

Tax Challenges of Digitalisation

Comments Received on the Request for Input - Part I

25 October 2017

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***OECD - Request for input on work regarding the tax challenges
of the digitalised economy***

ABI comments

13 October 2017

The Italian Banking Association (hereinafter ABI) welcomes the opportunity for dialogue offered by the OECD in relation to the note published on the 22nd September 2017, concerning a “request for input” on work regarding the tax challenges of the digitalised economy, launched by the Task Force on the Digital Economy to support the development of its interim report for the G20 Finance Ministers due by end of 2018.

ABI represents and promotes the interests of its member banks and financial intermediaries (about 800 Associates).

1) General comments

From a general point of view, ABI supports the conclusions agreed both at international and EU level whereby the introduction of new international rules aiming at tackling BEPS issues raised by the digital economy may ensure a fair and effective taxation across the digital market as well as a level playing field for all businesses.

Through reading the key issues identified in the note (request for input), it is quite clear to us that the debate in the following months will be focused on the choice between the research of a solution based on a longer-term strategy and the possibility to relay on a sort of “quick response” solution, based on more immediate, supplementary and short-term measures, that could protect the direct and indirect tax bases the States. Such alternative approaches are envisaged as well among the options considered by the EU Commission in its Communication entitled “A Fair and Efficient Tax System in the European Union for the Digital Single Market” dated 21st September 2017.

2) Long term/short term remedies

In our view, a long-term strategy would be more appropriate. This would require a deeper analysis of the issues and opportunities that digital economy creates.

However, since we must be aware of the increasing political pressure for the swift adoption of a remedy, we do believe that any alternative approach should address mainly – if not exclusively – those digital companies that are not currently paying their fair share of tax where they generate corporate profits and value. Otherwise, the risk is to introduce new taxes that would create a new burden for companies

carrying on their activities in the “old fashioned” way, such as banks, that are already subject to tax and to high regulatory constraints.

3) Withholding taxes

Keeping this in mind, we would like to focus our comments on the specific item of the possible alternative approaches, and more in detail on the possibility to entrust the task of ensuring a fair and effective taxation across the digital market to the creation of a new withholding tax, to be applied on certain types of digital transactions.

Such a proposal is recurrently present in any discussion paper regarding the tax treatment of digital economy and, regardless the number of objections already set out over time by experts and commentators, it is still usually invoked as a sort of panacea in the belief that the instrument would be easy to apply and highly effective. Usually, it is taken for granted that banks and other financial intermediaries are well equipped for such task.

ABI does not agree on the idea that the introduction of a withholding tax– that we assume to be qualified as an income tax – could achieve the objective of an efficient and fairer taxation of the digital industry. In any case, then, the practical difficulties underlying the proposal are underestimated, unless we assume a scenario where **all** cross-border payments are subject to a withholding tax, even when made to subjects that in no way are involved in transactions connected to digital economy. It should be clear to anyone that similar consequences would be detrimental and not congruent with the functioning of a modern economy.

Many reasons support this position.

The mechanism of a withholding tax levied by banks and other financial intermediaries, which are involved in the transfer of payments to non-residents, implies the knowledge of a set of information not included in the data set accompanying the transfer. A withholding tax on “certain” payments should be structured to identify correctly the operations and the operators that need to be taxed. Payments made in the Single European Payment Area (SEPA) are characterized by the International Bank Account Number (IBAN) as a unique compulsory identifier, so that any other additional information should be acquired

by the intermediary in a separate autonomous way. It should be self-evident the unfeasibility, in the modern economy, of a system requiring the intermediaries to previously “interview” the person making the payment before processing it (interview to be reiterated for each payment), in order to verify whether the payments in question are or not included in the perimeter of those “certain” payments that are to be taken into consideration for withholding tax purposes.

To grant intermediaries the necessary detailed information on the transaction a mandatory registration system might be needed, based on specific agreements at international level, in order to assure a uniform implementation and interpretation of the rules across different national legal systems, procedures and languages.

The architecture of such a system is bound to prove not easy, and unlikely to be completed in the short term. The result, in any event, would be costly and burdensome for the intermediaries.

In addition, one has to consider that the intermediaries would be charged with a burden connected to their clients’ activities, in respect of which they operate as a mere instrument in the transfer of financial flows. Banks would thus be forced to customize the existing payment procedures with significant additional charges remunerating their monitoring activity (e.g. identification of payments made to non-resident providers of goods and services ordered online to subject them to withholding tax). Moreover, such additional burden would affect the economy of the banks, and eventually its consumers, leaving - on the other hand - unaffected the digital company.

In addition, withholding taxes imply a risk of double taxation. They would apply to a new category of taxable income that is not covered (or uncertainly covered due to unclear wording) by the relevant tax treaty applicable.

A renegotiation of all existing tax treaties would be necessary to eliminate the resulting double taxation. This is an additional element that makes withholding taxes hardly viable as a short-term solution.

Finally, it should be considered that a withholding tax on gross income is quite problematic as all the taxes withheld on gross income and may lead, in specific circumstances, to the violation of EU law (Brisal, C- 18/15, 13 July 2016).

4) Conclusion

In the context of direct taxation, ABI agrees that, in order to tackle BEPS issues associated with the digital industry, it is necessary to adopt new international rules to make cross-border digitalized businesses pay their fair share of tax.

Such a goal could be better achieved through a long-term strategy, that would permit a more rigorous and comprehensive analysis of the different options, considering any possible effect and accompanied by a proper impact assessment.

However, we understand that short-term measures could be decided. In this respect, ABI would like to stress the need to limit the intervention to the strict necessary, for the time frame needed to adopt a long-term strategy, with all due attention to avoiding potential negative repercussions for the activity of third parties, such as financial intermediaries.

Submitted by email to: TFDE@oecd.org

12 October 2017

Dear Sir,

AFME/UK Finance response to the discussion draft entitled OECD request for input on work regarding the tax challenges of the Digitalised Economy

AFME¹ and UK Finance² welcome the opportunity to respond to the OECD's request for input on work regarding the tax challenges of the Digitalised Economy ('the consultation').

As a general comment, we note that the Action 1 report on 'Addressing the Tax Challenges of the Digital Economy' released in October 2015 recognised that it would not be feasible to ring-fence the digital economy from the rest of the economy, and we agree with this conclusion from the perspective of the banking sector. All businesses are learning and addressing the challenges and opportunities presented by digital delivery of products and banking is no exception.

The challenges presented by this work are therefore of wide interest and we particularly support the OECD in consulting on the tax policy options arising from this project. We have set out below, some general comments to the consultation, and those which we believe are specific to the taxation of the banking sector.

General

1. We believe that any measures taken to address the tax challenges identified must be internationally coordinated in order to avoid the danger of double or multiple-taxation. The OECD BEPS project with its inclusive framework has a very broad base and we believe is the best place to ensure that international coordination takes place.

¹ AFME represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society. AFME is registered on the EU Transparency Register, registration number 65110063986-76.

² UK Finance is a new trade association which was formed on 1 July 2017 to represent the finance and banking industry operating in the UK. It represents around 300 of the leading firms providing finance, banking, markets and payments-related services in or from the UK. UK Finance has been created by combining most of the activities of the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association.

Whatever action is taken, there should be an ongoing forum through which unintended consequences can be identified by both countries and businesses and then addressed. The taxation of the digital sector should be an ongoing project rather than a single report.

2. The challenges faced in relation to the digital economy are such that new approaches may be developed. Any such measures have the potential for unintended consequences (which could lead to either under or double taxation). We believe that steps will need to be taken to minimise these risks, such as introducing “filters” to ensure that the measures apply only where needed (e.g. not between two high tax locations).
3. Equalisation and withholding taxes. The application of a tax on income, which is refundable or creditable against tax on profits, raises the risk of double taxation and can be particularly distortive for businesses conducted internationally. Where these taxes already exist, for example on cross border interest, the reclaim process is cumbersome and inefficient for both tax payers and tax authorities and obtaining credit against tax on profits can be problematic. We would therefore urge that these measures are not recommended.
4. Withholding taxes. Nonetheless, if any proposal to implement a new withholding tax is made in the final recommendations, it must be operable with the obligation imposed only on those parties who have access to the information necessary to identify appropriate payments.

Banking specific

5. The banking sector is subject to extensive and coordinated regulation, which reduces the BEPS risks in the banking sector. Regulation of the relevant banking service applies however they are delivered, digitally or otherwise and any recommendations should support and not contradict the regulatory environment.
6. Digital Permanent Establishments (PE). As addressed by the OECD in their recent discussion draft “BEPS Action 7 - Additional guidance on the attribution of profits to permanent establishments”, published on 22 June 2017, lowering the PE threshold brings the risk of administrative complexity without incremental taxation. Further expanding the PE definition to encompass a digital presence will exacerbate these issues. As in the recent discussion draft, a focus on whether an appropriate level of profits has been achieved in country can provide an appropriate override to establish fair and administratively effective taxation.
7. Digital Permanent Establishments. The OECD “2010 Report on the Attribution of Profits to Permanent Establishments” focused on the Key Entrepreneurial Risk Tasking functions (KERTS) and provides a robust and appropriate basis on which to attribute profits to bank branches. If the concept of digital PEs is developed and accepted, the 2010 report must be updated to ensure a consistent and coherent basis of taxation for banks.

If you have any questions on the above comments, please let us know.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'S Paduraru', with a horizontal line underneath.

Stefan Paduraru
Manager, Accounting and Tax Policy
AFME

A handwritten signature in black ink, appearing to read 'John Weatherburn', with a horizontal line underneath.

John Weatherburn
Interim Tax Policy Director
UK Finance



October 20, 2017
Organisation for Economic Cooperation and Development
By e-mail: TFDE@oecd.org

REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITALISED ECONOMY

Airbnb welcomes the opportunity to contribute to the OECD's consultation process on taxes and the digital economy.

Airbnb manages a trusted community marketplace through an online platform for people to list, discover, and book unique accommodations and experiences in nearly every country in the world. The overwhelming amount of money generated by hosts using the Airbnb platform stays with hosts and their communities, and is subject to local taxes. The Airbnb model is unique and empowers regular people and boosts local communities.

Airbnb is committed to partnering with governments in the jurisdictions our hosts and guests call home to ensure the fair collection of taxes. Airbnb has entered into tax agreements with over 300 jurisdictions and collected and remitted more than \$300 million in hotel and tourist taxes throughout the world on behalf of hosts. We also manage our own global tax obligations (including, corporate income tax, VAT, GST, sales and use taxes, and other taxes) under the rules of the jurisdictions and countries in which we operate.

Airbnb applauds and supports the consistent application of income tax determination rules to all sectors of the global economy. We strongly endorse the central conclusion set out in the BEPS Action 1 Final Report in 2015 that there is not a separate digital sector within the global economy. The recognition that no sector can be labeled as "digital" and then subject to a bespoke tax regime should inform the work in the current OECD process.

We believe that it is crucial that the examination and discussion of the digitally supported elements of the global economy are approached on the basis of a detailed understanding of how modern business models operate. This will help to demystify the digital debate and move beyond some of the misplaced assumptions which can undermine the public debate. Equally important, it will be essential that the analysis undertaken by the OECD is guided by a clear and transparent set of principles which can be applied – as established by the conclusion on BEPS Action 1 – equally across all sectors of the economy.

Airbnb is deeply committed to contributing to the communities our hosts and guests call home and we look forward to working with everyone to build a fair global tax framework. We stand ready to engage in further discussion and analysis.

888 Brannan Street
Fourth Floor
San Francisco, California 94103
United States

Federation of German Industries · 11053 Berlin, Germany

OECD
Task Force on the Digital Economy
2 rue André Pascal
75016 Paris
FRANCE

Berthold Welling
Managing Director
Tax and Financial Policy

13 October 2017

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Via Email: TFDE@oecd.org

Request for input on work regarding the tax challenges of the digitalized economy

Dear Sir or Madam,

BDI* refers to the OECD request for input on work regarding the tax challenges of the digitalized economy issued on 22 September 2017.

General comments

No ring-fencing of the “digital economy”

To start, we would like to reiterate our strong support for the OECD’s findings in the BEPS Action 1 Report that any ring-fencing of the “digital economy” for tax purposes is impossible. Rather, due to the rapid changes we have seen in recent years and the evolvement of new digitalized business models in almost every industry branch there is no such thing as the “digital economy” as opposed to the “traditional economy” any more. The “digital economy” is not only an era of new or revolutionary business models like online retailer models or social media platform models but rather represents the evolution of existing business models, products and services (“internet of things”). New products and business models will be established within traditional boundaries. They represent outcomes of the technological development in traditional industries, where traditional, primarily tangible business processes are transformed into digital business models e.g. in the automotive sector. Therefore, we believe that specific rules or even specific tax regimes for the “digital economy” are not the correct approach to effectively deal with the challenges of the digitaliza-

**Federation
of German Industries**
Member Association of
BUSINESSEUROPE

Address
Breite Straße 29
10178 Berlin

Postal Address
11053 Berlin
Germany

Phone Contacts
Tel.: +49 30 2028-1507
Fax: +49 30 2028-2507

Internet
www.bdi.eu

E-Mail
B.Welling@bdi.eu

* BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 36 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.

tion of global economies ahead. Rather, the OECD has to comprehensively deal with the different forms of the digitalized business models, since the digital economy is not only an exclusive group of multinational IT companies but rather entails new types of transactions and business models across also traditional industry sectors.

Careful analysis instead of “quick fixes”

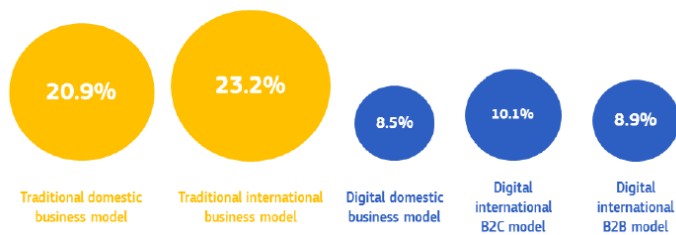
This being said, it is even more important to take considerable care to ensure that measures intended to address the taxation of the digitalized economy do not lead to serious distortions in markets and global value chains – not only in the “digital economy” but also in traditional businesses. Digital business models try to link data, IP, algorithms, software and company specific know-how in a very complex way. At the moment, we are only at the beginning of discussions of all those highly complex issues around the digitalization of the economies, of the question where we might be going in the future and possible implications of these possibly revolutionizing developments.

Any approach to changes in taxation must therefore be very considerate and should primarily be guided by approved principles, such as neutrality, efficiency, certainty and simplicity. The interim report to be issued by the OECD’s Task Force on the Digital Economy (TFDE) in spring 2018 must take these early stages of discussions into account and withstand political pressure to adopt a set of recommendations based only on a rough and very incomplete analysis, driven by the desire of some member countries to seize an alleged political momentum. From the business perspective it is inevitable to follow a well analyzed and sustained path, in order to avoid massive negative repercussions on the international tax system by “quick fixes” or any not well thought out approach, which would include uncertainty, a steep increase in double taxation and consequently a rise in disputes over taxing rights. We believe that this path cannot be paved successfully within a couple of months. Instead, these observations reinforce the need for patience and multilateral engagement in developing sustainable multilateral solutions and agreed international standards for dealing with the taxation of digital business models, instead of unilateral measures or regional “quick fixes”.

