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Michael Lennard
Chief, International Tax Cooperation,
Financing for Development
U.N. Dept. of Economic and Social Affairs
2 U.N. Plaza
Room DC2-2148
United Nations, New York, N.Y. 10017

Email: lennard@un.org, taxcomments@un.org

RE: U.N. Committee of Experts and Article 12B

Dear Mr. Lennard,

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the draft of the U.N. Model Tax Treaty on the digitalization of the economy under Article 12B that has been discussed by the U.N. Committee of Experts on International Cooperation in Tax Matters (the COE).

The NFTC, organized in 1914, is an association of some 200 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD and the Inclusive Framework in establishing and maintaining international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations.

The original OECD Base-Erosion and Profit Shifting (BEPS) project Action 1 determined that it was not possible to ring-fence the digital economy because the entire economy is becoming digitized. Global tax challenges arising from a more digitized global economy need to be addressed in a multilateral, cooperative and consensus-based agreement.

The OECD working with the Inclusive Framework seeks to achieve a multilateral solution by mid-2021. We believe this is the proper forum to address the tax challenges of the digitalization of the economy. The members of the U.N. COE are from participant countries in the Inclusive Framework. As indicated in the OECD's Economic Impact Report, failure to reach consensus is likely to cause wide-ranging negative economic impacts for consumers and businesses globally. The Article 12B proposed source rule conflicts with the source rules proposed by the OECD's Pillar 1 blueprint because it looks to the residence of the payor of the payment – significantly increasing the risk of additional double taxation.

Moreover, adding Article 12B to the U.N. Model would send a signal to developing countries that unilateral digital services taxes are an appropriate tax policy tool. This would be in direct conflict with one of the primary goals of the multilateral OECD-led effort, namely, to avoid the chaos of uncoordinated unilateral measures by agreeing to a globally consistent approach to the allocation of profits to market jurisdictions, requiring all countries with unilateral digital services taxes to repeal them.

We believe the OECD is the proper forum to address these issues and reach a multilateral agreement that minimizes double taxation. Achieving success at the OECD will help provide certainty and stability for the global economy, foster growth in international trade, and minimize the risk of global tax and trade disputes.

Tax Administrators and taxpayers have relied on a stable international tax system to promote economic growth, encouragement investment, and to expand their businesses globally. There are inherent rules that help to stabilize international tax regimes, many of these rules were adopted by the COE in January 2019 1 and include: 1) imposing taxation on net income rather than on gross receipts, 2) mitigating double-taxation, and we would include: 3) adopting dispute resolution measures, 4) not ring-fencing the digital economy, and 5) not imposing withholding taxes on business profits. The NFTC has concerns with the approach presented in Article 12B and believes that the proposed Model Tax Treaty changes will not produce the much-needed stable international tax system countries will need to flourish in a post-COVID 19 world economy.

We understand that the COE's Subcommittee on Tax Challenges Related to the Digitalization of the Economy (Subcommittee) intends to introduce for final 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 the COE members to 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 several technical concerns related to longstanding international tax principles, administrability, and expected impacts of Article 12B.

Gross Basis Withholding Taxes

The U.N. subcommittee has been tasked with developing proposals for taxing the digitalized economy and the proposed solution is a 3 to 4 percent withholding tax on "automated digital services" (ADS). We understand that the U.N. is not using the OECD definition of ADS and is defining the term to apply to any payment for a service provided on the internet or an electronic network requiring minimal human involvement from the service provider. The U.N. proposed commentary lists the types of services meeting that definition, including online advertising services, sale or other alienation of user data, online search engines, and digital content and cloud computing services. We believe that Article 12B lacks critical details including clear definitions of all terms. Definitions of terms cannot be left to adopting countries' domestic laws or bilateral

1 "*Tax Issues Related to the Digitalization of the Economy: Report*", U.N. Subcommittee on Tax Issues Related to the Digitalization of the Economy, January 16-18, 2019, Paris Meeting, Section II, p.3

treaty negotiations as this will lead to inconsistent definitions and create additional complexities for taxpayers and tax authorities – increasing the risk of disputes and double taxation.

The NFTC does not support taxing ordinary business profits through a gross basis revenue withholding mechanism. Digital services revenue represents ordinary business income that is burdened by all the normal expenses of a business including research and development, investment in plant and equipment, sales and marketing infrastructure, service provision, operations, customer support and other related costs. Taxes on gross receipts are particularly harmful as they penalize low margin or start-up businesses, and they may deter foreign companies from accessing a marketplace altogether. The penalty on low margin businesses is exacerbated by the fact that the Article 12B proposal does not include any revenue thresholds. Taxpayers that are either loss making or generating relatively low margins likely could not sustain the adverse economic impact of a gross basis withholding tax, even with a very low applicable tax rate that potentially approximates the amount that would be collected if the normal rate were applied to net profits. Gross basis withholding taxes will therefore discourage foreign direct investment and businesses are less likely to engage in jurisdictions in which the after-tax margins do not justify the investment.

Gross basis taxes may be less objectionable when the costs are insignificant, such as, for example, when a patent is licensed into a country and no further costs are incurred in maintaining or licensing the patent, but that is not the business model for ADS. Automated Digital Services require continuing investment in development, operations, hardware and software. Even in the case of more traditional licensing of intellectual property, many countries in double tax treaties take the position that zero withholding on royalties is appropriate. The ability to elect net basis taxation and the possibility of a refund after lengthy dispute settlement procedures is unlikely to resolve this problem, particularly if the withholding is in all cases required.

We believe a gross-basis withholding tax will create economic distortions as the result of the imposition of the tax only on non-residents. This will have the same effect as a trade tariff, and it will impose a direct competitive disadvantage on suppliers subject to the tax. The NFTC believes that a gross basis withholding tax that only applies to non-resident companies is discriminatory in application and should not be imposed.

