Tax Foundation Response to OECD Public Consultation Document: Addressing the Tax Challenges of the Digitalization of the Economy

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Introduction

The Tax Foundation has engaged in tax policy debates since its founding in 1937. Our goal is to promote principles for sound tax policy and provide research and analysis that evaluate tax systems around the world. For us, the four important principles of sound tax policy are neutrality, simplicity, transparency, and stability. These principles, paired with an understanding of how tax policy affects long-term economic growth, create the basic framework the Tax Foundation uses to analyze tax policy.

This framework should be in the minds of all policymakers who are involved in the discussion of rewriting international tax rules. Ignoring these principles or the impact of taxes on growth could lead to more uncertainty for taxpayers, complexities that create barriers to cross-border trade and investment, new distortions throughout the global economy, and implications for global growth and prosperity. Beyond the political trade-offs of arranging a new system for allocating taxable profits or designing a global minimum tax, policymakers should pay attention to how the incentives of a new system will affect taxpayer behavior and incentives for investment.

Principles to Guide the Deliberations

As the Public Consultation Document expertly outlines, there are a variety of technical "solutions" to the challenges of digitalization. But any technical solution should be based on a set of principles grounded in sound economics. Solutions that ignore the economic consequences of the policy risk harming users, domestic businesses, global trade, and domestic economies. So how should the OECD think about these solutions?

Of the four principles articulated above, neutrality is arguably the most important because the lack of tax neutrality is what causes distortions and behavioral effects that can retard economic growth. The OECD must consider the neutrality question on multiple levels. For example, will the policy benefit large mature businesses over new or growing businesses? How will it impact businesses in different industries? Will the policy be neutral to small exporting countries and large market countries alike?

The OECD must also attempt to measure the potential compliance burden of any proposal it selects. Anecdotal evidence suggests that MNEs have already sustained substantial costs to comply with country-by-country reporting and the new BEPS rules. These were not one-time costs but are permanent deadweight costs to the companies and to the broader economy. It seems certain that each of the proposals under consideration would add a layer of complexity and compliance costs. Those costs should be evaluated in advance.

While the policy solution should minimize the compliance cost to taxpayers, economics teaches us that the true economic burden of taxes ultimately falls on consumers, workers, and capital. Therefore, the OECD should also attempt to estimate the economic effect of each of these proposals on users, workers, and the cost of capital before moving forward.

An ideal solution should also be neutral to country size. However, both the user participation proposal and the marketing intangibles proposal would tend to benefit countries with large markets. As a result, it is likely that these proposals would shift tax revenues away from small exporting countries and to large market countries. This raises the question of how the current debate will impact the tax sovereignty of smaller countries. The OECD should estimate the magnitude of any reallocation of tax revenues in advance.

Lastly, uncertainty has hung over international tax policy since the BEPS project was launched in 2012 and has likely been a contributing factor in the global slowdown in FDI and economic growth. Once the OECD resolves this current debate, it must work to have countries amend or repeal any unilateral or temporary measures that do not comply with the new approach. What taxpayers fear most is that countries will continue to enact unilateral measures even after the OECD settles on a global solution. The OECD should provide a process for evaluating these policies from an economic and legal perspective in order to build a foundation for a new, and potentially more stable, future for international tax policy.

Pillar 1 Approaches

A broad portion of economic activity across the globe is now driven by digital business models or business models that rely heavily on digitalization to reach new markets, serve their customers, and receive feedback on their products. Over time, that share of businesses that rely on digitalization or perform services via a digital platform will grow. Access to the internet allows individuals to use online services even if the providers of those services are not directly trying to reach those individuals.

As the OECD moves forward in determining how to reallocate some portion of taxable profits of multinationals, it will be important to maintain consistency between the method of allocation and the goal of reallocating. If the goal is to reallocate as much taxable revenue to a market jurisdiction as possible, then single sales factor apportionment of all profits (both routine and non-routine) would be the most effective although such a regime would likely cause many new distortions in both business and government behavior.

However, if countries are trying to strike a balance between maintaining the majority of the current international tax rules and only reallocate non-routine profits to different jurisdictions than where they currently get booked, a residual profit split method would be more appropriate. That approach would also have the benefits of its connection to current international tax rules and profit allocation methods as well as a focus on non-routine returns. Through this process, the OECD should work to design a system that will provide taxpayers clarity on where, why, and to what extent they will be taxed. A system that creates unnecessary surprises for tax liability in multiple jurisdictions would likely do more to harm growth than support cross-border trade and investment.

Fractional Apportionment

From an economic perspective, the least attractive option is the multi-factor fractional apportionment approach. This approach would likely raise the cost of capital around the world and result in shifting behavior by companies as they try to minimize the tax costs of their operations in markets where they would have new tax liability.