Change of narrative to pro-growth

What is also important with regard to any approach to advance taxation of the digitalized economy is the narrative that goes with it. From our perspective, the (political) debate about the taxation of the digital economy is currently too much dominated by a one sided perspective on digital business models and the threat they may pose to tax revenue. However, while the figures published e.g. by the European Commission show, that so called “traditional” business models bear a considerably higher effective tax rate, they also show that with regard to digital business models, globally operating EU companies have a higher effective average tax rate than those with purely domestic digital business models.

Effective average tax rate in EU28



Source: Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market, COM(2017) 547 final, 21 September 2017; Digital Tax Index, 2017, PwC and ZEW.

This comparison shows that while certainly various intangibles (patents, brands, but also user-generated data etc.) have become important input factors for the provision of digital services, digital business models – as is often insinuated – are not per se aiming at base erosion and profit shifting or are even successful with it. Furthermore, it should be kept in mind that, according to the existing OECD principles, a direct foreign investment is, in general, only taxed if there is a taxable (physical) presence in the market country. Obviously, digitalization facilitates cross border business models. However, the fact that digital services are usually provided remote, i.e. without establishing any physical presence in the market country, is not per se an indicator for any BEPS intention, but just a consequence of digitalization.

We therefore urge the OECD to rebalance the discussion among its member countries to readjust the current narrative and to focus on the pro-growth aspects that need to be considered primarily when looking for possible changes to the current international tax system with regard to the increasingly digitalized economy. The digitalized economy is not only revolutionizing the way businesses operate but also creating new opportunities for global growth and prosperity, reaching from new business models we cannot yet think of today to very concrete opportunities for any kind of business – also traditional industries – in terms of centralization of sales activities, cost optimization and dynamic pricing models. If nurtured appropriately, technological advances and digital connectivity can spur innovation in business models, business networking and knowledge transfer while also facilitating access to international markets.

Importance of a multilateral uniform approach

As digitalization continues to be an important driver for global economic growth, we strongly believe that any discussions around the taxation of the digitalized economy should promote, and not hinder, growth and cross-border trade and investment. This is of utmost importance for a country like Germany as a leading economy heavily engaged in cross-border trade and investment. From a business perspective, the integrity of the international tax system is of crucial importance. Furthermore, a collaborative approach together with business would be highly recommended in order to fully grasp the challenges, implications, opportunities and solutions that the new digitalized business models present. A coher-

ent and coordinated implementation of international guidelines is essential in establishing a consistent global tax system that better facilitates cross-border trade and economic growth. If these issues are not carefully addressed there is a considerable risk that taxes could become a monumental barrier to future growth.

Specific Comments

Regarding the current international taxation framework both – legal uncertainty and the risk of double taxation as well as compliance costs – are likely to increase due to unilateral and internationally uncoordinated approaches. Companies face the threat of additional tax burden resulting from increasing taxation of gross income in source countries (e.g. new WHT, turnover taxes on digital business models etc.) without corresponding tax credits in the country of residence. In addition, compliance costs increase due to e. g. complex reimbursement procedures for WHT or mutual agreement procedures with treaty states.

When looking for possible approaches for an improvement of the current situation we believe – as previously mentioned – there are very clear principles that should drive any proposal for a solution. In particular the aforementioned principles of neutrality, efficiency, certainty, simplicity, effectiveness, fairness, and flexibility are the ideal starting point for the TFDE. We agree with the OECD's BEPS Action 1 report that sustainability and proportionality are also key principles against which proposals should be measured. This being said and given the lack of detail even at a conceptual level, we would like to highlight the following issues:

- The introduction of either a “virtual PE”, withholding tax on digital transactions, or equalization tax on the turnover of digital companies would clearly violate these principles. There are fundamental issues with each of these proposals, all of which seem to be aimed at enabling source countries to raise additional revenue, rather than considered measures to address either BEPS concerns or the “broader direct tax challenges” posed by the digitalization of the economy.
- Without discussing the individual technical details of the “potential options to address the broader direct tax challenges”, we believe that the nexus concept of “significant economic presence”, a withholding tax on certain types of digital transactions and a digital equalization levy would likely lead to material legal uncertainties and hence double taxation risks for the affected companies. In particular, a digital equalization levy would lead to the introduction of an additional tax system within the already complex international tax environment. Also, as experiences from e.g. the Indian equalization levy show, as long as there are countries that offer rather loose CFC regimes MNEs from these countries will keep their competitive advantage over e.g. European MNEs despite the equalization levy because of the lack of effective home state taxation.

As a result, all these approaches would massively distort companies' investment decisions regarding digital innovations, which cannot be in the interest of the global economy. As has already been pointed out also by the European Commission, many questions about the compatibility of such approaches with the double-taxation treaties and international commitments under the free trade agreements and WTO rules would need to be examined. Therefore we strongly recommend to focus on the tax systems and tax collecting methods which are already in place.

- In addition, we observe that each of the measures (and particularly the proposals regarding taxes levied on turnover) undermine one of the key objectives of the BEPS Project – to “better align rights to tax with economic activity”. For example, the BEPS Project sought to realign the allocation of taxing rights away from contractual allocation of risk, toward where such risks are managed. It is hard to see how any of the three proposals would achieve, rather than hamper, this objective.
- The introduction of a “significant economic presence” threshold would disconnect the PE concept from physical presence and thus be a significant departure from the existing rules and be incoherent with existing profit attribution rules of the Authorized OECD Approach (AOA) which are based upon the value of significant people functions located in a country. It must be considered that some kind of digital presence within a country cannot be linked with any specific value added from the digital business model. It is very difficult to match the digital presence (e.g. Kilobyte Transaction with Local Customers) with the appropriate amount of income for this country. On the other hand it needs to be kept in mind that the traditional consideration of significant people function for the evaluation of value drivers within a value chain might no longer be valid for the future due to the use of new technologies and artificial intelligence.

Against this background it must be considered that any changes to the nexus threshold required to trigger the existence of a PE would also need to be accompanied by a change to treaties and to the underlying profit attribution guidelines in order to be coherent. The challenges that businesses (and the OECD) have faced in finalizing this element of the BEPS package lead us to the conclusion that any such changes should be dealt with as an entire package, agreed globally, rather than divorcing the agreement of the threshold to the agreement around attribution principles or allowing divergences between countries. Without this coherence, changes regarding the definition of a PE will pose incredible challenges regarding administration, the allocation of profits and double taxation. They would undoubtedly result in significant controversy and discourage the expansion of digital goods and services into remote economies, thus adversely affecting economic growth.

- We would also like to share the thought that coping with the tax challenges of the digitalized economy is essentially a transfer pricing

question, namely the inter-nation allocation of profits and losses to the supply and market jurisdictions.

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Therefore (as recommended in the recent literature (see Olbert/Spengel, *World Tax Journal*, Vol. 9, Issue 1/2017, p. 3), the refinement of the OECD Transfer Pricing Guidelines with respect to digital transactions might also be considered as an appropriate and even sufficient approach. For example, a new chapter in the OECD Transfer Pricing Guidelines specifically dealing with digital transactions could take into account their characteristics in terms of functions, risks and assets to ensure an appropriate allocation of profits/losses among countries. In addition, a clear guidance on the application of the DEMPE-Approach within such digital business models would have to be implemented.

- When addressing the challenges of digital business models potential new international tax guidelines should also be harmonized with national/international data protection law as well as the copyright law: Currently it is very difficult to distinguish between the remuneration for the provision of services (Article 7 of the OECD model tax treaty) and license fees (Article 12 of the OECD model tax treaty) in the context of the digitalization of many conventional business models. Therefore, this distinction between services and royalties is currently subject to considerable legal uncertainty. The reason for this is the lack of a uniform definition of the terms "use of copyright" and "right to use copyright" in the tax treaties. Therefore, Article 3 (2) of the OECD model tax treaty refers to the local tax law of the contracting states, which mostly refers to not harmonized local copyright law. Since the local copyright laws in the contracting states are different, there are qualification conflicts when companies want to credit withholding taxes in their country of residence. To mitigate the threat of double taxation it would be desirable if the qualification of income between remuneration for the provision of services and royalties would be harmonized worldwide.
- With respect to indirect taxation (e. g. VAT/GST) of digital business models and regarding the implementation of the VAT/GST collection models agreed in the BEPS package we would like to share the following experiences in dealing with place of supply rules and VAT liability in cross-border-supplies:
 - B2B:
 - Applying reverse-charge for cross-border-supplies would be the most appropriate way to assure taxation according to destination principle. The business-customer will be liable for the local VAT/GST and as a registered taxable person there will be no specific additional burden for the recipient. Further, the foreign supplier will not have to register for VAT/GST in another country.
 - Identifying the place of business as the place where the business has established its business (assumption of consumption) seems to be proper way in practice.

- However, it appears that some countries follow this rule but a number of countries does still want to have the foreign supplier to register for VAT/GST in the business-customers country, which is a huge burden for both, the supplier and the local tax administration whereas the benefit is low, since business-customer in general will be allowed for input VAT recovery (mainly South Africa to be mentioned).
- B2C
 - Reverse-charge would not be a proper way of taxation since private final customers should not or cannot properly levy and remit VAT/GST. In this respect it seems a proper way to oblige the supplier itself to collect also local VAT in the destination country.
 - However, suppliers need to registers for VAT/GST in foreign countries where we identify the following difficulties:
 - Different local rules for registration
 - Different languages, different official VAT returns, different filing and payment deadlines in different countries
 - Different tax rates, different invoicing requirements to be met and to be permanently monitored
 - Different regimes in case of audits or requests
 - Overall significant burden for VAT/GST compliance in many countries, if supplies are made to customers in different countries
 - Significant burden combined with critical deadlines when remitting and paying VAT cross-border wise (international payments)
- Place of supply rules should be more accurate on the one hand and more flexible on the other hand
 - Usual place of residence should be the general fall back rule for place of supply
 - Technical aspects and developments should be considered in specific cases
 - Mainly the place of supply rules established by EC (EU-VO282/2011) with legal assumptions and the possibility of refutation are good in theory but sometimes difficult in practice. Hence, to identify place of supply at customers address as final fall back could be a further simplification in practice
- It would be recommendable to focus on the already implemented EU VAT regulations with respect to the definition of the taxable supply of electronic services and the implementation of the MOSS (“Mini One Stop Shop”)-procedure. The MOSS-system is a simplification in practice compared with 28 individual VAT registrations in each single country since VAT declaration and payment can be made to the tax office in the

member state where the company is established. It would therefore mean a further simplification if at least a wider number of EC and non-EC countries would agree on similar “MOSS”-systems with reciprocity, instead of having to deal with a huge number of non-harmonized single VAT registrations in many countries. Thus, such an approach and the extension to third countries might help to reduce administrative burdens in this area; additionally such a model should be very efficient in case of the implementation of a collecting agent (e.g. payment provider or credit card companies).

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Please do not hesitate to contact us if you have any questions.

Sincerely,



Berthold Welling



Dr. Karoline Kampermann

The BEPS Monitoring Group

Submission on TAX CHALLENGES OF THE DIGITAL ECONOMY

These comments have been prepared by the [BEPS Monitoring Group](#) (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organisations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet and Sol Picciotto, with contributions and comments from Attiya Waris, Tommaso Faccio and Tatiana Falcao.

We appreciate the opportunity to provide these comments, and are happy for them to be published. They are primarily addressed to the Request for Input (the Request) issued by the Task Force on the Digital Economy set up under the G20/OECD project on Base Erosion and Profit Shifting (BEPS). However, we will also take account of and comment on other proposals and initiatives related to digitalisation, especially in the EU,¹ India and the US. Our comments build on those we previously submitted on this and other related issues.

October 2017

SUMMARY

Digitalisation has further exacerbated the fundamental flaws in international tax rules. The ability to do substantial business in a country without a significant physical presence has long been a problem especially in relation to services. The importance of intangibles and the ability to transfer ownership of such assets to affiliates in low-tax jurisdictions was pioneered long ago by pharmaceutical companies.

Although digitalisation has resulted in important changes in business models, their effects are less significant for those rules than the transformations resulting from the emergence and growth of multinational enterprises (MNEs) since those rules were devised almost a century ago. MNEs have exploited the ‘independent entity’ principle, by creating complex corporate groups and fragmenting their functions to allocate a high proportion of their global income to low-taxed affiliates. The BEPS project has so far aimed only to patch up these rules, and has not resolved the central challenge of how profits should be allocated according to where ‘economic activities occur and value is created’. This requires a paradigm shift, to move away from the independent entity principle, and treat MNEs in accordance with the economic

¹ Especially the Commission’s Communication on *A Fair and Efficient Tax System in the European Union for the Digital Single Market* of 21 September 2017 (COM(2017) 547 final), referred to hereinafter as the Communication.

reality that they are unitary firms.

The BEPS issues raised by digitalised products or services are not caused by small companies, such as software firms, selling digital products to customers around the world, but by the giant web-based MNEs. These firms usually do have a significant physical presence in countries where they have a significant level of consumers, but they fragment their activities, and attribute functions such as sales, order fulfillment, production, marketing and customer support to different affiliates.

The main changes due to digitalisation are (i) the closer relationship it both requires and enables between producers and consumers; (ii) the digital services that are often supplied with no direct charge to users, while their inputs are monetised through revenue generated through services provided to other customers, especially advertising; and (iii) the ability that digitalisation gives for some firms to recharacterise themselves as pure intermediaries between producers and consumers. The various unilateral and defensive measures introduced or proposed by countries (diverted profits tax, equalisation levy, etc) may be necessary in the short term but are only interim solutions.

We propose a new definition for taxable presence based on significant presence; a holistic approach in attributing profits to take account of the combined contributions of all the affiliates of a MNE within a country; and a shift towards allocating aggregate profits of all relevant associated enterprises based on factors reflecting the drivers of profit for typical business models.

1. GENERAL COMMENTS

The Need for a Paradigm Shift

We agree with the arguments in the BEPS Action 1 report, summarised in the Request, that digitalisation is pervasive, and hence does not pose unique issues, but exacerbates the challenges for international taxation. In particular, it has further increased the opportunities for multinational enterprises (MNEs) to exploit the fundamental flaw in international tax rules: the independent entity principle. This requires tax authorities to start from the accounts in each country of the various affiliates of MNEs; and, although they have powers (though without adequate resources) to adjust those accounts, they are expected to do so on the basis that such affiliates are independent entities, dealing at ‘arm’s length’ with each other. This independent entity fiction runs counter to the economic reality that MNEs operate as unitary firms under centralised control and direction. It also allows, indeed encourages, MNEs to create complex corporate groups, with often hundreds of affiliates, many located in tax havens, enabling them to achieve low overall effective tax rates on their global profits. Such strategies have become easier for all MNEs due to digitalisation of business models, even those which involve supplying physical commodities (e.g. Apple, Amazon).