Net Income Based Approach Election

As an alternative to the gross basis withholding tax, paragraph 3 of the proposed Article 12B would allow taxpayers to elect to have their qualified profits from automated digital services subject to the domestic rate. Qualified profits are defined as 30 percent of the amount resulting from applying the group's overall profitability ratio for that business segment to the gross annual revenue from automated digital services derived from the source jurisdiction. We do not believe that the net income election will remedy the deficiencies of the alternative withholding tax approach from a compliance perspective – and it would result in additional controversies and double taxation created by the proposed payor-based sourcing rule and definition of qualified profits.

Article 12B doesn't adequately describe practical aspects of making the Net Income Based Election. 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 taxpayers making a request for a refund. One way to address this would be to permit taxpayers to elect the net basis approach in advance and to make tax payments as required under the regular income tax rules of the jurisdiction.

Article 12B also should reflect impacts to businesses that are loss-making and include provisions that recognize that losses should also economically be borne by market/source countries. If a group does not earn a profit at least equal to the routine return (i.e., it generates "non-routine losses"), those non-routine losses should be carried forward and "earned out" before any allocation of profit is made to market countries.

The proposed fractional profit split or formulary apportionment approach included in Article 12B will increase the complexity of the international tax system. Although this approach may be attractive on its face based on assertions of purported "simplicity", it will increase the likelihood of costly disputes and result in widespread double taxation of business profits as a competing system to countries following the arms-length principle. Again, we believe the OECD-led multilateral forum is the best place to resolve this issue.

Proposed Article 12B's Net Income Based Approach would increase double taxation, global complexity, and disputes as the result of:

o The lack of details on apportionment factors. These factors must be well defined, i.e., the factors of apportionment are known and measurable. Under the proposal, it is unclear whether companies will have to do separate valuations of such factors in order to operationalize apportionment under Article 12B's net income solution, which is likely to increase disputes.

o Profit reallocations to market jurisdictions on top of existing transfer pricing. This will create circumstances where results may be inconsistent with the arm's length standard under the OECD guidelines. The arm's length principle has proven to be a robust and flexible framework for over 80 years providing a reliable basis for new and innovative industries – the hypothesis that the arm's length principle doesn't work for highly digitized business, for example, is unproven.

In dispensing with the differentiation between routine versus residual profits, the U.N.'s Article 12B fractional profit spit/formulary apportionment-based proposal moves further way from the arm's length standard and decreases the ability to amend existing transfer pricing legislation to get relief in the "surrender" country.

The coexistence of arm's length principle-based systems (e.g., the OECD's Pillar 1 proposal, and most domestic transfer pricing rules) with formula-based systems such as that proposed under draft Article 12B will lead to significant complexity and double taxation.

Collection Mechanism – Withholding Tax and Financial Intermediary Collection

We are concerned that Article 12B relies heavily on the use of withholding as a mechanism to collect taxes due from non-resident enterprises. Given that rules will need to be applicable to all cross-border B2B and B2C payments for in–scope digital goods and services, it will be very challenging to set the rate in a way that can translate a tax on revenues as being equivalent to a tax on profits.

The application of a global withholding tax regime to B2C payments presents significant administrative concerns for individual consumers and SMEs who make payments to foreign companies to purchase digital goods and services as they don't have the capability to collect and remit a withholding tax to tax administrators. This approach is also inconsistent with the approach taken in Article 12A to exclude payments made by individuals.

Using a financial intermediary to collect amounts due also raises concerns and creates administrative challenges. Financial institutions will need to develop complex and costly technology and tax remittance systems that do not exist today on such a wide scale. Financial Intermediary collection models for cross-border sales of digital services have only been implemented recently in a small number of countries, and so their effectiveness remains unclear.

Financial Intermediaries will have a lack of control and knowledge in relation to the tax treatment of services provided by taxpayers that will be taxed by the financial intermediary – creating a significant risk of withholding tax on payments for out-of-scope services. This is likely to lead to a poor experience for consumers affected by the Article 12B tax and excess/double taxation of the nonresident businesses. This substantial tax collection burden may require financial intermediaries to pass along significant compliance costs to businesses and consumers.

Consideration will need to be given to addressing challenges such as: how penalties/interest will be imposed, how overpayments or underpayments of tax will be rectified, and the extent to which financial intermediaries or taxpayers will be held liable for such overpayments or underpayments.

Conclusion

As part of the extensive debate over digital services, the 21st session of the U.N. Committee of Experts also considered a proposal to limit publication of the lengthy summary of individual countries' unique transfer pricing practices to an online format. We understand this proposal was rejected after a compelling case was made about the lack of internet access and electricity in many developing countries. This lack of digital infrastructure in many developing countries makes the position advocated in Article 12B even more troubling. Given that doing business in developing countries is often more expensive than elsewhere, imposing additional costs in the form of taxes is likely to discourage businesses from investing in those countries, thereby depriving them of the digital infrastructure needed to expand their economies. Imposing more obstacles to developing countries' ability to access information technology risks leaving them farther behind. As the global pandemic has made clear, businesses, homes and governments without easy access to information technology have fallen more behind economically. Imposing additional taxes on the very businesses countries need for obtaining the technology to support growing out of the economic problems caused by COVID-19 will not yield the anticipated benefits and could work to the detriment of developing country economies.

The NFTC opposes the adoption of Article 12B and recommends that countries continue to work within the OECD and Inclusive Framework to reach a sustainable multilateral agreement.

Sincerely,

Catherine G. Schultz

Catherine G. Schultz
Vice President for Tax Policy
cschultz@nftc.org
202-887-0278 ext. 104