ITI Promoting Innovation Worldwide

ITI Comment on UN Tax Committee's Draft Agenda for the 2021-2025 Term

21 September 2021

Members of the UN Tax Committee:

First and foremost, congratulations to both new and returning members of the United Nations Committee of Experts on International Cooperation in Tax Matters' (UN Tax Committee) on their appointment to the 2021-2025 term. On behalf of the Information Technology Industry Council's (ITI) 80 member companies, we are looking forward to continuing our engagement with the UN Tax Committee's work and welcome the opportunity to comment on the UN Tax Committee's draft agenda.

ITI is the premier global advocate for technology, representing the world's most innovative companies. Founded in 1916, ITI is an international trade association with a team of professionals on four continents. We promote public policies and industry standards that advance competition and innovation worldwide. Our diverse membership and expert staff provide policymakers the broadest perspective and thought leadership from technology, hardware, software, services, and related industries.

While the brief comment period precludes the development of more comprehensive feedback, we would like to underscore the importance of effective stakeholder engagement and clear and transparent decision-making to support better policy development. We strongly encourage the UN Tax Committee to consider how to better integrate taxpayer perspectives into their information-gathering, deliberation, and decision-making processes. Both the UN Tax Committee and the global business community would benefit from robust dialogue to ensure that proposed policies can achieve the UN Tax Committee's intended short-term and long-term objectives, and to engage with impacted firms and tax administrations about effective implementation. This can be achieved through a combination of formal and informal opportunities, with an emphasis on soliciting feedback from the widest range of stakeholders. Taking deliberate steps to exchange views with stakeholders on taxation measures also strengthens trust and accountability between the UN Tax Committee and all impacted parties. Because any rules developed by the UN Tax Committee will likely have significant impacts on business and on governments' ability to raise revenues and foster cross-border trade and investment flows, it is even more critical that policy deliberations benefit from stakeholder engagement.

In order to meet the UN Sustainable Development Goals it is essential that trade and investment can flow between nations free from tax frictions. With this in mind, an overarching focus of the committee must be the facilitation of cross-border trade and investment and the elimination of harmful tax barriers (e.g., double or multiple taxation).

We thought it may be useful to share our most recent submissions so that newly appointed members will have a snapshot of our perspectives and priorities with regard to the UN Tax

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Committee's workstreams. One theme worth repeating here is that some elements identified in the draft agenda are within scope of ongoing negotiations among the 140 governments participating in the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework's project to realize a multilateral, consensus-based solution to the tax challenges arising from the digitalization of the global economy. It is critically important that the UN Tax Committee does not promulgate duplicative and/or conflicting approaches to international taxation policy. Such a scenario would lead to further fragmentation of and excessive pressure on the global tax system – exactly the outcome that participants in the ongoing multilateral negotiations are now seeking to avoid. Given the UN Tax Committee's term lasts through 2025, there is more than enough time for governments, taxpayers, and other stakeholders to fully consider the results of the OECD/G20 Inclusive Framework's efforts as they relate to areas of interest to the UN Tax Committee.

Thank you again for the opportunity to provide feedback on the UN Tax Committee's draft agenda for the upcoming term. We appreciate the UN Tax Committee's attention to our concerns and reiterate our interest in opening a more substantive dialogue on these critical issues.

Sincerely,

Megan Funkhouser
Director of Policy, Tax and Trade

Attachment I: ITI's March 2021 Comment on the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of Software Payments in the Definition of Royalties

Attachment II: ITI's February 2021 Comment on the United Nations Tax Committee's Consideration of Article 12B

Attachment III: ITI's October 2020 Comment on the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of Software Payments in the Definition of Royalties

ITI Promoting Innovation Worldwide

ITI Comment on Possible Changes to the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of Software Payments in the Definition of Royalties

15 March 2021

Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries:

Thank you for the opportunity to comment on the United Nations (UN) Committee of Experts' (COE) updated discussion draft for possible changes to the UN Model Double Taxation Convention Between Developed and Developing Countries (UN Model) to include software payments in the definition of Article 12 royalties subject to gross-basis withholding taxes.