This clearly requires a paradigm shift in international tax. It was implicit in the call from the G20 leaders for reform of the rules to ensure that MNEs could be taxed ‘where economic activities occur and value is created’. Regrettably, however, the BEPS project failed to address the implications of this mandate directly, and took an ambivalent approach to the separate entity concept and the arm’s length principle. Some progress was made towards a more realistic approach, notably in establishing a template for country-by-country reporting by the largest MNEs. This will for the first time provide all tax authorities with an overview of the firm as a whole, as well as of its activities in each country. Other proposals adopted an apportionment approach, notably for low-value-adding central services, and interest deduction limitations (the ‘group ratio rule’), but these applied only to costs. For the

allocation of profits, in the transfer pricing rules the arm's length principle has been regarded as sacrosanct. However, there remain deep disagreements about how it should be applied, which generate increasing conflicts. Furthermore, work has not been completed on the profit split method, nor on attribution of profits to a permanent establishment (PE).

The failure to agree on principles for allocation of profit 'where economic activities occur and value is created' has led to the proliferation of unilateral measures (mentioned in para. 1.f of the Request): such as diverted profits taxes and equalisation levies. Many countries have also introduced special taxes for highly profitable sectors, such as banking and insurance, telecommunications and oil and gas, and such measures are now being considered for internet-based firms. All these are clearly only partial and interim solutions. It is now time to think more broadly.

Three main approaches have been identified which would treat MNEs in accordance with the economic reality that they operate as unitary firms.² One is Residence-Based Worldwide Taxation, which would extend rules on controlled foreign corporations (CFCs) to treat all foreign affiliates as CFCs on a full-inclusion basis. Under this system, the MNE would be taxed on its worldwide profits in the country of residence of its ultimate parent, but subject to a credit for foreign taxes. This option could have emerged under Action 3 of the BEPS project dealt with CFC rules, but was not seriously considered. A second, the Destination Based Cash Flow Tax, supported by some economists, was proposed in June 2016 in the US Congress, and extensively debated earlier this year, but now seems in abeyance. The third, Formulary Apportionment,³ is the approach proposed within the EU by the European Commission, with detailed proposals now being debated by the European Parliament. This is clearly a more long-term goal, although transitional measures could be adopted to move in this direction, such as strengthening the profit split method of transfer pricing, with the formulation of concrete allocation keys and weightings for common business models.

As can be seen from this brief account, all these approaches have considerable traction, but they have not been debated in the BEPS project, which mainly focused on short-term fixes. This was perhaps inevitable, given the very short time-scale and ambitious nature of the project. In our view, these options should now be properly examined in the context of the work of the Task Force on the Digital Economy. It is not a matter of choosing between them, since combinations are possible (e.g. regional formulary apportionment with full-inclusion for CFCs outside the region). Transitional measures are also possible. In addition, some other principles could be introduced into current rules which would explicitly reject the separate entity principle, and make it easier to allocate profit to where economic activities occur and value is created.

We recognise that acceptance of such a paradigm shift would be difficult for many government tax officials and MNE tax advisers. It involves a reorientation of thinking, and a radical rethinking of techniques and routines in which much intellectual capital has been invested. In addition, MNEs will be fearful of the consequences of being subject to a more comprehensive system unless adequate coordination can be agreed. However, all concerned should consider the alternative, which is the continued proliferation of unilateral measures, while international rules for allocation of profits remain subjective and discretionary, generating uncertainty and increasing conflicts.

² For more details see S. Picciotto (ed.), *Taxing Multinational Enterprises as Unitary Firms* (2017), ICTD, available at <http://ictd.ac/publication/6-books-journal-articles/164-taxing-multinational-enterprises-as-unitary-firms>, especially ch. 2, which outlines the advantages and disadvantages of each.

³ Sometimes described as 'fractional apportionment', as in the BEPS Action 1 report, p. 112.

2. SPECIFIC COMMENTS

In this section we address the issues outlined in the Request.

A. Digitalisation, Business Models and Value Creation

Although digitalisation has indeed brought extensive changes to business models, these changes and their implication for international taxation have largely accentuated those which had occurred in the prior period of expansion of MNEs, especially since the 1960s, and in the 1990s. It is important to be clear about this, so we will discuss first the background, as briefly as possible.

Background

It should be recalled that international tax rules were devised in 1928-35, before commercial air travel and long-distance telephony, let alone the internet and before many countries in the world were independent. Those rules were aimed mainly at portfolio investment, which dominated in the first part of the last century, with investors resident in one country buying bonds or stocks of issuers in another country including in the colonies. Hence, the basic rule which was agreed for the allocation of tax rights was to tax business profits at source, where the entity carrying on the business was located often in the colony, and tax the 'passive' returns in the country of residence of the investor, which was often in the imperial state. However, tax authorities understood that MNEs were centrally controlled, so that profits could be shifted among entities in the group, hence powers were introduced to check and if necessary adjust the accounts of affiliates. MNEs at that time were managed in a largely decentralised manner, so it was agreed that such adjustments should be based on the independent entity principle. This aimed to place taxation of direct and portfolio investment on a similar footing, with 'active' income taxed at source where the business was located, and 'passive' investment returns in the country of residence of the investor.

However, in the second half of the last century this changed rapidly, and MNEs emerged as internationally integrated firms under centralised direction. They developed structures, especially for financing their global operations, which could take advantage of international tax rules to reduce their tax liability especially on retained earnings, which helped to power their expansion. Such techniques included using intermediary entities to route revenue from sales through a 'conduit' (to minimise withholding taxes at source) to another in a 'base' jurisdiction where they would remain untaxed. Business profits of operating affiliates could also be reduced by charges for interest, royalties and fees for services, while these payments would also flow to intermediaries offshore, which nominally owned the rights to assets such as intellectual property rights.

These techniques quickly aroused the concern of tax authorities, especially in the US, which was the main home country of MNEs at that time. Hence, the US enacted CFC rules as early as 1962, which were later emulated by some other OECD countries, although others objected (some claiming that they were contrary to tax treaties). Many retained 'territorial' taxation, exempting foreign profits, hence facilitating the shifting of profits out of source countries. Gradually the CFC rules were weakened by tax competition and business lobbying, and have become largely ineffectual in most countries. The USA urged the OECD to investigate the problem of tax treaty abuse, and a working party (Denmark and the USA) was formed in 1962, but had little impact. The US took the lead in developing limitation-of-benefits provisions to curb treaty abuse, but these needed continual refinement, and including them in bilateral treaties was a cumbersome process.

The US also enacted detailed Transfer Pricing Regulations in 1968. However, while CFC

rules disregarded the legal personality of CFCs, the Transfer Pricing regulations entrenched it in the arm's length principle, through functional analysis and the emphasis on comparability. These concepts were accepted by the OECD in its report on Transfer Pricing of 1979. In the meantime, the US found that in practice the arm's length principle in practice did not work.⁴ The 1986 Tax Reform Act made the first substantial revision to the basic transfer pricing rule in s.482 since its enactment, and the regulations were revised to introduce a 'comparable profits method'. This caused considerable conflict in the OECD, but the OECD Transfer Pricing Guidelines finally issued in 1995 included two new profits-based methods, the transactional net margin method (TNMM) and the profit split method (PSM). However, these have continued to be described as 'transactional' methods, and the PSM has remained limited in scope.

Since the 1990s, MNEs have found further ways to take advantage of the limitations of these rules. They have structured many of their operating subsidiaries, in production, distribution and even services such as marketing and research, so that they can claim to operate on a 'stripped risk' basis. Hence, when applying profits-based transfer pricing methods they can be attributed only a 'routine' return. Under the arm's length principle, it has become accepted that 'risk' can be transferred to any affiliate of a MNE, even in a low-tax country. These profits can therefore be further reduced by deduction of royalties and interest, and the payments are generally routed through intermediaries to remain untaxed offshore, as 'stateless' or 'homeless' income.

These techniques have become ubiquitous, driven further by digitalisation. Although worldwide businesses are being conducted in a fashion that is truly seamless to customers and other persons (vendors, suppliers, etc.), these groups typically break up the various business activities and carefully place them into different group members, some of which are in countries where there are many customers and some of which are in low or zero tax countries. While there will of course be on occasion some legitimate business reasons for some of these decisions on which group member will perform which business function, very often the primary motivation will be minimisation of taxation. The concerns that they aroused gave rise to the BEPS project.⁵ Yet most of the outputs of that project have done little to resolve the problems.

The Impact of Digitalisation on Business Models from an International Tax Perspective

Although digitalisation has brought important changes to business models, in our view they are not as significant for international tax rules as is sometimes supposed. For example, it is often pointed out that digitalisation enables cross-border sales without the need for the level of physical presence required under tax rules for a PE. However, this has already been the case for several decades in relation to services, which has long been a source of tension

⁴ A report to Congress by the General Accounting Office in 1981 stated that 'Because of the structure of the modern business world, IRS can seldom find an arm's length price on which to base adjustments, but must instead construct a price. As a result, corporate taxpayers cannot be certain how income on inter-corporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers'. It recommended that Treasury should 'evaluate the feasibility of ways to allocate income under s.482, including formula apportionment, which would lessen the present uncertainty and administrative burden created by the existing regulations' (Report of the Comptroller-General to the Chairman, House Committee on Ways and Means, CGD-81-81, p.54). During the public consultation on the proposals in the BEPS project for 'special measures' for transfer pricing on 19 March 2015, a senior tax official from China also frankly stated that 'the arm's length principle does not work': see <https://www.youtube.com/watch?v=hjuhPtmTx64&feature=youtu.be>.

⁵ See Jeffery M. Kadet, 'BEPS - A Primer on Where it Came from and Where It's Going', *Tax Notes*, Vol. 150, No. 7 (February 15, 2016), available at <http://ssrn.com/abstract=2739659>.

especially between developed and developing countries. Improvements in communications due to digitalisation have heightened this problem.

As regards digitalised products, the BEPS problems are not caused by small companies, such as software firms, selling digital products to customers around the world, since their income can generally be taxed where the company is actually located; also, most are not large enough to pay the expensive fees of lawyers, accountants, and other facilitators to set up the required structures. The problems arise when larger MNEs take advantage of the separate entity principle to fragment their activities, and attribute functions such as sales, order fulfillment, production, marketing and customer support to different affiliates. In fact, such MNEs will often have real and considerable physical presences in the countries where they have high sales.⁶ Of course, they could choose to out-source such functions to genuinely independent firms. Where they elect not to do so, the basic theory of the firm tells us it is because carrying out these activities in-house enables the firm to capture additional profits from control and closer coordination due to economies of scale, and synergy effects.

Similarly, while digitalised business relies extensively on proprietary rights such as brands and software, this is not significantly different from other business models such as pharmaceuticals, which has relied on brands and patents for well over a half-century. There is perhaps a difference for software engineering, which can more easily be organised on a collaborative but decentralised or dispersed basis. However, this seems to be a feature for all firms. For example, in response to the consultation on transfer pricing of Intangibles, BASF, the German-based chemicals firm, explained:

‘Quality management and controls relating to the risks, functions and assets employed are to a wide extent part of corporate procedures which are generally valid group-wide and are fully integrated in the business processes. The research and development process is managed by electronic systems which track the allocation of projects to specific research centres, the adherence to budgets, the sign-off processes and the registration of IP rights. “Control” is therefore to a large extent built in to group-wide guidelines and operating systems, and can therefore be performed anywhere as such systems enable a decentralised, collaborative organisation’.⁷

Hence, digitalisation has enabled all firms to operate in a more decentralised way geographically, while still under centralised management and control.

There are three aspects of the changes in value creation as a result of digitalisation which are in our view significant for tax. The first is the closer relationship it both requires and enables between producers and consumers. However, this is also part of the wider shift digitalisation has facilitated towards the delivery of products to customers in the form of continuous services rather than one-off sales of physical goods. Provision of services that continue on an ongoing basis generally entails a closer relationship between the supplier and consumer than does a discrete sale of a physical product. Digitalisation has facilitated this so that such closer relationships can even be managed across the globe. It also means that they have become more interactive, with significant contributions of value from the customer to the MNE. Hence, access to customers is a major source of value. This is sometimes thought of in terms of data collection, which implies a static role and understates the active and often frequent contributions of the customer. For example, many web platform firms aim to create a

⁶ This is noted in the BEPS Action 1 report *Addressing the Tax Challenges of the Digital Economy* (2015), p. 100.

⁷ In its submission to the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, September 2013, www.oecd.org/ctp/transfer-pricing/basf-intangibles.pdf

‘community’, with users contributing content such as product reviews, photos and text, ranging from personal communications to literary, audio and video productions of many kinds.⁸

The second, related, aspect is that digital services are often supplied with no direct charge to users, while their inputs are monetised by sales to customers of other services, especially advertising. This poses a particularly difficult problem in deciding how to allocate profit, since the value contributed by user contributions is separately monetised.

Thirdly, digitalisation enables some firms to recharacterise themselves as pure intermediaries between producers and consumers. This has become particularly spotlighted recently in relation to platforms providing taxi and accommodation services, which assert that the actual suppliers of these services are independent contractors and not employees. However, this is a wider phenomenon, including for example many forms of publishing and media, which often treat content creators as independent contractors. Tax authorities can relatively easily ensure that the contractors pay tax on their earnings. Indeed digitalisation makes this easier, and arrangements have been put in place in some countries for automatic transmission to tax authorities of all fees paid to contractors. The issue for MNE taxation is rather that the significant percentage which is taken off the top by the digital intermediary is usually paid to an entity elsewhere, usually to ensure low or no taxation.

B. Challenges and Opportunities for Tax Systems

A large number of reports and analyses have publicised the central problem that international tax rules are largely failing to align tax rights with the location of real economic activities and value creation. These have aroused the concerns of the general public and politicians, who increasingly and insistently are demanding better solutions. The spotlight has fallen particularly on the giant internet-based firms which now dominate the world economy. A representative example is a recent report issued by two Members of the European Parliament⁹ which claimed that as much as €5.4 billion in tax revenue was lost in the EU from two technology companies between 2013 and 2015. Such reports stress the disjuncture between the location of users and sales revenues and tax paid. However, as pointed out in the previous section, these companies also have a significant physical presence and many thousands of employees in the EU.

This kind of public pressure led the UK government to introduce a Diverted Profits Tax (DPT), which took effect in April 2015, which is now being emulated in Australia and New Zealand. This unilateral measure was resented by many participants in the BEPS project negotiations, and indicated that the UK did not expect the project to result in effective solutions, or perhaps even that the UK did not support multilateral solutions. Recent official estimates are that the DPT raised £31m in 2015/16 and £281m in 2016/17.¹⁰ These official estimates came from relatively few firms: HMRC said it was targeting 100 large MNEs, and it was reported in May 2017 that one alone (Diageo) would pay £107m, although under protest. Although relatively simple in its concept, the DPT drafted in technically complex language, and gives considerable discretion to the tax authorities, so is uncertain in its

⁸ Noted in the BEPS Action 1 report *Addressing the Tax Challenges of the Digital Economy* (2015), p. 101.

⁹ Paul Tang and Henri Bussink, *EU Tax Revenue Loss from Google and Facebook* Sept. 2017, available at <https://paultang.pvda.nl/wp-content/uploads/sites/424/2017/09/EU-Tax-Revenue-Loss-from-Google-and-Facebook.pdf>

¹⁰ It seems likely that these low figures do not include the effects of the additional changes in the UK effective from 17 March 2016 that impose royalty withholding tax in many cases affected by the DPT. The additional tax revenues from these royalty withholding tax changes may very likely be much more substantial than those arising solely from the DPT.

application. While it seems to have encouraged some digital platform firms to restructure and attribute some sales to a UK affiliate,¹¹ others have not,¹² it is not clear how many have done so.

