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Written Comments of

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Hearing on

"Section 301 Investigations of Digital Services Taxes"

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The Information Technology and Innovation Foundation (ITIF) is pleased to provide written comments regarding the Office of the United States Trade Representative's (USTR) investigation of Digital Services Taxes (DST) that have either been passed or are being considered by a number of countries. As ITIF testified at an earlier USTR hearing on France's DST, these taxes represent 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 the end of 2020.[1]

Since 2013, the OECD has made progress in reducing the ability of companies to shift profits to low-tax jurisdictions and to use differences in international tax laws to generate artificial credits and deductions. For the most part, these negotiations addressed real problems in the way that multinational companies were legally skirting the purpose of the international tax system. Nations have already implemented many of the remedies agreed to.

But some nations are also worried about the rise of new technologies and freer trade that allow companies to shift a large portion of the value of a product or service overseas so that what once was produced domestically is now imported and therefore not subject to corporate tax. Rather than address this by taking steps to grow their Internet-enabled economies, some nations find it easier to try to impose taxes on these foreign companies, even though these companies have no legal nexus within their territory.

These countries claim that large Internet companies generate significant revenues selling to their citizens but pay little if any tax in their country. They claim that, unlike other products, most of the value of Internet platforms is created by the data their citizens generate. Although individual DSTs differ in many respects, their defining characteristic is that they impose a revenue tax on a narrow base of transactions provided by large digital companies. This ensures that the tax falls mainly on foreign companies, most of which are American. Because of their intentionally selective reach, DSTs are best seen as a unilateral move to generate tax revenue from these companies regardless of existing tax treaties or trade agreements.

Existing DSTs do not raise large amounts of revenue precisely because their scope is limited to a narrow group of digital transactions of the world's largest digital companies. Originally one of the main purposes of DSTs was to force a resumption of the OECD negotiations on Base Erosion and Profit Shifting (BEPS). This was accomplished and the negotiations made rapid progress toward an agreement with two pillars. Pillar One would increase the amount of corporate tax revenue going to destination countries even in the absence of a permanent establishment, which would pave the way to tax importing companies without nexus. Pillar Two would implement minimum global tax rates. Despite the tight timeframes, many observers believed an agreement could be concluded this year.

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[1] Joe Kennedy, "Testimony to the U.S. Trade Representative on France's Digital Service Tax," August 19, 20019, https://itif.org/publications/2019/08/19/testimony-us-trade-representative-frances-digital-services-tax.

The outbreak of Covid-19 has changed the landscape, however. Every country is running significant fiscal deficits and looking for future sources of revenues. This has made DSTs even more attractive because they primarily affect foreign companies, not domestic ones. The recent U.S. decision to drop out of the OECD negotiations until the Covid-19 crisis has passed makes it unlikely that negotiations will conclude this year. As a result, many other countries will likely consider implementing some version of a DST, possibly at higher levels and covering more digital services than current proposals. It is imperative that the United States protect American firms by communicating to the international community that it will not stand idly by as countries unilaterally rewrite international tax treaties to target the most successful and innovative U.S. firms.

The core argument that users create value is wrong. The distribution of taxable profits between countries normally reflects where value is created. The export of a product or service, whether digital or analog, usually does not create additional value and profits from imports into a country are normally not subject to corporate income tax. International law is clear that, in the absence of a permanent establishment, 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.[2]

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 low, it can still pose a large burden to profitable companies. For a business with profit margins of 15 percent, a 3 percent revenue tax is equivalent to an income tax of 23 percent. For a company with only a 5 percent margin, it is equivalent to a 63 percent tax on profits. Rates this high can affect both the competitiveness and viability of even established firms.

Second, DST's clearly discriminate against large, foreign companies. In its investigation of France's DST the USTR concluded that only one of the firms likely to be affected by the tax was French. Seventeen were American. However, the final version of the DST excluded even this one firm.[3] It is true that countries 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. In its investigation of France's DST, the USTR correctly concluded that the tax was inconsistent with international tax principles. Many analysts have concluded that DSTs also violate international trade agreements.

Third, 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

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[2] Joe Kennedy, "Digital Services Taxes: A Bad Idea Whose Time Should Never Come" (ITIF, May 2019), https://itif.org/publications/2019/05/13/digital-services-taxes-bad-idea-whose-time-should-never-come.

[3] Mattias Bauer, "Digital Services Taxes as Barriers to Trade" (Property Rights Alliance and European Centre for International Political Economy, November 2019), https://ecipe.org/wp-content/uploads/2019/11/CaseStudy_DigitalService.pdf.

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. Google users in France create no more value that Mercedes drivers in the United States. Such a major change to long-standing international practice should not be implemented unilaterally.

Fourth, Internet companies are not unique. DSTs typically target a few narrow sources of revenue such as the sale of information provided by users, the sale of advertising; and fees for operating a multi-sided platform. The United States has correctly argued that any change in the nexus requirement should not create an artificial divide between digital and nondigital products. Technology is rapidly increasing the digitalization of other industries. Thus problems associated with valuing software, the reduced need for permanent establishments, the ability to conclude sales over the Internet, and the ease of outsourcing routine functions will increasingly affect all industries, not just those targeted by DSTs. The OECD has previously warned countries not to ring fence the digital companies from the rest of the world economy. 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.