The Information Technology Industry Council (ITI) is the premier global advocate for technology, representing the world's most innovative companies. Founded in 1916, ITI is an international trade association with a team of professionals on four continents. We promote public policies and industry standards that advance competition and innovation worldwide. Our diverse membership and expert staff provide policymakers the broadest perspective and thought leadership from technology, hardware, software, services, and related industries.

Up front, we would like to state that a payment for the use of, or the right to use, a software copyright is a royalty. A payment for the use of a software program copy – which is standardized across all potential customers – is not a royalty, just as a payment for a physical or electronic book is not a royalty.

The February 2021 discussion draft – a follow-up to the September 2020 discussion draft – would expand the definition of Article 12 royalties to include payments of any kind received as a consideration for the "the use of, or the right to use, computer software" or "the acquisition of any copy of computer software for the purposes of using it." A change of this nature would not be a clarification, but a fundamental reclassification of revenue derived from computer software payments. It would also create significant ambiguity regarding the interaction of proposed Article 12, Article 12A, and proposed Article 12B. These changes would result in additional disputes between taxpayers and tax authorities. As such, ITI recommends that the COE should not adopt the proposed amendment to the definition of "royalties" under Article 12 to include software payments.

In addition to principled objections, ITI members have practical concerns about the impact of such a change on their ability to globally market their software products to the benefit of individuals, businesses, governments, and non-governmental organizations. However, if the COE decides to

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continue its discussions on this proposal, ITI reiterates our previous suggestion that it be taken up by the next COE given the limited remaining time for the current COE to consider such a significant proposal. Delay would also provide time for full consideration of the results of the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework's efforts to realize a multilateral, consensus-based solution to the tax challenges arising from the digitalization of the global economy, which may have implications for the tax treatment of digital transactions and intangibles.

While the solicitation for comments in response to the February 2021 discussion draft focuses on technical aspects of how amending the definition of "royalties" to include software payments would work in practice, ITI believes the COE should take a step back and give greater consideration to such a change. ITI's response to the September 2020 discussion draft raised several concerns that have not been acknowledged or addressed in the current discussion draft. We have included this communication for your reference and will highlight a few of our principled concerns about the underlying rationales cited to justify the reclassification of revenue derived from software payments.

There is no doubt there have been significant advances in productivity-enhancing goods and services. However, the supporters of the discussion draft have not demonstrated that advances in software technology would necessitate a change in tax treatment: the development of more streamlined and cost-effective mechanisms for delivery of software does not merit a change to the underlying classification of the payment.

Article 12 of the OECD Model Tax Convention on Income and on Capital, of which the Commentary maintains that "payments in these types of transactions would be dealt with as business profits in accordance with Article 7," draws on a reasoned approach of usage versus the exploitation of software copyright rights. As the minority notes, this approach to classifying transactions involving software accounts for the difference between a copyright right and a copyrighted article. To reiterate, a payment for the use of, or the right to use, a software copyright is a royalty. A payment for the use of a software program copy – which is standardized across all potential customers – is not a royalty, just as a payment for a physical or electronic book is not a royalty. Paragraph 14.4 of the Commentary of the 2017 OECD Model applies this logic as it acknowledges that "distributors are paying only for the acquisition of the software copies not to exploit any right in the software copyrights," and therefore relevant transactions should be treated as business profits under Article 7. Rather than distinguishing between a software copyright holder and a distribution intermediary, the classification of such software payments should reflect that software copies sold without the use of, or the right to use, a software copyright right should be subject to net basis taxation in accordance with Article 7.

By making minor edits to the existing Article 12 Commentary relating to software, the proposed changes would effectively render irrelevant all distinctions based on differences between use of a copyright and use of a copyrighted article, at least where payments are taxable under proposed Article 12(3)(a)(i), 12(3)(a)(iv), and 12(3)(c) are subject to the same rate.