It is therefore clear that the dysfunctional nature of the current international taxation framework is generating considerable debate, conflict and uncertainty. This is not confined to OECD countries, as the same issues are present in emerging and developing economy countries, which are now experiencing the impact of digital platforms, such as Jumia in Africa. In relation to e-commerce there are immediate issues about sales and value-added-taxes. But much of the public and political concerns focus on taxation of business profits, and the perceived unfairness that giant MNEs are able to pay low taxes while generating enormous revenues.

C. Implementation of the BEPS Package

As outlined in our response to section A, in our view the BEPS project package did little to resolve the central problem of how to align taxable profits with real economic activities and value creation. This failure particularly affects the changes which were expected to do something to mitigate the problems caused or exacerbated by digitalisation. Thus, Actions 8-10 relating to Transfer Pricing failed to establish clear criteria for allocating profits. For example, although apparently intended to eliminate pure ‘cash-box’ intermediary entities, there is considerable subjective judgment and hence uncertainty involved in deciding what level of managerial support that might be considered to provide substance for a holding company handling intellectual property rights or financial assets, or when such entities could be said to assume risks. This continues to provide scope for aggressive tax planning, and helps to explain why some countries are resorting to unilateral defensive measures such as the DPT.

Implementation of the treaty-related outputs relies mainly on the Multilateral Convention on BEPS (MC-BEPS). Although it has now been signed by 71 jurisdictions, this does not include some key states, notably the USA. This endangers implementation of the minimum commitments, particularly the provisions against treaty abuse in Action 6, since the US seems to have opted for bilateral negotiations to introduce complex limitation-of-benefits provisions, rather than the simple principal purpose test preferred by almost all others. Instead of establishing a basic common floor of anti-abuse provisions in all treaties, the MC-BEPS may add to the kaleidoscopic complexity of the treaty system, which creates loopholes that can be exploited. Furthermore, many signatories have made reservations against other provisions, including the modest changes to the PE definition. This may be due to caution, since work is not complete on the implications of these changes for attribution of profits to a PE. Nevertheless, this indicates the uncertain state of implementation of even the minimal changes agreed in the BEPS project.

D. Options to address the broader direct tax policy challenges

Tax nexus concept of “significant economic presence”

This issue has two related aspects: the definition of taxable presence, and the principles for allocating income to the activities (or ‘transactions’ as stated in the Request) carried out

¹¹ For example Facebook: see the 31 December 2016 Facebook UK Limited annual report and financial statements filed 3 October 2017.

¹² Notably, Google: see Public Accounts Committee (2016), Corporate Tax Settlements. UK House of Commons HC 788, available at <https://publications.parliament.uk/pa/cm201516/cmselect/cmpubacc/788/78802.htm>

through that presence. We will take these in turn.

In relation to the first, we will quote from our submission to the consultation under BEPS Action 1 in 2014:

‘The criteria which we suggest for a Significant Presence should reflect the contribution to value added resulting from the closer and interactive relationships with customers. These should include:

(a) relationships with customers or users extending over six months, combined with some physical presence in the country, directly or via a dependent agent;

(b) sale of goods or services by means involving a close relationship with customers in the country, including (i) through a website in the local language, (ii) offering delivery from suppliers in the country, (iii) using banking and other facilities from suppliers in the country, or (iv) offering goods or services sourced from suppliers in the country;

(c) supplying goods or services to customers in the country resulting from or involving systematic data-gathering or contributions of content from persons in the country.

Although broad, these criteria would still exclude many businesses involved in the digitalised economy. For example, a software designer which supplies a program in digital form to customers all over the world from a single website in the language of its residence country would not be covered. The aim of the definitions is to capture situations where the firm has a significant presence in the host country although digitally, and to include the element of value added from systematic collection of data and contributions of content from persons in the host country.’

This proposal extends the concept of a PE into the digital age. A more radical approach would be to apply a defined quantitative threshold, such as a minimum level of sales, assets and/or employees within the country. This would have the merit of being easier to apply, but also perhaps to avoid.

The more important question is the second one, the criteria for attributing income. Under current rules, this depends on an analysis of the risks assumed, assets owned and functions performed by the entity. However, it is important in our view not to apply this functional analysis to the various affiliates of a MNE in isolation. As pointed out in section 2.A above, internet-based MNEs commonly also have affiliates in countries where they have substantial customers which perform many support functions. Hence, in our submission to the current consultation on Attribution of Profits to a PE, we proposed that functional analyses should not be applied to each group entity in isolation.

This submission argues that activities such as marketing, sales, order fulfilment and customer support are closely related. This means not only that it is often difficult to distinguish where one ends and another begins, but that it is the **cumulative importance** of the activities that should be considered when evaluating the value which is created. ‘For example, activities such as marketing or customer support, if linked with sales, can provide valuable feedback to software engineers responsible for the design of a sales website or platform. Equally, operating flagship stores displaying and selling a MNE’s products directly to customers may enhance reputation and branding, thereby contributing significant value by increasing sales concluded through independent third-party retailers.’

This is one example of how it is possible, and indeed necessary, to move away from the independent entity principle even under current rules, as we argued above.

A more direct approach to allocation of income is possible, at least in principle, under a formulary apportionment approach, such as the CCCTB. Such an approach allocates income according to factors quantifying levels of economic activity or presence in a jurisdiction, such as assets, employee remuneration and sales. However, some have argued that account should be taken of the ‘immaterial labour’ in the digital economy, resulting in unpaid contributions to value creation from users. Reflecting this view, the draft report for the European Parliament on the CCCTB of July 2017 proposed adding data collection and exploitation as a fourth apportionment factor. The data factor would be equally made up of the proportion in that country of the ‘volume of personal data of online platform and services users’ collected and exploited.

This issue requires further evaluation and debate. We do consider that the collection and exploitation of data, and even more active content, amount to sufficient presence to justify a taxable nexus. We have also provided in past submissions¹³ an approach to applying the profit split method that would include the value of the users as a concrete factor. This example is included with this submission as Appendix A. Nevertheless, it cannot be said that these inputs contribute to income or profits until they are monetised. In this regard, it should be noted that a key element of the business model of many web platform firms is that they at first aim at rapid growth by creating a large user base, even if this does not initially generate much revenue or profits. Such growth is reflected in the valuation of the firm, which may benefit the founders and early investors if and when it goes public or is acquired. However, this would normally be treated as a capital gain, not income. Nevertheless, the user base constitutes an asset, although not usually shown in the balance sheet. Hence, it could be taken into consideration in calculating the asset factor if one is used in the formula for allocating profits.

Withholding tax on digital transactions and/or digital equalisation levy.

The Request asks the same questions in relation to both of these options, and those questions indicate the problems they pose, to which we see no ready solutions. Each country is likely to make its own decision on which transactions to include in the scope of such taxes, reflecting factors such as the intensity of lobbying by both foreign and domestic business. Gross taxation has intrinsic defects as it has no relation to profitability. Furthermore, such taxes are generally passed directly to consumers. Since they are not taxes on income or profits, tax credits would not be available, so they pose the threat of double taxation. Of course, as we have noted above, MNEs have a range of refined techniques available to avoid this threat. They also have the option of booking sales revenue to a local affiliate and paying tax on its profits, instead of the withholding tax on payments to a non-resident.

The main merits of such taxes are that they are relatively easy to administer. This of course is the reason that governments are increasingly resorting to such expedients, however undesirable they may be in principle. Furthermore, we expect that many MNEs will simply pass on such taxes directly to consumers through increased pricing. MNEs may therefore consider them tolerable, as they do not impinge directly on profits, although they do affect market growth and share. Whilst we do not consider this type of measures to be a long-term solution, they respond to an immediate abuse of the current international tax rules and ensure that tax is collected on sales by digital MNEs to local customers.

Other tax measures

We have already commented (section 2.B above) on the DPT in the UK, as a unilateral and

¹³ Example 1 on page 20 of our comments submitted 14 September 2017 concerning the profit split method.

essentially defensive measure. Such measures may have some success in persuading, or bullying, MNEs to restructure so as to pay some more taxes in the countries concerned. This may allow politicians to claim that effective action is being taken. However, they clearly do not contribute to resolving the basic problem.

MNEs should be concerned that such measures and proposals are proliferating, in the absence of an effective and equitable way of allocating income internationally.

How to translate the “significant economic presence” test into the existing tax treaty framework

The “significant economic presence” test can only be incorporated into a tax treaty framework through some remodelling of the existing international tax rules contained in the tax treaty Models. For an effective implementation of such rules, and so that they can operate and correlate to all of the existing tax provisions discussed in a treaty context, we would propose the inclusion of a new article, establishing the parameters for a digital PE. The commentaries to this proposed new Article 7A, would explain when a digital PE would arise, provide examples, and also clarify the rules for tax allocation.

Following the practice derived from developed and developing countries (as per section 2.B above), we would propose that greater emphasis should be put on the application of withholding income taxes at the country where the activities take place and value is created. The new article and commentaries would define a single methodology for the allocation of income between source and residence states, and provide more consistency in the way countries come to tax income derived from digital activities where there is little or no physical presence in the source State.

APPENDIX A

EXAMPLE OF ALLOCATION KEYS AND WEIGHTINGS INVOLVING USERS

Example 1

This example is taken from DD10’s Scenario 2.

“The RCo Group provides a number of internet services (e.g. search engines, email services, advertising, etc.) to customers worldwide. On one side of the business model, advertising services provided through an online platform are charged to clients for a fee that is generally based on the number of users who click on each advertisement. On the other side, online services are offered free of charge to users, whose use of the services provides the RCo Group with a substantial amount of data, including location-based data, data based on online behaviour, and data based on users’ personal information. Over the course of years of data collection, refinement, processing, and analysis, the RCo Group has developed a sophisticated technology that enables it to offer to its clients the ability to target specific advertisements to certain users. The more extensive the online services, and the greater the extent of the associated data, the more valuable and attractive the other side of the business model becomes for clients wishing to advertise.

“The technology used in providing the internet advertising services, along with the various algorithms used to collect and process data in order to target potential customers, were originally developed and funded by Company R, the parent company of the RCo Group.

“For larger markets and in order to deal with key clients for advertising services, the group has established a number of local subsidiaries. These local subsidiaries perform two functions: they promote the use of online services provided free of charge to users, translate

them into the local language, tailor them to the local market and culture, ensure that the services provided respect local regulatory requirements, and provide technical consulting to users. In addition, they generate demand for and adapt advertising services. In doing so, they also regularly interact with staff members in Company R in charge of developing the technology and make suggestions, notably on the algorithms and technologies used and their adaptation to local market features, and on new features that would be attractive to users in their market.”

Simplified Allocation Keys

For the combined profits of this common business model, two equally weighted allocation keys are defined as follows:

- Users

Using users as an allocation key reflects the importance of each market and the value of Aco’s users to the global business of Aco and Aco’s fee-paying third-party customers seeking advertising services. The country is determined by the location of the user and not the legal terms of any contracts, licenses, or other documents with either users or the third-parties that pay Aco for advertising, aggregate user data, etc.

- Operating Expenses

This allocation key recognises all operational inputs. As such, it covers all research and development, website maintenance, sales, marketing, distribution, management, support functions, etc.

This key would include categories of expenses such as:

Salaries and bonuses of all operations personnel (allocated by location of personnel)

All other direct and allocated operating expenses (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for all operational functions (allocated by location where the other party provides the services) (These payments economically include all personnel costs, office and manufacturing costs, etc. of the legal entity performing the relevant operational functions for the taxpayer. Payments to any related parties whose profits are included in the combined profits for the profit split would of course be excluded.)

William Morris

Chair, BIAC Tax Committee
13/15, Chaussée de la Muette, 75016 Paris
France

Task Force on the Digital Economy

Organisation for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris, Cedex 16
France

Submitted by email: TFDE@oecd.org

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REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITALISED ECONOMY

Dear Members of the Task Force on the Digital Economy,

Thank you for the opportunity to provide input on the tax challenges of the digitalised economy. As an initial matter, however – and while this may seem a semantic point it is, in fact, a critical one – we believe it would be better to refer instead to the “digitalising” economy rather than the “digitalised” economy. Although the changes over the past five/ten/twenty years have been dramatic, our members feel that we are standing on the threshold of changes of orders of magnitude larger than those we have seen so far. In that context, the interim report that the TFDE is to deliver to the OECD should be a review of where we have come from, and where we may be going, and an invitation to start a conversation on the implications of that. We do not feel it would be productive for the report to focus on a set of recommendations fixed in present and, inevitably, heavily influenced by the past.

Twenty years ago, with remarkable foresight, the OECD worked on principles eventually articulated in the Ottawa Taxation Framework that ensured that growth-suppressing national taxes would not be imposed on the nascent digital sector. Twenty years later we can say, without doubt, that this has been one of the most significant achievements of the OECD in its half century of existence. Today – thanks to that framework – digitalisation is revolutionizing economies, business models, and the lives (at work and at home) of billions of citizens. This will have dramatic effects of every corner of every economy – including on tax bases and the ability of governments to raise the revenues their citizens expect them to raise. The conversation of the past five years has – appropriately – been focussed on dealing with the issue of Base Erosion and Profit Shifting (including in relation to the digital sector). But with the fifteen recommendations having been made, approved, and now beginning to be implemented, we need to turn to the challenges of the future, and the overwhelming need to make sure the changes being wrought by digitalisation promote growth and employment, including through cross-border trade and investment.

However, we see significant issues with each of the proposed options to address what are perceived as the direct tax policy challenges of the digitalising economy in the Request for Input. Double taxation, increased compliance burdens, conflicting unilateral interpretations, potential treaty conflicts, and increased taxation for low margin and loss making businesses will suppress rather than promote the growth that digitalisation can offer.

Instead of rushing towards imperfect solutions, there needs to be a serious and sustained conversation, not just between governments but with the businesses, large and small, that are driving, and accelerating this digital revolution. There is no body better suited to this task than the one that gave us the Ottawa Framework – the OECD. But this must be a deliberative and considered conversation. It cannot be completed in a few months. Furthermore, it must be a conversation which – unlike BEPS, where business was the “problem” – involves a close partnership between the OECD, a broad range of national governments, and business to try to discern what the future might look like. Only with business closely involved is there any hope of even vaguely comprehending what the next five to ten years may bring, and how growth can best be promoted and protected while still enabling governments to raise tax revenue.

At the heart of this conversation – and, obviously, a source of contention between countries – is the fundamental question of where value is created. BIAC believes that it will take time to establish what must be a multilateral consensus on this issue. At the same time we understand that this conversation cannot take for ever. BIAC stands ready, therefore, to fully engage in that sustained conversation, and to work constructively and cooperatively over the next three years, into 2020, to help reach a truly multilateral agreement that sets a new pro-growth tax framework that meets the needs of all stakeholders.