Fractional apportionment will create incentives not only for businesses responding to the factors and weights in the formula, but also for governments that may want to modify the formula for their own domestic benefit. The history of formulary apportionment among U.S. states reveals a drift toward single sales factor apportionment despite there being an initial agreement to allocate based on property, payroll, and sales. In 2018, just five U.S. states used three-factor apportionment while a majority used either single sales factor or overweight sales as a factor in their formulas.[1]

Allocating taxable profits to various jurisdictions based on sales or other factors also raises the question of whether a business would also be able to allocate loss carryforwards or carrybacks across jurisdictions. If that were the case, then the OECD should also seek agreement on which country's rules or whether some set of international rules for restrictions on offsetting losses would apply. Otherwise, differing restrictions or limits on losses could cause further disputes over taxing rights.

User Participation Approach

The second least attractive option is the user participation approach. The OECD has already declared that the digital economy should not be ringfenced. Yet, the user participation approach seeks to do just that rather than find a solution that would be more neutral across industries. A user participation approach would create distortions as businesses seek to alter their business models to avoid the tax or minimize their exposure to this targeted policy.

Since the policy would allocate non-routine profits based on some metric of users, it clearly has the most potential of the three options to shift revenues from small exporting countries to populous market countries. The OECD should question the fairness of such a move. From an incidence perspective, however, if users are considered the value creators, then allocating taxes based on user participation is effectively a tax on them.

The user participation approach would also rely on analysis that would separate user-created value for non-routine profits from the value delivered by other company activities or assets. It would require a multitude of new simplifying assumptions that may result in economic value being misrepresented for users.

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[1] Taxadmin.org, "State Apportionment of Corporate Income," Jan. 1, 2019, https://www.taxadmin.org/assets/docs/Research/Rates/apport.pdf.

A shift to user-based allocation of taxing rights will also likely trigger behavior to undercount (or undervalue) users in some jurisdictions and overcount (or overvalue) them in other places.

Verifying user bases will likely prove difficult, especially if such an approach causes the users themselves to use tools that would mask their actual location. Allocation of taxing rights to a country that hosts VPN servers because users appear to be there would likely be a suboptimal outcome.

Moreover, this proposal seems to be based on the premise that users are geographically fixed. Digital companies cannot always track their customers. How is this proposal impacted by mobile customers?

For example, in 2017, some 39 million tourists visited the United Kingdom. Of these, the French topped all other tourist nationalities with nearly 4 million visits to the UK.[2] On the other hand, France is the most visited country in the world with 89 million visitors in 2017. According to one survey, France was the favorite destination for British tourists.[3]

The typical Briton visits 9.58 countries in their lifetime. Let's say a British tourist visited Paris, Madrid, and Rome on the same trip and posted pictures of their visit to their favorite social media platform at every stop. How would this policy treat this tourist? Would they count as one "user," or would they count as a different "user" in each country?

Customer mobility, thus, raises some practical questions for implementing such a user-based policy:

- Do countries that benefit more from tourism also benefit more from these proposals than other countries?
- Is there a mechanism for netting out tourists and business travelers between countries?
- Do tourists and business travelers count in their home country and not where they visit?
- Or, how does the digital platform company know where their user is from?

A related point is that contributions by various users may seem similar (pictures or short videos) but may be much more valuable if the contribution is from a particular user with broad popularity among other users. The allocation of profits based on user contributions would then need to include other difficult steps of analysis. The initial contribution could be more valuable depending on who is making the contribution, and that is partially determined by the number of other users who pay attention to the user making the contribution, and the number of users who are interacting with the contribution.

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[2] VisitBritain.org, "Market Ranks and Growth 2003-2017," https://www.visitbritain.org/sites/default/files/vb-corporate/Documents-Library/documents/2017_ranks_and_growth_65_markets_for_web.xlsx.

[3] Kara Godfrey, "Mapped: How many countries have Britons travelled? The number is surprising," express.co.uk, March 16, 2018, https://www.express.co.uk/travel/articles/932706/how-many-countries-britons-travel-favourite-holiday-destinations.

A single post on a social media platform by a famous personality—President Trump, Ruben Gundersen, or PewDiePie, for example—could drive interactions from users all over the globe. If all the value associated with that post is allocated to the user who posted it, then the value associated with shares, likes, and views is ignored.

For example, the OECD's Tweets are seen by thousands of interested parties across the globe. No doubt, these Tweets drive countless users to visit the OECD's website located in Paris. If the OECD's website was considered an interactive social media platform, the question would be whether those "hits" would be allocated to France or the source country of the person who posted their content.