We agree with the views described in paragraph 15 of the draft Commentary concerning the disadvantages of expanding Article 12(3) to cover payments for the use or acquisition of copyrighted computer software (i.e., as distinct from the use of the copyright itself), including the

particular challenges of trying to exercise such taxing rights over payments by individuals. There are significant practical and administrative implications for imposing a withholding obligation on individuals. The proposed taxing right would be much broader than domestic taxing authority in most jurisdictions, which calls into question the rationale for the proposed change.

In addition, significant additional thought and analysis is required to clarify how proposed Article 12 (covering all computer software program and copyright payments) would interact with Article 12A (provision of technical services including software consulting) and the proposed Article 12B. The proposed Commentary on Article 12 is ambiguous and fails to explain how to distinguish between Article 12 payments and Article 12B payments, since it does not address the question of how to determine whether a payment falls within Article 12(3)(a)(iv) (i.e., payment for the use of computer software) rather than Article 12B (payment for automated digital services). Failing to address these critical issues will lead to more, rather than less, disputes between taxpayers and tax authorities based on these substantial ambiguities and overlapping definitions.

Thank you again for the opportunity to provide comments on the COE's updated discussion draft concerning the possible inclusion of software payments in the definition of royalties. For the reasons outlined above and in our previous submission, ITI recommends that the COE should not adopt the proposal described in the discussion draft, which will result in more disputes between taxpayers and tax authorities. We appreciate the COE's attention to our concerns and stand ready to answer any questions that may arise.

Sincerely,

Megan Funkhouser
Director of Policy, Tax and Trade

Attachment: ITI's October 2020 Comment on the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of Software Payments in the Definition of Royalties

Attachment:

ITI Comment on Possible Changes to the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of Software Payments in the Definition of Royalties

1 October 2020

Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries:

Thank you for the opportunity to comment on the United Nations (UN) Committee of Experts' (COE) discussion draft for possible changes to the UN Model Double Taxation Convention Between Developed and Developing Countries (UN Model) concerning inclusion of software payments in the definition of royalties.

The Information Technology Industry Council (ITI) is the leading global association for technology companies. Our members are headquartered around the world, operate globally, and include all major verticals of the tech sector, including companies that specialize in hardware, software, internet services, cybersecurity, and beyond. We take a global perspective with our comments, drawing on the deep international experience of our members.

ITI understands this proposal has been raised for consideration by members of the COE before (and no action was taken on the previous proposal), although the current discussion draft under consideration incorporates new rationales in support of amending the UN Model Convention. As active participants in the innovation economy, ITI members have practical concerns about the impact of such a change on their ability to engage with global markets, as well as principled concerns about the underlying rationales cited to justify the reclassification of revenue derived from software payments. ITI does not believe that the newly raised arguments for amending the definition of "royalties" to include software payments are persuasive. ITI therefore recommends that the COE should not adopt the proposal described in the discussion draft. However, if the COE decides to continue its discussions on this proposal, ITI suggests that it be taken up by the next COE, given the limited remaining time for the current COE to consider such a significant proposal. ITI welcomes the opportunity to further participate in an exchange of views with our many members that are active in the software industry.

A change to include computer software payments in the definition of royalties in the UN Model would be a concerning departure from Article 12 of the Organisation for Economic Co-operation and Development's (OECD) Model Tax Convention on Income and on Capital, of which the Commentary maintains that "payments in these types of transactions would be dealt with as business profits in accordance with Article 7," based on a reasoned approach of usage versus the

exploitation of software. In addition, such a change should only be made to the UN Model if such change enjoys widespread support. Based in part on the arguments put forth by opponents to the proposal as outlined in the discussion draft, it is our belief that this proposal does not represent a widely held view. The fact that some jurisdictions have unilaterally opted to treat payments to non-residents for software copies as royalties should not be considered relevant in the context of amending the definition of royalties in the UN Model Convention for the purposes of bilateral treaty negotiations. The proposed comprehensive expansion of the definition of royalties to include computer software payments would not only increase compliance costs and raise the likelihood of disputes, it would effectively institutionalize greater fragmentation across jurisdictions (many jurisdictions, notably, do not treat as royalties payments for software without the right to exploit the copyright).