Sincerely,



Will Morris
Chair BIAC Tax Committee

General Comments

BIAC would like to start by reinforcing its support for the conclusion drawn in the Base Erosion and Profit Shifting (“BEPS”) Action 1 Report that there should not be a separate taxation regime for the “digital economy”. We, of course, acknowledge that there are important issues concerning the digitalisation of our economies but considerable care must be taken to ensure that measures intended to address the taxation of the digital economy do not lead to serious distortions in markets and global value chains. A tax system specifically designed to target “pure” digital companies, rather than a system designed to be neutral across all sectors, will inhibit cross-border growth and investment, foster uncertainty, and increase double taxation. One of the OECD’s core principles is to reduce barriers to the expansion of trade, and instances of double (or multiple) taxation on one stream of revenue threaten this principle.

BIAC understands that much of this conversation is being conducted at a political level, and acknowledges the political pressure under which the TFDE is operating but we strongly believe that the only path towards a solution for all stakeholders is if the overall discussion is rebalanced to focus on encouraging the growth of the digital economy rather than the threat it may pose to tax revenue. There is a tremendous opportunity at present to shape international tax law in a way where tax can be a catalyst for cross-border investment and growth and not only for large multinationals but also for small and medium-sized enterprises (“SMEs”). However, without a change to the current narrative, we risk having the opposite impact.

The growth of the digital economy has been one of the greatest economic success stories in the past twenty-five years with a remarkable increase in connectivity, technological leaps in developing countries, and new opportunities for multinationals and SMEs. The OECD must work to rebalance this discussion amongst its member countries by highlighting how enriching this growth has been for many people in many countries and the considerable risk that tax could become a monumental barrier to future growth if these issues are not carefully addressed.

BIAC acknowledges that the fundamental issue at the heart of the debate on taxation of the digital economy is the pressure that digitalization places on determining where value is created. This is an enormously difficult area that must be addressed through a global agreement and not through unilateral measures, whether or not these measures are considered short-term solutions. The central tenet of the BEPS Project was to establish an international tax framework that would provide for a level-playing field under which profits are taxed where economic activity and value creation occur. As such, significant time and effort was spent during the BEPS process determining where value is created and now it appears that those standards are considered by some to no longer be viable before we have seen their full implementation. It will take time for the considerable changes advanced through the BEPS Project to be implemented so it would be a costly mistake (at the expense of global trade and growth) to abandon these principles now. It is imperative that the OECD promotes patience and thoughtful analysis despite the upcoming deadlines mandated by the G20 or pressure from member countries for a quick fix.

A primary concern among the business community regarding the unilateral measures that have been proposed or already adopted is the lack of consideration for the impact these measures will have on the operation of traditional and non-traditional digital businesses. There are a wide range of diverse business models within sectors, geographies and scales, and these business models have degrees of

interdependence and crossover but also separate, commercially-led strategies that are responsive to the needs of their stakeholders yet constrained by market forces, competition, and regulation. Tax policy choices should encourage business decisions to be taxed neutrally, but the reality is that if measures are proposed and adopted that do not align with emerging business models, this will have an impact on business and investment decisions.

As previously mentioned, BIAC understands the political pressures for the TFDE G20 interim report to recommend proposed solutions for taxing the digital economy. However, as we have tried to make clear throughout our response, we should consider ourselves to be in the infancy of the discussion around taxing the digital economy. Therefore, an analysis of the scope and impact of various proposed solutions (and, a fortiori, any recommendations) is premature. For instance, there seems to be no consideration for how any proposed solutions would impact an overall goal of the OECD to work towards a uniform international tax framework across jurisdictions and business sectors. That being said, we believe there are very clear principles that should drive any proposed solution. Specifically, BIAC continues to support the principles established by the Ottawa Taxation Framework of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility as the ideal starting point for the TFDE. We also agree with the OECD's BEPS Action 1 report that sustainability and proportionality are also key principles against which proposals should be measured.

The introduction of either a “virtual PE”, withholding tax on digital transactions, or equalization tax on the turnover of digital companies would clearly violate these principles (more information is included in our specific responses questions below on this conclusion). There are clearly fundamental problems with each of these proposals, all of which are dangerously blunt tools fashioned to enable “source”¹ countries to raise additional revenue (which could result in double/multiple taxation on the same revenue streams), rather than considered measures to address either BEPS concerns or the broader tax challenges posed by the digitalization of the economy.

In fact, we observe that each of the measures (and particularly the proposals regarding taxes levied on turnover) undermine one of the key objectives of the recently concluded BEPS Project – to “better align rights to tax with economic activity”. For example, the BEPS Project sought to realign the allocation of taxing rights away from contractual allocation of risk, toward where such risks are managed. It is hard to see how any of the three proposals would further, rather than hamper, this objective.

It is equally unclear that any of the proposals have been suggested with growth in mind, as seems to be an expectation of the G20 Finance Ministers. **Together, we believe that these observations reinforce the need to take an appropriate period of time with multilateral engagement – including crucially with business, – in order to develop more pro-growth and sustainable multilateral solutions.**

¹ BIAC increasingly finds “source” and “residence” to be very unhelpful terms. They connote a binary world of capital-importers and -exporters, rich and poor, developed and developing, whereas (not least because of digitalization) a serious conversation about value creation should allow for a more nuanced picture, and range of possibilities.

BIAC strongly urges the TFDE to work to change the narrative to one of pro-growth and resist the political pressure for immediate, drastic measures when it is clear from the complex issues addressed in this RFI that there is still a great deal of analysis required in this area. We continue to believe that the OECD is the only organization that can drive a consensus solution that satisfies all countries, and we stand ready to continue to support the OECD in its endeavors.

Responses to Questions

A. Digitalisation, Business Models and Value Creation

- 1 Please describe the impact of the digitalisation process on business models, and the nature of these changes (e.g., means and location of value creation, organisation, supply chains and cost structure).
 - There are a number of different ways in which digitalisation has impacted business, including:
 - Many “pure” digital businesses are now prominent players in local economies and the global economy. Such businesses provide goods and services that do not have “traditional” counterparts to which they could be compared, because they offer goods and services that would not exist without digitalisation. Such businesses tend to be innovative and highly dependent on IP generated early in their life cycle, and continued investment and innovation throughout their life cycle. Whilst they may require localisation, this can often be delivered in different ways (i.e. remotely) than was the case for traditional business models.
 - Digitalisation has given “traditional” businesses much more freedom in where they locate their assets, functions and resources. This leads to more efficient business outcomes due to (i) options for employing better quality resources, and (ii) options for employing cheaper resources (which will include any tax savings/costs that may arise as a result of the location of this resource).
 - Many traditional B2B businesses are now also able to deal with and communicate with their end customers/users without intermediaries. This has empowered new sales channels which have impacted supply chains and pricing structures of different business models in different ways. Also, though, this has increasingly resulted in such companies needing to invest in developing their brands and building connections with consumers and communities.
 - Similarly, some (but not all) “pure” digital business models and digitalised “traditional” business models have become multi-sided in nature, which is not a key observation of historical business models. In such cases, rather than developing and providing products and services to customers in multiple locations, the business model is a platform that connects users/customers in different locations, or at least centrally benefits from the interaction of dispersed users/customers without facilitating a direct interaction between the two. Coupled with the rise of social media has also contributed to more “customer-centric” business models; there are greater risks and rewards to failing or exceeding customers’ expectations.

- Whilst in some industries barriers to access remain high (which includes, but is not limited to “pure” digital businesses), the ability for customers and consumers to select from a broader range of international suppliers of goods and services, delivered through a broader range of mechanisms (which can be increasingly bespoke), has driven greater competition, and consequently more innovative and customer-centric products, services, and delivery mechanisms. Again, this may be delivered through cost savings (or alternative payment methods such as through agreeing for companies to use data and/or show advertising) or better/new products and services.
- Increasingly, business offerings have become (and continue to become) more service based. In delivering this, software is increasingly a crucial infrastructural element and key value driver relative to physical products and hardware.
- New entrants are competing with and working with existing businesses on an unprecedented scale, resulting in more frequent and swifter disruption to business models than has traditionally been seen.
- These changes have resulted in greater efficiencies in business models and a redistribution in the traditional allocation of functions between economies. In some instances the provision of digital services does not necessarily generate revenue but remains critical as a means for providers of traditional products and services to remain relevant in the digital economy. The impact has been a greater degree of choice (in supplier, delivery method and pricing structure), better products/services, and even new product/services for customers and consumers.
- Other emerging areas of importance, such as Big Data, Internet of Things, 3D Printing, and “Everything” as a Service (over cloud or virtual platforms) are increasingly important for global business. Whilst the key value of such offerings is increasingly found in software, we do not believe that this fundamentally changes the business decisions and business models outlined above.

2 What role does IP play in highly digitalised businesses, and what are the types of IP that are important for different types of business models (e.g. patents, brands, algorithms, etc.)?

- Digitalized businesses are not necessarily more IP-intensive than traditional businesses. IP is clearly a key value driver for most businesses (traditional and “pure” digital) and this question depends very much on individual businesses and business models. It would therefore be a mistake to assume as a starting point that digitalized and non-digitalized business models can be differentiated in this way.
- As a general rule it could be said that patents are more important for “traditional” business models, brands are of increasing importance for all business models, and algorithms are more important for “pure” digital businesses (but are also increasingly important as all businesses move to digitalised delivery).
- For example, under traditional “service” models, a business may have historically needed to send out a human to diagnose a problem with a machine, and propose a fix. Under a “digitized” model, the software/IP may now be able to remotely diagnose the same problem, and then either send a repair person with the part to install, or ship the part to the customer and remotely guide them through a self-repair process. The same (or greater) value is being created in such instances, but it is the DEMPE of the algorithms that generates this value.

- 3 How are sales operations organised across different highly digitalised business models? What are the relevant business considerations driving remote selling models, and in which circumstances are remote selling models (as opposed to local sales models) most prevalent?
- As noted above, as a result of digitalisation, businesses now have much more freedom in where they allocate their assets, functions and resources. This leads to more efficient business outcomes due to (i) options for employing better quality resource, and (ii) options for employing cheaper resource (which will include any tax savings that may arise as a result of the location of this resource).
 - The key driver for remote selling models is cost reduction in combination with increased quality. If a business stream can be managed remotely, without having to visit different locations/sites, support will become less expensive and it will be easier and more cost effective to centrally monitor the business from a remote location. Increasingly, this is also the case for all business models. Bespoke solutions regarding the physical presence of employees and assets (i.e. warehouses, stock, servers) are required for each business, and will be based on an analysis of quality and cost of resources relative to the impact on delivery.
 - It is also of note that the level of physical presence related to the selling/marketing activity in-country depends on a business' growth phase and its level of maturity. Remote selling of services may not require any physical presence of supporting employees, but to achieve any scale, some physical presence is still generally required (and some business models rely on signing up users/customers online to benefit from offline (physical) services).
 - For example, there are some industries where proximity to the customer is important (e.g. delivery of perishable goods which may expire, or computerised trading platforms through which fractions of a second in transmission time may be critical). Whilst some businesses in such industries may make this their USP, others may choose to locate functions elsewhere and offer better quality, or cheaper (but slower) services.
- 4 What is the role of data collection and analysis in different highly digitalised business models, and what types of data are being collected and analysed?
- Data can be used in the same way as any other information, by individuals, to create value (e.g. through developing tools that use the data to improve predictability of maintenance and operation of industrial assets, or through combining with other data and analysing in innovative ways to identify trends). However, raw data does not have value in and of itself.
 - See also below answer to question A5.
- 5 Is the establishment and operation of such global (or at least cross-country) user networks new and specific to certain highly digitalised business models, and what are the potential implications for value creation?
- No. Increasingly, "traditional" businesses also need to engage with their customers (and end consumers, where relevant) digitally and directly, and increasingly communities of users and customers are important to their success (see QA1 above).
 - The impact on value creation depends on the nature of the business and the business model employed.

- Where users are simply providing data to their suppliers in order to improve the service, this may be collected much more easily (and combined in new and innovative ways that result in better outcomes), but this is not fundamentally different to a customer completing a survey or providing feedback and sending it to its supplier under traditional business models. This data does not generate additional revenue but is simply required for businesses to remain relevant in the sale of traditional products.
- Users may receive valuable services (e.g., maps, email, connectivity tools, etc.) for free in exchange for providing personal data. Where users are supplying their personal data in return for access to a “free” (e.g. paid for through advertising) service, this is again not new; traditionally marketing companies have collected a wide range of data on individuals and markets through surveys and market research to enable advertisers to be more effective in how and to which communities they target (although, as above, digitalisation may allow it to be combined in new ways that result in better outcomes). Under such traditional methods of data collection, those who collect the data would create value where their functions, assets and risks that analyse that data are located.
- We therefore question whether the number of “users” really does change the location of where the value is created.

6 Please describe how you see business models evolving in the future due to advances in information and communications technology (e.g. Artificial Intelligence, 3D printing).

- We believe it would be imprudent to assume that it is possible to further predict product/service development, let alone the business models that would deliver them. Many of the products and services that we see today could not have been accurately predicted as little as twenty-five years ago. Even for those products and services for which we expect to see developments in the near future, industry experts are divided as to their usefulness and the impact that they will have on our lives and economies.
- However, technology advancement by itself has not fundamentally changed how enterprises generate revenues. Rather technology and automation may increase operational efficiencies or replace certain routine/administrative functions. Because servers and software programs/algorithms now replace what used to be offices with humans performing tasks, certain business functions are now more mobile. For example, e-commerce selling is similar to catalogue selling, except now, order and payment processing can happen on a server (which can be located anywhere) rather than in an office with humans taking orders and processing payments.
- We would expect businesses to continue to make investment and product/service decisions based upon where the factors critical to the success of their businesses can be performed most efficiently and at the lowest cost. The current trend in this vein appears to be that traditional jobs can increasingly be automated or performed remotely, and that new opportunities are provided by new innovations.

B. Challenges and Opportunities for Tax Systems

- 1 What issues are you experiencing with the current international taxation framework? (e.g. legal, administrative burden, certainty)
 - BIAC has commented extensively on the difficulties that businesses face in the international tax system. Administrative burden and uncertainty are of particular importance to our members, particularly as a result of the BEPS Project and including particularly interpretation of Transfer Pricing Guidelines, application of anti-abuse provisions, and the fundamental changes to the long-standing concept of permanent establishment.
 - In addition, it would be valuable if the OECD – as the tax standard setter -- could help bring more coherence to the tax system by standardizing the interpretation of phrases and key terms. For example, a consensus on the definition of “income tax” would make it more difficult for countries to levy tax on income while asserting that it is not an income tax (e.g. that it is a penalty). Another example would be the definition of “royalty”, and the importance of an analytical approach based on an analysis of differences between a user receiving a right to use copyrighted software against a user receiving a right to the copyright itself.
- 2 Digitalisation raises a number of challenges and opportunities for the current international tax system. In particular:
 - a. What are the implications of highly digitalised business models and their value chain on taxation policy? In particular:
 - i. What impact are these business models having on existing tax bases, structures of tax systems and the distribution of taxing rights between countries?
 - ii. Are there any specific implications for the taxation of business profits?
 - See in particular our response to A1 above.
 - The additional options that taxpayers have regarding where to locate their functions, assets and risks allows them to make investment and business decisions that deliver better outcomes and lower costs.
 - This, of course, has an impact on the tax bases of countries who previously benefitted from investment because of (in part) their geographical location or proximity to other functions (or markets).
 - Conversely, countries that have embraced the digital economy and provided the tools (e.g. digital infrastructure) and climate (e.g. regulation, tax regime) that encourages such investment have benefitted from increased investment.
 - b. What opportunities to improve tax administration services and compliance strategies are created by digital technologies?
 - We expect that there are numerous ways in which digitalisation could assist taxpayers and tax authorities in both overall experience and levels of compliance.

