges of highly digitalized business models, including a digital profits tax and withholding tax. The question asks stakeholders to address the advantages and disadvantages of these approaches and how the latter may be mitigated through tax policy design. Taxpayer experience with the diverted profit tax (DPT) in the United Kingdom and its equivalent in Australia is that these taxes are not used in practice to address digitalized

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[7] For example, section 891 of the U.S. Internal Revenue Code authorizes the U.S. President to impose additional taxes on citizens and companies from nations that impose discriminatory or extraterritorial taxes on U.S. taxpayers.

business models, so their discussion in the context of taxes to address the digitalized economy is inappropriate. The DPT in practice appears to be used as an opportunity to review an enterprise's global activities in greater depth and seems to proceed from the assumption that any activity within the country or sales made to customers within the country should be treated as constituting a PE, whether or not the business is digitalized or conventional. As in the past, tax authorities remain focused on transfer pricing. As noted above, such special measures should not apply to businesses reporting revenue in the local jurisdiction.

The other suggestions in D.2 are essentially the same as those referred to in D.1 b) and c), and have the same significant drawbacks, noted above.

Conclusion

TEI appreciates the opportunity to comment on the Request regarding the tax challenges of the digital economy. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Giles Parsons. If you have any questions about the submission, please contact Mr. Parsons at +44 1455 826561, parsons_giles@cat.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.

Robert L. Howren
International President