So, while the aim of the policy is to make large digital firms pay "their fair share" of taxes, the party most harmed by the policy would be, for example, a small ceramics maker in Spain who is trying to reach a larger market, or the small hotel owner in Tuscany who is trying to attract Nordic vacationers.

Many social media platforms track metrics like revenue per user. Some modified version of this metric could be used to simplify the analysis. However, any formulaic approach should be tailored to account for differences across business models even within the three main lines of business targeted by this approach.

Marketing Intangibles

Of the three options, the marketing intangibles approach would seem to produce the least amount of economic harm for the activities of current, mature multinationals. For these existing multinationals, this option would likely add the least amount of extra compliance burden—although not zero—because it is based on established procedures in the current transfer pricing system.

The OECD should measure how a rules change under this approach might impact growing businesses that aspire to reach customers around the globe. Putting a safe harbor in place to protect small and medium-sized enterprises from the changes may seem like a helpful approach for smaller firms. However, a sufficiently complex policy with a safe harbor for smaller firms might make it more likely for a growing firm to get bought out rather than achieve success as a separate global firm.

In general, allocating taxing rights for non-routine profits based on a company's investment in marketing intangibles could lead to businesses changing their marketing strategies and ultimately having less efficient or more expensive models for acquiring new customers. A likely consequence of shifting taxing rights to large market countries is that these tax costs would simply be shifted forward to domestic advertisers or sales operations.

Like the User Participation approach, the Marketing Intangibles approach would also tend to favor large market countries, likely shifting profits and revenues away from small exporting countries. Again, the OECD should measure these tax base effects before moving forward.

Pairing an apportionment regime with a withholding tax to ease the administration costs for smaller countries could create compliance burdens for businesses and barriers to cross-border investment. Therefore, countries permitted to administer withholding taxes under any of the allocation approaches should pay attention to whether their compliance regimes or processing of tax returns from multinational businesses work as barriers to trade by harming the ability of companies to have tax certainty for their operations in the jurisdiction.

Focus on Noncompliant Policies

Beyond seeking agreement on some new allocation method, the OECD should commit to reviewing policies that countries have used to unilaterally expand their tax bases and evaluate whether they fit with the new international system that will result from this process. The OECD should begin an effort now to focus on the economic, administrative, and legal consequences of these unilateral policies so that there may be broad understanding of how each fits (or perhaps does not fit) within the eventual agreed-upon system.

In recent years, various countries have sought to expand their tax base through unilateral efforts. Among other policies, these efforts include diverted profits taxes, digital services taxes, and definitions for digital permanent establishments. Some of these measures are specifically designed to tax digital companies or certain multinational business models differently than other businesses are taxed. This diverse set of policies and the political momentum behind them could undermine the current OECD process or the stability of whatever agreement is eventually reached.

The potential ramifications of both the eventual agreement and the unilateral measures should be fully analyzed before the current OECD process concludes.

It would be quite unfortunate, and perhaps even a failure of the OECD process, if an international agreement was reached, but individual countries still felt it necessary to continue to administer unilateral policies that go against that agreement.

The BEPS project has resulted in a sort of floor for tax competition for policy regimes previously designed to attract investment or taxable profits from multinational corporations. A ceiling may now be necessary to limit base expansion efforts by taxing jurisdictions. The current, slow shift from source-based to destination-based taxation can be seen in the proposals being considered by the OECD and in many unilateral efforts. However, this shift is currently uncoordinated and creating more complexity than certainty for taxpayers. The OECD must then succeed in reaching agreement on a system that allows this shift of taxing rights to market jurisdictions to continue while minimizing chaos and quickly resolving issues of double taxation.

It is therefore critical for the OECD to take a clear stance that it will undertake a review of unilateral policies of base expansion to set the stage for elimination of those policies that could undermine the current process and eventual agreement. Analysis should focus on the economic impact of policies, the complexities they create, distortions to economic activity, and whether they present barriers to entry to companies looking to expand their market footprint. Additionally, the OECD should review policies from the stance of a government evaluating the revenue generation of policies, the auditing process, and the overall costs of administering the policy. Finally, the OECD should contribute legal analysis that would allow for future comparison of policies in the context of a new international agreement, including how unilateral policies align with existing or revised treaty obligations and how they create or undermine certainty for taxpayers.

Pillar 2 Policies

OECD research[4] has found that the corporate income tax is the most harmful for economic growth, and research by IMF staff[5] has found that transfer pricing regulations like those associated with the BEPS project effectively work as an increase in corporate tax rates. This directly impacts the cost of capital, decisions on whether to invest or expand in a particular jurisdiction, and long-run economic growth.