- However, experiences of taxpayers to different countries' implementation strategies has been mixed. Like any project, in order to be effective, introduction of such systems need to have clear and realistic objectives outlined and considerable thought given to practical application in advance, and to be introduced in phases to allow taxpayers and tax administrations to become accustomed to them (and for any issues to be dealt with quickly).
- We believe that innovations such as online tax accounts, blockchain, risk assessment, greater automation (including artificial intelligence), greater access to data and decision makers, e-payments, cashless payments, and real time working, could combine to provide taxpayers with systems that are easier to use, more visible/transparent, and more secure to interact with. It would also give tax administrations the data they need (from taxpayers or other tax administrations / stakeholders) in more accurate and more timely ways.
- We would welcome opportunities to discuss all of these areas with the Forum on Tax Administration.

C. Implementation of the BEPS package

- 1 How have the various BEPS measures (especially those identified as particularly relevant for the digital economy – i.e. BEPS Actions 3, 6, 7 and 8-10) addressed the BEPS risks and the broader tax challenges raised by digitalisation?
 - It is too early to determine, which is why we understood that the OECD had originally planned to report back in 2020.
 - In particular, we note that:
 - Regarding Action 3, even frontrunners such as the EU are still implementing changes to domestic rules.
 - Regarding Actions 6 and 7, the MLI has not yet been ratified in sufficient countries for it to enter into force.
 - Regarding Actions 8-10, the OECD is still completing follow-up work in this area (and even in relation to completed work, the revised guidance has only recently been finally approved and published).
- 2 What has been your experience from the implementation of these collection models (e.g. compliance, impact on business operations)? What are some examples of best practice in this area?

Business experiences

- Following the 2015 BEPS Action 1 report on 'Addressing the Tax Challenges in the Digital Economy', a growing number of countries have either already implemented new VAT/GST rules to tax the import of digital services into their territory, or they have announced plans to do so in the near future. Many of the new collection models follow, at a high level, the general principles of taxation set out in the OECD's VAT/GST International Guidelines – i.e.:
 - The place of taxation for digital services is where the customer is established, has his permanent address or usually resides.

- For B2B supplies, the reverse charge is the most efficient means of accounting for the VAT/GST due, because the foreign supplier is not obliged to register for VAT/GST purposes in the customer's jurisdiction.
- For B2C supplies, local VAT should apply, achieved via the local registration of the non-established business in the place where the customer is deemed to be located.
- However, beyond the general framework set out above, the speed and scale at which changes are being introduced around the world has produced a wide variety of challenges for businesses operating in the global marketplace, even where governments have tried to keep compliance obligations for foreign vendors as simple as possible (e.g., by adopting simplified registration procedures). This is largely caused through the globally inconsistent implementation of the abovementioned principles into respective national laws, as a result (mainly) of the diverse local legal and administrative tax environment (VAT/GST laws, procedural laws and administrative processes).
- The result, even if overall the broad aims of the rules are similar, is a great multiplicity of legal and administrative practices established by different countries, including different registration platforms and collection mechanisms. Our experience is that even simple and flexible rules can still result in significant complexity if there is limited co-ordination between different countries in addressing what are effectively global issues. Therefore, in our view, more consistency is required internationally to ensure that there is greater efficiency and cost effectiveness whilst safeguarding tax revenues. We also believe that a better exchange of information between tax authorities could ease the compliance burden for foreign businesses, particularly when it comes to the registration process – e.g., basic data about the foreign vendor (business name, address, commercial activity etc.) could be shared between the tax authority where the business is established and the tax authority where the business is obliged to register in the course of making digital supplies to consumers.
- It should also be noted that there are some countries that have not followed the OECD framework set out above. In particular, businesses have experienced difficulties in those countries that do not make a distinction between B2B and B2C transactions according to the status of the customer. Whilst from a theoretical approach this may simplify the legislative process, in practice it creates unnecessary administrative burdens and cost for businesses that only provide services in a B2B context (as well as for tax authorities), particularly when considering the fact that the majority of business customers will in any case be in a position to fully recover the VAT charged.
- From a Direct Tax perspective the BEPS Action 7 and Actions 8-10 recommendations have resulted in some businesses changing their business models (e.g. move to buy/sell contractual models) to ensure that they do not face undue PE risk and are compliant with transfer pricing guidelines².

² Although we note that in some cases, such a move from commissionaire to buy-sell could actually increase the US tax exposure for US MNCs.

Best practices

- From business experiences to date it is possible to identify a number of best practices:
 - In general, a simple and flexible tax regime (in terms of the way businesses are required to collect the tax) is key in order to ensure that trade remains as unaffected as possible by VAT/GST considerations, thereby helping to foster the tremendous potential of the digital economy to enhance economic growth whilst simultaneously maximising tax revenues – a clear win-win for all. With this in mind, early consultation with business is crucial in order to understand business models and processes and, therefore, how best to optimise the legislative and administrative framework. We are pleased to report that a small number of countries have been very proactive in adopting an open and consultative approach, but certainly more could be done in this respect.
 - On the basis that the rules ultimately impact foreign businesses, once the legislative framework is finalised, determining an effective communication strategy is critical to success in order that non-established businesses know that the rules exist and understand how to comply with them. Hand in hand with this, sufficient lead time needs to be set aside so that business and tax authorities are able to make adequate preparations for implementing the rules. From a business perspective, 12 months is generally considered a minimum length of time for making ready, although longer may be required if significant IT systems development is necessary.
 - The OECD work being undertaken on the (as yet unpublished) implementation package ('Design and operation of efficient foreign vendor VAT/GST collection mechanisms'), and into which Business at the OECD (BIAC) has given business input via the OECD VAT/GST TAG process, is critical for the consistent implementation and application of the framework set out in OECD VAT/GST International Guidelines. Looking ahead, we would encourage governments to analyse the implementation package in detail and we very much hope that the guidance will introduce a host of legal and administrative best practices to those countries envisaging new digital taxation regimes and will also assist those countries that have already adopted digital taxation regimes in considering whether there are ways to improve their current arrangements. As ever, BIAC would be pleased to consult with governments to highlight the key business aspects contained in the report and to share practical information on business models, systems and processes. Furthermore, we would recommend that any VAT/GST digital policy considerations/actions should be benchmarked against the OECD implementation guidance in order to drive a greater level of consistency.
 - Countries should be encouraged to introduce tools designed to alleviate the VAT/GST compliance burden facing particularly foreign businesses. These tools should include digital measures (e.g., allowing for remote e-filing), sensible registration thresholds, and safeguards against unnecessary additional registrations with no need for local bank accounts, local fiscal representation, local invoicing, and local language requirements. Such

measures could significantly contribute to achieving greater levels of certainty and consistency.

Conclusion

- The critical points for a successful digital VAT/GST strategy can be summarised as follows:
 - Simplicity and flexibility - Day by day the digital thread runs through more and more businesses across all industry sectors - the traditional economy and digital economy are now, to all intents and purposes, inextricably linked. Business models vary widely and there is no one size fits all approach. Therefore, in order to encourage growth and safeguard tax revenues, digital taxation rules need to be simple and flexible to allow businesses to comply easily today, and to accommodate new digital business activities tomorrow.
 - Consistency - Simple and flexible rules can still result in complexity if overall at a global level there is limited co-ordination between different countries. The OECD work being undertaken on the implementation package is critical for the consistent implementation and application of the framework set out in OECD VAT/GST International Guidelines.
 - Business consultation - It is vital to design and implement new rules for taxing the digital economy in partnership with business. In the majority of cases businesses merely act as VAT/GST collectors, thus their knowledge and understanding of models, systems and processes is key to delivering an efficient and cost effective regime.
 - Sufficient lead time - The introduction of new VAT/GST rules to tax digital supplies drives major organisational changes across all business sectors. In line with this, business needs time to implement and execute with quality, including setting up the right internal procedures and processes, as well as configuring IT systems and compliance tools. This is also true for tax authorities. Therefore, we strongly recommend that governments grant sufficient lead time between the date of publication of new VAT/GST laws and their effective date of implementation.

Final remark

- As a final point, one currently highly debated topic is the role of digital platforms and intermediaries in the VAT/GST collection process. Some governments have already taken steps to implement measures in this area, while others are in the process of considering whether and how best to take action. The commercial reality is that there is a wide variety of new and constantly evolving business models with different parties involved in the digital value chain all performing different functions. As a result, there is no one size fits all solution, and the practical aspects have to be analysed in detail in order to determine who can reasonably act in the collection process (e.g., as a tax collector or information provider for the tax authorities) and who cannot. This matter is currently being discussed in the OECD VAT/GST TAG process with BIAC giving commercial and practical input. Above all, it is important to find solutions that on the one hand safeguard tax revenues and on the other hand make it as easy as possible for business to comply, which is key for ensuring a global level playing field and promoting growth in this rapidly expanding market.

D. Options to address the broader direct tax policy challenges

- 1 The 2015 Report outlined a number of potential options to address the broader direct tax challenges driven by digitalisation. Please identify and describe the specific challenges associated with the application (e.g. implementation, compliance, neutrality) of these options. What are the advantages and disadvantages of these options, including from an administrative and economic perspective, and how might some of the disadvantages be addressed or mitigated through tax policy design? In particular, comments are welcome on the following specific issues:
 - a. Tax nexus concept of “significant economic presence”:
 - i. What transactions should be included within its scope?
 - ii. How should the digital presence be measured and determined?
 - iii. How could meaningful income be attributed to the significant economic presence and how would such an approach interact with existing transfer pricing rules and profit attribution rules applicable to the traditional permanent establishment?
 - iv. How could such a measure be efficiently and effectively implemented in practice?
 - We do not consider that these are appropriate questions because we have fundamental concerns over the appropriateness of the method.
 - However, we have the following comments on the tax nexus concept of significant economic presence (with particular reference to the Ottawa/OECD’s tax framework design concepts):
 - The introduction of a “significant economic presence” threshold would untether the PE concept from physical presence and thus be a significant departure from the existing rules, and be incoherent with existing profit attribution rules based upon the value of significant people functions located in a country. The current attribution rules have been a subject of considerable debate in recent years, including particularly as the OECD seeks consensus following the changes to the threshold from BEPS Action 7. An even more fundamental change to the threshold would result in even greater difficulty in achieving consensus, and result in unilateral interpretations and even greater inconsistencies.
 - Any such move would not be in line with the neutrality concept unless it applied equally to all businesses (and would, in any case, require arbitrary lines to be drawn).
 - Any changes to the nexus threshold required to trigger the existence of a PE would also need to be accompanied by a change to treaties and to the underlying profit attribution guidelines in order to be coherent. The challenges that businesses (and the OECD) have faced in finalizing this element of the BEPS package lead us to the conclusion that any such changes should be dealt with as an entire package, agreed globally, rather than divorcing the agreement of the threshold from the agreement around attribution principles or allowing divergences between countries. Without this coherence, changes regarding the definition of a PE

will pose incredible challenges regarding administration, the allocation of profits, double taxation. These would undoubtedly result in significant controversy and would discourage the expansion of digital goods and services into remote economies, thus adversely affecting economic growth.

- Given the lack of detail (even at a conceptual level), it is hard to comment on whether the proposals could meet the efficiency, simplicity, and certainty concepts, although the difficulties already faced by businesses with the existing threshold (and the fact that the OECD's latest Discussion Draft suggests that there will be situations where there is little or no profit to be allocated) indicate that this will be very challenging.
- Regarding flexibility and sustainability, it is challenging to say with certainty whether a new threshold will be more resilient to changes in business models than the existing thresholds, but given our comments above about the inherent uncertainty regarding future developments in business as a result of the digitalisation of the economy, that seems very unlikely.
- Finally, as noted in the BIAC response to the recent OECD Discussion Draft on profit attribution to PEs, lowering of PE thresholds results in a tremendous need for administrative simplification. Further deviations from the traditional concept of a PE will only exacerbate that need as companies with a handful of remote transactions in a particular jurisdiction could be required to meet considerable compliance obligations that may ultimately drive underlying business decisions.

b. Withholding tax on certain types of digital transactions:

- i. What transactions should be included within its scope?
- ii. How could the negative impacts of gross basis taxation be mitigated?
- iii. How could the threat of double taxation be mitigated?
- iv. How could such a measure be efficiently and effectively implemented in practice?
 - We do not consider that these are appropriate questions because we have fundamental concerns over the appropriateness of the method.
 - However, we have the following comments on digital withholding taxes (with particular reference to the Ottawa/OECD's tax framework design concepts):
 - A withholding tax on digital transactions presents considerable issues in terms of neutrality, scope, and administration in particular.
 - The concept of neutrality is clearly violated by applying a withholding tax only on cross-border e-commerce transactions and that would arise only after addressing the difficulty of properly scoping which digital transactions this withholding tax could be applied to.
 - Many of these transactions are likely to be business-to-consumer ("B2C") and very low value. It is unlikely that individual consumers

will collect and pay over a withholding tax, creating a significant burden on financial institutions to act as a tax collector.

- Given the lack of detail (even at a conceptual level), it is hard to comment on whether the proposals could meet the efficiency, simplicity, and certainty concepts.
- Regarding flexibility and sustainability, it is challenging to say with certainty whether a new definition will be more resilient to changes in business models than the existing thresholds, given our comments above about the inherent uncertainty regarding future developments in business as a result of the digitalisation of the economy.
- Regarding proportionality, effectiveness, and fairness, it is difficult to conceive how turnover based taxes (which hit businesses with different margins in the same way) could be conceived to be fair, and would likely create an uneven playing field.

c. Digital equalisation levy:

- i. What transactions should be included within its scope?
- ii. How could the negative impacts of gross basis taxation be mitigated?
- iii. How could the threat of double taxation be mitigated?
- iv. How could such a measure be efficiently and effectively implemented in practice?
 - We do not consider that these are appropriate questions because we have fundamental concerns over the appropriateness of the method.
 - However, we have the following comments on equalisation levies (with particular reference to the Ottawa/OECD's tax framework design concepts):
 - It is critical that any solutions are specifically limited to taxing profits only. A corporate income tax on turnover would pose a serious threat to growth and drastically distort competition. Similar the preceding examples, the risk of double taxation would be large and it would be difficult to create rules that were neutral and easily administrable.
 - Regarding flexibility and sustainability, it is challenging to say with certainty whether a new definition will be more resilient to changes in business models than the existing thresholds, given our comments above about the inherent uncertainty regarding future developments in business as a result of the digitalisation of the economy.
 - Regarding proportionality, effectiveness, and fairness, it is difficult to conceive how turnover based taxes (which hit businesses with different margins in the same way) could be conceived to be fair, and would likely create an uneven playing field.
 - It is incorrect to believe that a tax on turnover would not be passed on to consumers in the same vein as a value-added tax. This represents a prime example of how tax can become a barrier for the growth of the digital economy.