As noted in the discussion draft by COE members who oppose the proposal, the sale of a software copy (e.g., shrink-wrap software) represents "a sale of a good that would give rise to business profits that fall under Article 7" of the UN Model Convention because the product is standardized across all potential customers, as is the case with a tangible good or product. This approach to classifying transactions involving software acknowledges the difference between a copyright right and a copyrighted article. A payment for the use of, or the right to use, a software copyright is a royalty. A payment for the use of a software program copy is not a royalty, just as a payment for a physical or electronic book is not a royalty. ITI believes that there have been no developments that would warrant a change to this classification. While the software industry has developed more streamlined and cost-effective mechanisms for delivery of software, this in itself does not merit a change to the underlying classification of the payment.

Furthermore, the implication that a company's access to copyright protection – and by extension, recourse – through a State's legal system should have any impact on a State's justification for the allocation of taxing rights disregards the valuable but disparate roles that intellectual property (IP) protection and tax law play in facilitating a stable and thriving business environment. There are several fundamental issues with this implication. First, on principle, a State's reallocation of taxing rights should not be evaluated or dependent on a State's activities to protect a copyright. Both tax administration and the effective and balanced protection of IP are incredibly important legal systems for the operation of global businesses that drive innovation, create jobs, and enable growth. However, the administration of IP law should not be considered as a viable justification for a departure from existing, long-standing international tax principles in the development or administration of taxation law. Second, for the specific case of software, businesses selling software into a market are more likely to make use of end user license agreements (EULAs), which serve as a legal contract between the specific customer and the developer, than source state copyright laws in order to provide additional legal protections for the seller/developer. In fact, modern software delivery models (such as online platforms and "app" stores) provide greater control for businesses to prevent unauthorized activities with respect to their software. For example, EULAs impose restrictions on customers *in addition to* the restrictions that copyright law already imposes on such activities (i.e., reselling the program copy or reverse engineering the software source code) that either do not, or may not, rise to the level of copyright infringement. Third, software's "level of engagement" with the economy has no relevance for the technical question of whether a payment should be characterized as business profits or royalties. The discussion draft's example of natural

resources further reinforces that even if this was the case, software is not unique in its "level of engagement" with the state where it is used. The fact that software products are prevalent does not distinguish them from a variety of products sold today and does not justify a change to the classification of a payment for the use of a software program copy as business profits. A software product does not "engage" in a market any more than does a commodity such as oil or copper.

Software is a business input that benefits businesses of all sizes as well as governments and non-governmental organizations, and its use can amplify the efficient and seamless execution of everyday activities. Within this context, the imposition of gross withholding taxes on all software payments (assuming the proposal is adopted and a tax treaty does not eliminate the royalty withholding tax) not only disregards the costs associated with creating, updating, and delivering the software, but may also contribute to a higher tax burden and reduced profitability as well as the potential for passing the tax onto end users through higher prices. Companies may have to divert their business activities away from jurisdictions that treat all computer software payments as royalties subject to withholding tax, which would effectively reduce domestic access to productivity-enhancing goods and services that drive economic growth in the market jurisdictions.

Providing a stable tax environment enables companies to devote resources to sustaining and growing the business, all the more important as governments continue to mount the strongest possible economic and public health responses to the outbreak of COVID-19. The March 26 statement released by G20 Leaders underscores this sentiment: "*We reiterate our goal to realize a free, fair, non-discriminatory, transparent, predictable and stable trade and investment environment, and to keep our markets open.*" During these exceptionally challenging times, we applaud the G20 leaders for their commitment to realizing a stable and open environment and encourage the COE to adopt a similar approach.

