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Testimony of

Joseph V. Kennedy

Senior Fellow

Information Technology and Innovation Foundation

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The Information Technology and Innovation Foundation (ITIF) is pleased to provide testimony regarding the Office of the United States Trade Representative's (USTR) investigation of France's Digital Services Tax (DST). This tax, which other nations are considering, represents a radical departure from current practice and would greatly complicate ongoing efforts by the Organization for Economic Cooperation and Development (OECD) to negotiate changes to the international tax regime by 2020.

The OECD has already made progress in reducing the ability to shift profits to low-tax jurisdictions and generate artificial credits and deductions. Yet some nations remain deeply worried about base erosion, especially with the growth in traded services. In particular, they claim that large Internet companies generate significant revenues from their citizens but pay little if any tax. DSTs are best seen as a unilateral move to generate tax revenue from these companies regardless of existing tax treaties or trade agreements.

The distribution of taxable profits between countries normally reflects where value is created. The sale of a product usually does not create additional value. The key argument that DST supporters make is that their citizens create a large amount of value for certain Internet businesses, which companies reap in the form of profits. Yet, the countries are not allowed to tax the profits from this value. Although this may sound plausible, in the absence of a permanent establishment and the creation of significant value, countries cannot tax the profits associated with imports, whether they are goods or services. An ITIF report explains why both the premise and the structure of DSTs are mistaken for several reasons.

First, in order to get around international treaties, DSTs tax revenues rather than profits. But this end run creates significant economic inequalities. Revenue taxes are especially burdensome on firms with low or negative profit margins, making it harder for new companies to gain scale. Although the tax rate is set at only 3 percent, it can also pose a large burden to profitable companies. For a business with profit margins of 15 percent, it is equivalent to an income tax of 23 percent. Rates this high can affect both the competitiveness and viability of even established firms.

Second, DST's clearly discriminate against large, foreign companies. French authorities have been very clear that the tax is not expected to affect many French companies. It is true that France could accomplish the same result with a Value Added Tax on the sales of foreign firms, but only if it also applied the tax to sales of domestic companies. Indeed, the fact that DSTs tax a portion of the sales price from foreign services is likely a violation of international trade agreements.

The argument of user-created value is also misguided. In every respect, the real value of an Internet service such as Google Search, Uber, or Amazon Marketplace is the software and business model created by the company. Consumers use these services because they derive great value from them. This in turn attracts other users. But the source of value remains the company, not users. The vast majority of users create little of value to the company, yet they are allowed to use the service for free.

Fourth, Internet companies are not unique. DSTs target three narrow sources of revenue; the sale of information provided by users, the sale of advertising; and fees for operating a multi-sided platform. Yet the application of the law makes several false distinctions. The Internet of Things is rapidly expanding the number of industries that benefit by collecting data from their users. Yet the DST would only apply if this information is used by others, not the firm collecting it. The law would apply to Internet marketplaces that give buyers a choice of sellers, but not to websites with only one seller. The law also would not apply to subscription revenues even though the current practice of free use is more popular and more egalitarian.

For all these reasons, DSTs represent a dangerous trend in international tax law. The United States should strongly oppose them even as it works within the OECD to update current tax law to a changing world.