- 2 A number of other tax measures have been proposed, announced or introduced by various countries that seek to address the direct tax challenges of highly digitalised business models (e.g. diverted profit taxes, new withholding taxes, turnover taxes).
- a. What are the advantages and disadvantages of these approaches? Where possible, please share any direct experience from the implementation (e.g. compliance, impact on business operations) of these approaches.
 - b. How might some of disadvantages of these approaches be addressed or mitigated through tax policy design?
 - The major disadvantages of these approaches are:
 - i. That they have not been aligned internationally (i.e. operating outside of double taxation treaties and without regard to differences in other countries' taxation systems), thus increasing the risk of double taxation without credit (and particularly the arbitrary outcomes that can arise as a result) and increasing the compliance burden.
 - ii. That their interactions with other taxes (e.g. VAT) has not been considered in detail before implementation.
 - iii. The inherent uncertainty that accompanies rules that are divorced from internationally agreed and well defined best practices (particularly where they are introduced quickly rather than as a result of considered consultation).
 - iv. The impact that they have had on businesses that were not originally intended to be within scope (e.g. the UK's Diverted Profits Tax has applied even to UK headed businesses, rather than just businesses without a physical presence in the UK).
 - v. The disproportionate impact on small, growing, loss making and low margin businesses (particularly with regard to turnover based taxes).
 - vi. The considerable risk of distorting competition by creating an uneven playing field for digital and non-digital companies across different sectors.
 - We do not see any advantages with the unilateral measures that have been introduced in recent years. However, the disadvantages of any solution would be curtailed somewhat if one solution were agreed internationally for against which credit were available.
 - c. What are the specific impacts of these unilateral and uncoordinated approaches on the level of certainty and complexity of international taxation?
 - Aside from investors' overall assessment of the stability of each country's tax regime³ (which is influenced by departures from international standards and frequent legislative changes), unilateral and uncoordinated approaches negatively impact certainty and increase complexity of cross border trade and investment for the following reasons:
 - Interaction with tax treaties, and qualification (or lack of qualification) for foreign tax credits.

³ The OECD's recent work on Tax Certainty found that "the overall tax environment" was in the top three general factors affecting investment and location decisions.

- Interaction with other laws (both domestic and foreign), including anti-hybrid rules, controlled foreign company rules, VAT/indirect tax rules, and general principles of expense deductibility.
- Novelty (i.e. departure from longstanding and/or internationally agreed guidance and principles, or those which courts have previously ruled).

E. Other Comments

- 1 Are there any other issues not mentioned above that you would like to see considered by the TFDE as part of its work on taxation and digitalisation?
 - We believe the above is a practical starting point, but only a starting point, and, as we have made clear above, we look forward to the opportunity to feed in more extensively (across longer timeframes where more comprehensive thoughts can be collected) as the project continues.

Request for Input on Tax Challenges of Digitalisation

BlaBlaCar is the leading carpooling platform in the world. We connect people who need to travel with non-professional drivers who have empty seats and who want to maximize their trip by sharing their travel costs. BlaBlaCar is not a cab company on demand service as the driver cannot make any profit (drivers and passengers split only the costs of the journey such as toll fees or petrol cost). BlaBlaCar is compensated by a commission levied on travels booked on the platform and we are not a data reseller.

We have more than 45 million members across the world and more than 12 million people share a ride on BlaBlaCar every quarter on our website and mobile apps. By sharing rides, our community is increasing the efficiency of road transport, saving money on travel and reducing our impact on the environment. At BlaBlaCar, we imagine a fairer, more open world of travel, where people are given the independence to connect with the places they love in a smart, simple and affordable way. Through these values of freedom, fairness and fraternity, BlaBlaCar has an impact on society and having a tax morality is something we stand.

Current international tax rules have been implemented 60 years ago in order to correspond to the business reality of that time. These rules are not anymore in line with digital business. It is now crucial for governments to set-up new rules to find a fair taxation of digital companies. At BlaBlaCar, we strongly support the initiative of the Action 1 and the action performed by TFDE. The solution to find the best tax mechanism which will respect the government's interests and the business constraints implies a constructive discussion by all the actors. By providing comments, BlaBlaCar affirms its support for this OECD initiative and follows a proactive approach to help authorities to create a fair tax system for the digital economy.

A - Digitalisation, Business Models and Value Creation

A.4 Digitalisation has permitted businesses to gather and use data across borders to an unprecedented degree. What is the role of data collection and analysis in different highly digitalised business models, and what types of data are being collected and analysed?

BlaBlaCar collects data on its users to identify them and mainly reinforce trust among its members. Indeed, thanks to the data collected (such as driver behavior on road or punctuality for example) we can give the opportunity to passenger to trust in BlaBlaCar and get into a car where they don't know the driver.

At BlaBlaCar we have identified three types of data:

- (i) Metric data which helps to measure the business performance (such as attrition rate for example to analysis on which frequency members use the service);*
- (ii) Business data which helps to improve the service and the user experience;*
- (iii) Data which are sold to third party.*

These three types of data can be then divided into two pillars:

- a. Data for internal purpose which do not generate any revenue (i.e. metric data and business data described above); and*
- b. Data for external purpose which generate revenue (i.e. data which are sold to third party).*

At BlaBlaCar we use data collection for internal purpose to measure our business performance and improve the user experience. In fact, at BlaBlaCar, we collect data like any other non-digital company, to improve our service as, for example, a super-market does to understand where is the best place to locate goods to improve the client experience or to get the right number of employees at the cash desk depending of the client volume. At BlaBlaCar these data are strictly confidential and aren't resold under any circumstances. It won't be logical to tax such data.

B. Challenges and Opportunities for Tax Systems

B.1 What issues are you experiencing with the current international taxation framework? (e.g. legal, administrative burden, certainty)

(i) The current international taxation framework is not adapted to the digital economy. The lack of clear rules creates tax uncertainty which puts a brake on business life. For example, the current concept of permanent establishment is clearly not adapted to digital companies:

On one hand, it can create abnormal situation where the market generating the biggest profit do not trigger significant amount of tax thanks to artificial structure which do not correspond to the business reality. On other hand, it can also trigger aggressive tax audit and tax reassessment while no added value is created locally. The creation of a specific definition of digital permanent establishment is thus necessary.

(ii) Besides, transparency obligation, fairly required by tax administrations, can trigger bureaucracy and useless administrative costs which are important for company which have the size of BlaBlaCar but can be easily absorbed by the biggest digital companies. These costs covered external direct costs (local advisor to fill the supporting documentation under the specific rule in each country, translator fees etc.) and internal indirect cost (necessity to hire employee to follow the compliance). Recent initiatives to strengthen automatic exchanges of information are a first step but could be improved.

In the same way, it's often necessary to introduce our business and our tax structure to various tax administrations to help them to verify our tax morality, for example. To simplify this process, it could be possible to imagine a specific process inside the OECD to present our tax structure during a meeting where representative agents of each tax administrations will attend to this meeting.

To sum up, to reduce the bureaucracy and the uncertainty it would be necessary to increase the collaboration and cooperation between each tax administration and the digital companies inside the OECD.

B.2 Digitalisation raises a number of challenges and opportunities for the current international tax system. In particular:

a) What are the implications of highly digitalised business models and their value chain on taxation policy? In particular:

At BlaBlaCar, we believe that the imposition of the digital economy must be mainly based on the added value created. However, with the digitalised business model the value chain can move very easily, for business reason, from one tax jurisdiction to another one. It's not uncommon that at the beginning of financial year the value chain is located in one country but won't stay in the same jurisdiction at the end of the financial year.

For digitalised business model, the value chain and the location of such value can be determined (a) by the functions performed by employees, (b) the risk borne and (c) the assets owned:

(a) The value created by the functions are the strategy, the engineering, the communication, the marketing, the customer support and the support function (such as finance, legal, human resource departments);

- (b) The risks borne are the reputational risk, the R&D risk, the market risk, the bad debt risk and the regulatory risk;*
- (c) Lastly for digital companies, the assets which generates value are brand, platform, know-how and data storage.*

The location of the risk and the asset can be done easily. However, the location of employees who generate value can be tricky as they are very mobile. In fact, we can observe a parallelism between employee mobility and employee creation of value (e.g: strategic functions use to move a lot in each tax jurisdiction caused by business constraint). For example, it's not unusual that strategic employee such as marketing key leader moved from one tax jurisdiction to another several times during the same tax period. Tax regulation should take account of this flexibility in the establishment of the tax basis.

To resolve this issue, it would be necessary to set-up a tax matrix mixing (a) strategic function, (b) risk borne and (c) asset owned to determine tax basis in each tax jurisdiction. This tax matrix could be pre-approved by all tax administrations, via an international tax ruling, and then automatically adapt as soon the added value is moving from one country to another. Thanks to this matrix, accepted by the digital companies and tax administrations, the tax uncertainty will be dramatically mitigated.

b) What opportunities to improve tax administration services and compliance strategies are created by digital technologies?

Digital technologies can provide an easiest way to discuss with tax administration services all around the world and transfer automatically taxes levies especially regarding indirect tax such as VAT.

D. Options to address the broader direct tax policy challenges

D.1 The 2015 Report outlined a number of potential options to address the broader direct tax challenges driven by digitalisation. Please identify and describe the specific challenges associated with the application (e.g. implementation, compliance, neutrality) of these options. What are the advantages and disadvantages of these options, including from an administrative and economic perspective, and how might some of the disadvantages be addressed or mitigated through tax policy design? In particular, comments are welcome on the following specific issues:

a) Tax nexus concept of “significant economic presence”:

(i) The purpose of the introduction of the concept of “significant economic presence” is to overcome the inadequacy of the traditional concept of a permanent establishment to tax the benefits of digital companies. This concept can effectively and equitably spread the revenues between different countries where digital companies operate.

In the same way as the concept of permanent establishment can be defined in several ways, different approaches of the notion of “significant economic presence” can be used according to the economic models of each digital company. For example, the economic presence could be:

- the number of registration on a platform. The difficulty with this notion is that a person can be only registered on a platform but doesn’t use the service;

- the number of active users. The difficulty here is the notion of “active”. For example, at BlaBlaCar a person who doesn’t use the service providing by the platform (i.e. book a seat) could be considered as active if he has the intention to book a trip (i.e. looking for a trip or sending a private message to the driver to have trip detail);

- the amount of asset present in a jurisdiction such as server. The difficulty with the asset is that server can be easily located in jurisdiction to do business in another jurisdiction;

- the amount of cost, such as marketing expenses, spent for a target country. The difficulty with this notion is that such expense cannot reflect the revenue generated in a target country but only the potential business and the revenue expected in the future.

Consequently, the term of significative presence can be defined in different ways and each definition have pros and cons argument. The choice for one of these definitions defines a very different scope of taxation. It would be necessary to find an objective definition which could cover the various situation and various business model applicable to digital companies.

The risk would be to apply a restrictive definition which will increase the tax burden of digital companies starting their international expansion and break the scale-up period where digital starts to implement their business model abroad. One solution could be to mix all the elements

described above (registration, active users, asset presence, amount of cost) to prove the significant economic presence.

(ii) Once it is definition of “significant economic presence” will be determined, the second step will be to split the revenues between the countries, following a specific allocation key with profit split method. However, the digital companies are characterized by important losses during their international development. Thus, it would be necessary to allow a loss split when the company is not yet break-even. In a same way, if this method is applied for the future it would be necessary to allow the current digital companies to transfer a part of their stock losses generated in the past and localized in the jurisdiction of the head-quarter.

Lastly, it would be necessary to allow to centralize the revenue to one country and then transfer the revenue in each country depending the allocation key. Indeed, the current transfer split method implies to recognize revenue in decentralized method in each country and then transfer a part of this revenue in abroad jurisdiction depending the value created abroad. Such method implies to set up a payment service provider in each country which trigger important cost. It is more cost efficient to have one payment service provider located in only one country and then transfer the revenue. Besides, the profit split can really work only if the government applies the same accounting rules to determine the revenue and allow the deductibility of same category of expenses.

b) Withholding tax on certain types of digital transactions:

The creation of a withholding tax on certain types of digital transactions implies to define precisely the term of “digital transaction”. It can cover several situations which are very different from one another. Just as in the non-digital world, companies carry out very different transactions depending on the sector in which they operate. The definition used for the transaction term must be both sufficiently precise to ensure legal certainty and sufficiently flexible to adapt to the specificities of each sector of the digital economy.

Besides, withholding tax on digital transaction could also apply to the “classic” economy which tries to find new business opportunities thanks to internet. For example, it’s not uncommon that craftsperson who facing business difficulties use new technology (such as website) to find new opportunities abroad.

Lastly, an uncertainty arises regarding the basis of such withholding tax. At BlaBlaCar, in lot of countries, using our platform is completely free as the carpooling activity is not yet common in the way of life of the local population. In this situation, it won’t be fair to apply a withholding on digital transaction as we do not generate any revenue.

D.2 A number of other tax measures have been proposed, announced or introduced by various countries that seek to address the direct tax challenges of highly digitalised business models (e.g. diverted profit taxes, new withholding taxes, turnover taxes).

Some European countries would like to implement a tax on the turnover. Such initiative it's not adapted and could impact the competitiveness of European digital companies which start their business development in Europe. Moreover, a tax on turnover could be considered as incompatible with European law which implies unanimity to implement a new tax indirect tax. Besides, such tax based on the turnover will be trigger an important tax burden on digital company which are in loss position.

The initiative on the European Commission, presented during the Tallinn conference on September 29th 2017, to implement a tax on digital transaction is still unclear and could also impact the competitiveness of European digital companies which start their business development in Europe.

We strongly recommend to the governments to collaborate and work together to define a clear and common taxation rules to avoid (i) the risk of double taxation and (ii) to implement a fair rule applicable to all digital companies through the world. This solution could be only find through OECD.

E. Others comments

As already mentioned, at BlaBlaCar we strongly support the action performed by OECD to find new tax rules applicable to digital economy.

However, we would like to draw your attention on the following points:

- The current biggest digital companies became so big under tax regulation which was not specific to digital companies. If a solution is found to apply new tax rules specific to digital companies there is a very high risk to create a competitive distortion between the historical biggest digital companies and the new digital companies. At the end, this distortion could put the brakes at the innovation and/ or create a barrier to market entry. Turnover threshold to apply specific rules could be a solution.*
- The business model and the size of digital companies are very different from one to another. It will be crucial to find a tax rules which cover all this situation and do not generate any distortion for some specific business model.*
- Lastly, specific digital tax rules could apply only if the company is generating revenue. At BlaBlaCar some countries are using our service for free as the carpooling activity is not yet common in the way of life. It won't make sense to tax such markets.*

October 13, 2017

Task Force on the Digital Economy (TFDE)
Center for Tax Policy and Administration (CTPA)
Organisation for Economic Co-operation and Development (OECD)

(delivered via email)

BEPS Action 1—Request For Input On Work Regarding The Tax Challenges of the Digitalised Economy (22 September – 1 November 2017), (hereinafter, the “request”)¹

Comments by Pat Breslin²

Dear members of the OECD/CTPA and working parties:

Breslin Consulting would again like to thank the OECD including the Task Force on the Digital Economy (TFDE) and the Center for Tax Policy and Administration (CTPA) for the opportunity to provide input on this ongoing and very important project. As with previous input and comments on OECD international tax projects, I preface by noting extensive experience in areas directly relevant to the request and this project. This includes experience as a business executive negotiating complex, intangibles-focused arm’s length transactions during the early stages of the development of the digital economy, and dealing with many issues on which the request focuses. Furthermore, my experience as an economist and expert on matters involving intellectual property and other intangible property (collectively, “IP”), and international tax and transfer pricing more generally, also includes extensive experience with respect issues of particular focus in the request.