Finally, ongoing work under the auspices of the Inclusive Framework – which features participation from nearly 140 governments – to address tax challenges of the digitalizing global economy will likely have implications for the tax treatment of digital transactions and intangibles. Nevertheless, ITI does not believe that such work affects the classification of computer software payments, which enjoys a general consensus among countries to distinguish between payments for acquiring copyrighted articles (i.e., business profits) and payments for exploiting copyright rights (i.e., royalties). In the interest of ensuring a predictable and stable tax landscape, ITI recommends that the proposal described in the discussion draft not be adopted. If the COE decides to pursue further discussions on the proposal, it may be appropriate to hold consideration of this topic until the next COE is convened and after the Inclusive Framework has completed the designs for its project, and tax administrations and companies alike can work through the implementation of what are expected to be significant changes to the global tax system.

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22 February 2021

Committee of Experts on International Cooperation in Tax Matters:

We are writing to share our members' perspectives on the United Nations (UN) Committee of Experts on International Cooperation in Tax Matters' (the COE) consideration of a new Article 12B ("Income from Automated Digital Services") in the UN Model Double Taxation Convention Between Developed and Developing Countries (UN Model) with Commentary.

The Information Technology Industry Council (ITI) is the leading global association for technology companies. Our members are headquartered around the world, operate globally, and include all major verticals of the tech sector, including companies that specialize in hardware, software, internet services, cybersecurity, and beyond. We take a global perspective with our comments, drawing on the deep international experience of our members.

ITI continues to be fully committed to the ongoing negotiations through the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework's (IF) project to address the tax challenges arising from the digitalization of the global economy. We also understand the COE's Subcommittee on Tax Challenges Related to the Digitalization of the Economy (Subcommittee) intends to introduce for approval language and commentary for a new Article 12B during the COE's next meeting in April 2021. In view of this ongoing work, while we strongly encourage focus on the negotiations taking place through the OECD/IF-led process as a means of avoiding duplicative and/or conflicting approaches to international taxation policy, we have presented for consideration several technical concerns related to longstanding international tax principles, administrability, and expected impacts.

General observations

The entire global economy is becoming digitalized. Global tax policy challenges – like those arising from the digitalization of the global economy – are inherently international and require consensus multilateral global tax policy solutions. Therefore, any tax reform intended to reflect the changing nature of the global economy must progress through multilateral, comprehensive and consensus-based agreement, otherwise it will fail to address significant issues such as the withdrawal of unilateral measures that contribute to the further fragmentation of our global tax and trade system and the possibility of double or multiple taxation. A multilateral solution is also expected to provide a mechanism for multilateral implementation, greatly reducing the burden on developing countries.

Should the Subcommittee continue to advance the present workstream, ITI encourages the COE to continue to pursue robust stakeholder engagement – both through formal and informal means – as part of its ongoing work related to the digitalization of the global economy and the other portfolios within its scope. Pursuing accelerated timelines for policy consideration eliminates the ability to mitigate unintended consequences or spillover effects that would only come to light through thoughtful engagement with consumers, industry, and other stakeholders. Formal consultations also increase the likelihood that policy meets a government's intended objectives, and that future implementation takes administrability, simplicity, and certainty under consideration.

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International tax principles

Taxpayers have relied on the institutionalization of long-standing international tax principles to create jobs, encourage investments in research and development, and grow their businesses throughout the world. Tax administrations have also benefitted from the stability provided by the global tax system, which incentivizes greater investments and supports more reliable domestic resource mobilization. Many of the issues we cover below reflect the guiding principles adopted by the Subcommittee in January 2019.

- **Imposing taxation on revenue rather than income**. The proposal relies primarily on a gross-basis withholding tax. First, taxing corporate revenue, rather than income, is inconsistent with international tax principles, as reflected, for example, in the UN Model Double Taxation Convention, the OECD Model Tax Convention on Income and on Capital, and over 3,000 bilateral tax treaties.[1] Second, charging even a "modest" tax on gross revenue does not account for margins that can vary widely based on different circumstances and business models (e.g., start-up businesses, loss-making businesses, low-margin businesses, and small and medium-sized enterprises (SMEs)), discourages long-term investments, and exposes impacted firms to double or cascading taxation.