Tax competition has lowered the cost of capital and barriers to trade and investment across the globe. Placing a floor on tax competition or raising taxes on non-routine profits from intangible assets could have serious economic effects.

A minimum tax targeted at non-routine profits would directly lower the after-tax return on investment in business lines that generate high returns. This approach also calls into question how such a policy might impact the sovereign choices of tax jurisdictions. Though the consultation document is silent on the rate of taxation, it is important for the OECD to avoid several potential pitfalls of a minimum tax approach.

First, FDI should be excluded from the tax base of any minimum tax. As the OECD's own work has concluded, inbound FDI is incredibly sensitive to tax rates.[6] A global minimum tax regime that creates a tax burden on FDI will create distortions that lead to more investment decisions based on tax rather than market reasons. Instead of effects that individual countries might see in FDI shifting elsewhere, a global regime could reduce FDI everywhere.

At a time when FDI has been falling and global trade negotiations are tenuous, it is particularly important for the OECD to study how various minimum tax regimes might interact with FDI flows.[7]

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[4] Organisation for Economic Co-operation and Development (OECD), "Tax and Economic Growth," Economics Department Working Paper No. 620, July 11, 2008, http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?doclanguage=en&cote=eco/wkp(2008)28

[5] Ruud A. de Mooij and Li Liu, "At A Cost: the Real Effects of Transfer Pricing Regulations," International Monetary Fund, March 23, 2018, https://www.imf.org/en/Publications/WP/Issues/2018/03/23/At-A-Cost-the-Real-Effects-of-Transfer-Pricing-Regulations-45734.

[6] Organisation for Economic Co-operation and Development (OECD), "Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis," OECD Tax Policy Studies No. 17, Dec. 20, 2007, https://read.oecd-ilibrary.org/taxation/tax-effects-on-foreign-direct-investment_9789264038387-en#page1.

[7] United Nations Conference on Trade and Development (UNCTAD), "World Investment Report 2018," https://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=2130.

Second, the minimum tax should be assessed on a net basis. A gross-based minimum tax triggered by a formula or threshold would likely give rise to high effective tax rates for firms that operate on thin margins while more profitable firms would see lower effective rates. Just like the digital services tax (DST) proposals would create distortions by applying a tax to revenues rather than profits, a minimum tax regime that is based off revenues would make those distortions go worldwide.

The average U.S. firm has a profit margin of just under 9 percent.[8] As a simple example, a firm with $100 in sales and $90 of costs would have a 10 percent profit margin. If that firm faces a 25 percent corporate tax rate, it would pay $2.50 in taxes on its profits. A gross-based tax of just 2.5 percent would raise the same revenue. However, because the gross tax does not account for costs, it will impact unprofitable firms while a net income tax would not. This is particularly relevant because several DST proposals have called for rates greater than 2 percent.

Third, a minimum tax regime should, like the intent behind the U.S. GILTI (as the consultation document describes), aim to tax non-routine profits. There must also be attention paid to what counts as routine profits and non-routine profits on a country-by-country basis. This could be done by allowing a deduction for a percentage of business investment in a jurisdiction; however, the definition of what can be contained in the deduction will need to be carefully crafted to minimize complexity and contradictions with various existing domestic tax regimes. A cap on the deduction could be tailored to local rates of return.

Fourth, the minimum tax (targeted at super-normal returns) should have few triggers. A regime that includes an exemption for small and medium enterprises could do more harm to those businesses over the long run than good. Similar to the impact of a safe harbor paired with a Pillar 1 policy, a sufficiently complex minimum tax that has an exemption threshold with the goal of protecting small and medium enterprises could make it more likely that those businesses would be bought out by a larger global firm rather than grow to pass the threshold and learn to comply with the law on their own.

Finally, the minimum tax regime should be as simple as possible for both compliance and administration. This will likely be the largest challenge of all, but it could be the key to making the eventual compromise more stable over time and to making the new system less burdensome than the current one from a complexity standpoint.

[8] Aswath Damodaran, "Margins by Sector (US)," stern.nyu/edu, January 2019, http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/margin.html.

Conclusion

The current state of international political and economic affairs is fragile. There are threats to sustainable growth and challenges to trade relationships from China, to the UK, and the United States. International tax policy is having a similarly uncertain moment with individual countries seeking to expand their taxing rights in a unilateral fashion—making double taxation scenarios more likely for multinational businesses.

Though the challenges to international tax policy are many, the OECD has a chance to work toward a system that creates fewer distortions and negative economic effects than the current one. However, given the policies on the table, it will certainly take quite an effort to avoid further complexity of international tax rules that creates challenges to global trade and economic prosperity.