- **Risking double or multiple taxation**. While the UN Model and other bilateral tax treaties are traditionally intended to mitigate double taxation and encourage investment,[2] draft Article 12B would instead effectively authorize double taxation in bilateral tax treaties through the imposition of gross revenue withholding taxes. The Commentary states that Article 23 would be sufficient for avoiding double taxation through exemptions or credits. However, even if governments agree to provide a credit for such taxes, Article 23 does not account for a scenario where a third or fourth government also wants to impose taxing rights on the same stream of income. The only way to coherently and effectively address the issue of double or multiple taxation is through a multilateral process that results in a sustainable and consensus-based solution.

- **Attempting to ringfence the digital economy.** The COVID-19 pandemic has brought into focus more than ever how all companies throughout our global economy leverage digital solutions and technologies to enable their productivity. As the entire economy is becoming digitalized, the solution for addressing the tax challenges must not attempt to ringfence the digital economy or distinguish for tax treatment purposes between levels of digitalization. Article 12B's scope is based on "Automated Digital Services," a concept still subject to significant debate and negotiation in the OECD/G20 Inclusive Framework, which may further increase the difficulty of implementing and enforcing the provisions of Article 12B.

- **Applying gross withholding tax to individuals.** In addition to the risks of double taxation for businesses mentioned above, the application of a withholding tax to individuals introduces

[1] To illustrate how gross receipts taxes compare to corporate income taxes, a gross receipts tax of 3% applied to a company with a 10% profit rate equates to a 30% effective corporate income tax rate, with limited or no availability of credits. This is applied in addition to corporate income taxes paid by the company. The double taxation and subsequent effective corporate income tax rate are especially impactful to companies with lower profit margins and companies with losses.

[2] For example, see Point 2 of the 2017 Update of the UN Model: https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf.

significant challenges. The Commentary acknowledges these challenges but does not present ideas to overcome shortcomings in self assessments or the use of financial intermediaries as they apply to payments by individuals. Further, the withholding tax mechanism would almost certainly lead to the burden of the collection and the tax itself falling on in-country residents through the use of standard gross-up provisions in contracts.

Administrability

Because draft Article 12B does not have a revenue threshold, a taxpayer's first in-scope transaction – regardless of amount – imposes meaningful administrative burdens on the taxpayer and the tax administration. Companies will need to engage in significant re-engineering of their internal business and financial reporting systems to ensure that they can accurately capture required information and comply with the taxes. Companies will also need to include new filing and audit components on accounts in these jurisdictions, which creates legal and financial risks. To the extent that the taxes differ, those costs increase. While the compliance costs are great for any taxpayer, they are especially burdensome for start-up businesses, SMEs, loss-making businesses, and low-margin businesses. Tax administrations must also undertake significant administrative actions to ensure a taxpayer can comply from the first transaction, regardless of the transaction amount.

The proposal's application to individuals would necessitate the use of financial intermediaries,[3] though the exact mechanism is not immediately clear. Limited experience with collecting Value Added Taxes (VAT) through financial intermediaries has proven challenging for companies. It would not be a stretch to anticipate an even greater challenge for individuals looking to comply with domestic implementation of draft Article 12B. The secondary charge as a separate line item can take anywhere from seconds to weeks to materialize, adding both complexity and uncertainty for all parties involved. Those challenges become even more pronounced from an income tax withholding perspective because there is no visibility into the ultimate purchase and whether a withholding tax is applicable. The burden for resolving those issues would then lie with the jurisdiction's resident financial intermediaries, which will need to develop complex and costly technology and compliance systems to facilitate cross-border collection flows and effectively take on the role of tax collectors. Financial intermediaries may be unwilling to devote the investments necessary to establish and maintain the mechanisms. There also remain open questions about the interactions between a taxpayer, a financial intermediary, and the tax administration, including but not limited to which entity would hold liability for the tax resulting from under/over withholding, and whether that entity would be subject to related penalties and/or interest amounts.

As an alternative to applying gross-basis withholding taxes, draft Article 12B proposes that the beneficial owner of the income arising from automated digital services can instead apply the Contracting State's corporate income tax to the beneficial owner's "qualified profits." The primary methodology used to identify "qualified profits" assumes that a taxpayer not only maintains segmentation that is appropriate for this specific purpose, but that a particular segment would comprehensively include all income arising from automated digital services. As an example, a business unit that conducts in-scope activities may not reflect those activities as a separate segment on its audited financial statements due to the relative (small) size of the business unit. The draft article also maintains that in the absence of using the segmentation approach, "the overall

[3] It is also unclear why draft Article 12B imposes withholding taxes on individuals when Article 12A explicitly identifies individuals as out of scope. The disparate treatment of individuals within Article 12 may contribute to unnecessary confusion and inconsistencies in application.

profitability ratio of the beneficial owner will be applied to determine qualified profits," or the overall profitability ratio of a multinational enterprise group if the beneficial owner belongs to one. Each market involves unique characteristics and applying a multinational enterprise group's overall profitability ratio (especially considering the draft's condition that this approach would be used if "the profitability ratio of the multinational group [is] higher than" that of the beneficial owner) would not be an accurate representation of the beneficial owner's experience and profitability in a particular market. This effectively disproportionately affects taxpayers that use consolidated financial statements, even though such statements are readily accessible and easier for tax authorities to audit.

Finally, while the Commentary emphasizes the drafting group's intent to address the allocation of taxing rights, draft Article 12B provides no means of coordination over jurisdictions' right to tax. The imposition of gross withholding taxes already opens the possibility for double or multiple taxation, and this is further exacerbated by an approach that relies on bilateral tax treaties rather than multilateral cooperation. For example, draft Article 12B envisions imposing a tax based on payment location. This approach conflicts with the international consensus on sourcing for services, and creates a scenario in which a third jurisdiction may impose a tax based on user location, effectively leading to triple taxation. The lack of coordination over the right to tax increases the already significant difficulty in negotiating new or modified bilateral tax treaties, and also increases audit and dispute uncertainty for businesses, which in turn would contribute to higher burdens imposed on businesses and tax administrations alike. A multilateral structure reduces the implementation, administrative, and compliance burden on developing countries and business.

Potential impacts

Without an economic impact assessment, it is unclear how this approach may directly and indirectly impact consumers, taxpayers, and tax administrations. For example, the structure of gross withholding taxes means the burden of the tax is most likely passed onto in-country consumers. In the event there are gross-up provisions in contracts – which are prevalent in both business-to-business (B2B) and business-to-consumer (B2C) contexts – the obligation to pay the tax will then stay with the resident in the jurisdiction that is responsible for withholding. The diversity of business models, company sizes, profit margins, and other factors that may result in different outcomes makes it all the more important to clearly appreciate and understand the expected impacts from the draft policy at hand.

Another aspect for consideration in an economic impact assessment is how the adoption of draft Article 12B could affect the flows of foreign direct investment into a jurisdiction. Engagement in jurisdictions that have adopted such an approach may open a taxpayer to the possibility of double taxation, which effectively operates as a barrier to trade and may discourage investments in said jurisdiction, ultimately leading to a decrease in foreign direct investment. This may be especially impactful for smaller jurisdictions where taxpayers may be more hesitant to devote significant resources to fulfill compliance obligations given the relative market size. Small markets, especially in remote areas, already generally yield lower market returns and Article 12B's additional tax and compliance costs will further reduce or eliminate those returns.

A competitive analysis may also be appropriate to better understand how this approach would impact competitors within the same industry in the scenario the competing companies are taxed differently. Although implementation and compliance would be a challenge for businesses of all sizes,

the lack of a threshold means this approach would likely have an outsized impact on smaller operators that may not have the systems or personnel necessary to process the detailed tracking required for compliance.

Thank you for your consideration of our comments. We stand ready to answer any questions that may arise.

Sincerely,

Megan Funkhouser
Director of Policy, Tax and Trade