My input will primarily focus on request items A.1 and A.2 with responses that may include a few general comments.

¹ In addition to the request the author will make frequent reference to “Addressing the Tax Challenges of the Digital Economy: Action 1: 2015 Final Report” from the OECD BEPS project, hereinafter referred to as “the final report” or the “report.”

² The author would like to thank Julia Barakat, Jianwen Lu and Shiyuan Zhang of Breslin Consulting, LLC for their helpful assistance, research and analysis in support of these comments.

A.1 The process of digitalisation has become one of the main drivers of innovation and growth across the economy. Please describe the impact of this process on business models, and the nature of these changes (e.g. means and location of value creation, organisation, supply chains and cost structure).

On this request for input (item A.1), the author feels it would be appropriate to recognize a distinction between 1) “the process of digitalisation” itself as a “driver of innovation and growth,” on the one hand, and 2) the impact of digitalisation on business models, on the other.

Though items 1 and 2 stated above are complementary in some respects, in further discussing them the author would encourage maintaining focus on important distinctions between them as well. For convenience, these two separate areas of focus will be referred to below as an *innovation focus*, and a *business model focus*, respectively.

In the author’s view, the connection that item A.1 draws between the rapid process of digitalisation and innovation over recent decades is well-stated and undeniable. The report provides much useful discussion and a number of good examples in this regard. But while the request appropriately refers to “the process of digitalisation” as a driver of innovation, at the same time, it would be equally true to state that *innovation is a main driver of digitalisation*.

This latter statement—that innovation often drives digitalisation—should not be taken as a mere semantic reordering of terminology. Furthermore, in emphasising it the author does not mean to imply that the requested information in item A.1, as stated, is not well-taken regardless of the ordering of such terms. Item A.1 is clear and usefully-stated for its purposes.

Nevertheless, to focus on innovation as a driver of digitalisation (as alternative to the original ordering of terms in reverse) helps to better illustrate some of the author’s views on issues raised in the request. These alternative perspectives will elicit and highlight two key themes:

- a) A reinforcement of the role of *innovation* in value creation—not only in the digital economy, but in general—in addressing international tax challenges (as an alternative to a focus on digitalisation’s role in promoting innovation); and
- b) the need to avoid an over-reliance on *terminology* specific to the digital economy in order to better achieve the true aims of this project—that is, to address tax challenges.

Indeed, the Executive Summary of the final report highlights that,

Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes.

Thus, of course, there should be no separate classification or treatment for digitally-related areas of business activity that reflect a normal part of the “economy itself.” This conclusion is of significance to the comments below—as the author concurs that classification of businesses, assets and activities as “digital” (or not) should not be determinative of any particular treatment for tax purposes.

Thus, the key prevailing principles are to remain consistent in digital and non-digital facets of business, as is well articulated on page 12 of the final report and under the revised OECD Transfer Pricing Guidelines (the “TPG”).³

For example, for transfer pricing purposes, factors that determine proper application of the arm’s length principle would emanate from the process of accurately delineating the transaction as described in Chapter I, thus taking into account the facts, circumstances, functions, assets and risks of the transacting parties in relation to the transaction and each other. The conclusions resulting from this analysis of functions, assets and risks could be very different for two separate companies engaged in similar transactions, even though each may apply the same business models using the same or similar digital business processes or assets.

However, the Executive Summary of the report continues by focusing on key features of the digital economy and its business models,

The digital economy and its business models present however some key features which are potentially relevant from a tax perspective.

It further notes,

These features include mobility, reliance on data, network effects, the spread of multisided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations.

And further, the report says,

While the digital economy and its business models do not generate unique BEPS issues, some of its key features exacerbate BEPS risks.

It is on this point that the author begins to hesitate with the breadth of items listed and described as “potentially relevant from a tax perspective” and the suggestion that their presence alone may “exacerbate BEPS risks.”

Some of the key features discussed in relation to the digital economy are not really new and did not arise from digitalisation *per se*. Furthermore, any presumption that such activities would “exacerbate BEPS risks” because they may also have taken on a digitalised nature should be avoided.

Consider, for example, the traditional mail order catalog as a remote selling operation, the telephone and telegraph, and the fax machine as predecessors to e-commerce, various forms of networks, and related communications devices. And doesn’t a traditional newspaper or magazine—published and distributed in

³ Page 12 of the report states, “The revised transfer pricing guidance [concluded through BEPS Actions 8-10] makes it clear ... that the group companies performing the important functions, contributing the important assets and controlling economically significant risks, as determined through the accurate delineation of the actual transaction, will be entitled to an appropriate return.

physical form—often combine subscription- and advertising-based revenue streams that reflect a multi-sided business model? Nevertheless, it remains questionable whether or not these features alone exacerbate BEPS risks, whether occurring in a digital economy context or not.

In a related vein, the author would, on occasion, respectfully and constructively challenge the use of other terminology often used in the request and the final report—including, for example, terminology relating to the *business model focus* noted above.

Further, the report's repeated use of terms like *commoditisation* and *standardisation*, often in conjunction with an asserted relationship with declining prices for products or services, gives the author some pause. In some cases, these concepts may be present to a degree, but inferences about their effects on prices and value could easily be mistaken. Such terms thus could be out of context with the value propositions that may underlie core technologies and the staying power of their installed customer bases—whether or not they are considered “standardised,” for example.

In short, analyzing value creation should not be subject to labels that may be out of context and, in any event, may only be understood in an overly general and simplified manner, without full consideration of the actual facts and circumstances of each case.

In the author's view, it also remains necessary to separate and distinguish generic discussion about business models from value creation in any discussion focused on the latter. Indeed, value creation itself has been a central focus of the BEPS process, particularly with respect to transfer pricing and Actions 8-10.

As revisions to the OECD TPG make clear, the facts and circumstances of each case (including the functions, assets and risks of the transacting parties) will continue to inform any analysis of value creation. In contrast, business models alone do not inherently create or necessarily relate to value—as the same business model can be pursued successfully or unsuccessfully and, in the latter case, may even destroy value.

Further, value creation arises from the assumption of risks and is not pre-ordained, just as expected value (*ex ante*) will always become subjected to actual outcomes (*ex post*). For example, for the sake of illustration assume that in a certain technology market, roughly nine in ten risky technology ventures fails—a statement that might just as easily apply to internal technology innovation projects within established firms, such as through a pharmaceutical R&D project portfolio. Here, the connection between similar business models, on the one hand, and value creation on the other, cannot be sustained.

More generally, the author's comments would seek to reinforce the success of OECD projects to date in focusing on the accurate delineation of a transaction, the facts and circumstances, and the functions, assets and risks of the transacting parties in relation to the transaction and each other. These core operating principles are well-stated and well-supported lines of analysis—for which OECD efforts should be applauded. It is welcome that any guidance specific to the digital economy continue to defer to them.

The role of innovation as a means of value creation

In the author's view, innovation—and how and when it is successfully achieved—is of central importance regarding many questions in the request including, in particular, with respect to intangibles (*e.g.* item A.2,

addressed below). Innovation also plays a major role—though certainly not the only role—in value creation as a general matter.

Furthermore, in many ways, the intersection between this BEPS Action 1 Digital Economy project and other BEPS-related projects (*e.g.* the revisions to chapters I, VI and VII of the OECD transfer pricing guidelines) revolves around the role of innovation and intangibles development in value creation.

Once again, however, this focus does not (and is not intended to) overlook contributions to value creation other than through innovation. Nor, importantly, is the author's focus on innovation an assertion that efforts to innovate alone are necessarily value creating. It depends on outcomes and the playing out of risks through such activities. For example, at a very general level, R&D reflects a trial and error process—success at creating value is never assumed.

As noted in my prior comments on this project,⁴ it is my view that a focus on technology investment and innovation itself as a business activity (along with its corresponding risks) is essential to understanding value creation in the digital economy context. This is the case even as enterprises develop and pursue the same, or very different, business models, and irrespective of contractual, supply chain, or organisational structures. The contributions of parties that undertake risky technology investments greatly impact value creation in the digital economy, notwithstanding other potential contributions that may also exist.

A.2 Highly digitalised business models are generally heavily reliant on intangible property (IP) to conduct their activities. What role does IP play in highly digitalised businesses, and what are the types of IP that are important for different types of business models (e.g. patents, brands, algorithms, etc.)?

The discussion above pertaining the *innovation focus* draws a natural connection with other IP elements that directly relate to the ability to successfully innovate. That is, to develop and own valuable IP elements one must attract and retain highly skilled innovators in relevant creative, scientific and/or engineering fields, for example.

An innovating company's reliance on IP necessarily relates to its reliance on innovative professionals. Thus, relevant employee contracts and their terms and conditions represent a readily identifiable form of IP—one that binds the employees and their intellectual output to the company while enforcing strict confidentiality and non-compete clauses for similar purposes. These, along with potentially attractive compensation including bonuses and employee stock options, align incentives of technical and other creative employees with the innovating company while creating barriers to competitors seeking to access such intellectual output and capital, or to recruit it away.

Regarding scientific and technological innovation, it would often be important to recognize the importance of trade secrets which represent IP that is not legally registered and is instead protected and defended in part through the contractual obligations noted above and through other confidentiality

⁴ "Comments on OECD BEPS Action 1: Address the Tax Challenges of the Digital Economy," Breslin Comments submitted to the OECD Committee on Fiscal Affairs (April 2014). Response to "Request For Input Regarding Work On Tax Challenges Of The Digital Economy," P. Breslin response and comments submitted to OECD Committee on Fiscal Affairs (December 2013), also available at: <http://breslinconsulting.com/publications.html>

provisions and mechanisms used by innovative companies in their dealings with employees, contractors and outside parties. These thus relate to important contractual forms of IP and should be considered noteworthy in the digital economy, just as they are in numerous innovative industries outside of this context.

The fact that such trade secrets are not legally registered has a benefit in that, unlike a patent, the intellectual property itself is not required to be publicly disclosed—quite the contrary—and thus cannot be used as a basis or “roadmap” for “working around” the IP through limited modification to a patented technology, or to reveal aspects of the core IP that may lead competitors to imitate in unprotected markets, for example. Of course, trade secret protection intertwines with the contractual forms of IP protection already noted above. (One high profile example of how enforcement of such trade secret-related IP may come into play recently arose in a dispute between Google parent Alphabet, Inc. and Uber regarding a former employee of Alphabet’s Waymo division who contributed leading edge technology development experience with respect to “self-driving” cars.)⁵

More generally, the author has long observed that individual elements of complementary IP are usually more valuable in combination than on a standalone basis—and therefore, the author is hesitant to describe certain types of IP as being more or less important for different types of business models—one part of the item A.2 request.

This further reveals the author’s concerns with the business model focus and the potential for over-use of industry- or high tech-based terminology in this tax context. Indeed, two firms with a similar business model may have different types or elements of IP that they (or others) may weigh differently in terms of their importance. Additionally, that one party emphasises use of patents, for example, while another relies on trade secrets reflects potential choices in IP types/forms and related strategy that may have no bearing on the corresponding value contributed by the IP itself. Moreover, even if two parties each obtained a separate patent—*i.e.* the same “type” of IP—that was, in each case, relevant to their business models, the quality and value of the two patents could differ quite substantially.

Finally, between transacting parties at arm’s length, there will always be potential for discrepancies between each party’s perspective on real *versus* perceived values of such important transactional elements. These discrepancies may always exist but transactions are still concluded for the entire bundle of IP-related rights—*e.g.* in licenses and/or as their value contributions are embedded into the qualities of products and services.

In short, the author cautions against any potential analytical thought process that leads from

- 1) identifying the presence of an “important type” of IP (in general, without the underlying facts and circumstances) that is presumed to be
- 2) important in a certain type of business model that is

⁵ For example, see “Why the Waymo-Uber Trade Secret Theft Case is not over”, <http://www.marketwatch.com/story/why-the-waymo-uber-trade-secret-theft-case-is-not-over-2017-07-08> and also, <https://www.recode.net/2017/4/6/15194322/waymo-uber-lawsuit-self-driving-lidar-anthony-levandowski-injunction> . One aspect of the case is the departing employee’s assertion that he took thousands of proprietary company documents with him when he left Alphabet’s Waymo division in order to subsequently use them to prove to Alphabet that he had earned his \$120 million bonus from the company. The case remains unresolved.

- 3) identified (or perceived) as pertaining to a particular taxpayer or its subsidiary, and is
- 4) inherently inclined to exacerbate the potential for BEPS risks.

In the author's view, this would not reflect a sound analytical approach, and is not how the world really works. Of course, the Action 1 2015 report does not appear intended, and should not be read, in this way. But the author encourages the project's continued reinforcement of core principles (*i.e.* accurately delineating the transaction based on facts, circumstances, functions, assets and risks), which must be kept paramount in this digital economy context and this project.

Standard Essential Patents (SEPs)

As noted previously, the author has concerns that those less well-versed in relevant technology-related issues could misread the final report—and potentially other output from this project.

In particular, the report makes numerous references to the commoditisation of technology elements and corresponding reductions in prices (for certain elements). Any implications that such issues—addressed in too general a way—might have about the value contribution of certain technologies should be avoided, in the author's view. This is not to say that the report does not reflect appropriate discussion (in general) of such issues—it is more of a reinforcement to fully consider the facts and circumstances of each individual case.

Examples of general discussion about *commoditisation* and *standardisation* in the report include the following list of quotations from paragraph 64:

- 1) The development of ICT has been characterised by rapid technological progress that has *brought prices of ICT products down rapidly*, ensuring that technology can be applied throughout the economy at low cost.
- 2) In many cases, *the drop in prices* caused by advances in technology and the pressure for constant innovation have been bolstered by a constant cycle of *commoditisation* that has affected many of the *key technologies* that have led to the growth of the digital economy.
- 3) As products become successful and reach a greater market, their features have a tendency to solidify, making it more difficult for original producers to change those features easily.
- 4) When features become more stable, it becomes easier for products to be copied by competitors. This is stimulated further by the process of *standardisation* that is characteristic of the ICT sector, which makes components interoperable, making it more difficult for individual producers to distinguish their products from others.
- 5) Unless the original producer can differentiate its product from the copies (for example, by bundling its product with services or other features that are not easily duplicated), or

otherwise find a way to maintain a dominant position in the market, *it will be forced to compete solely on price* or move to other market segments.⁶

These items 1 to 5 may or may not ring true, depending the facts and circumstances of the case. In actual arm's length commercial contexts—involving high profile independent parties and technology—very different conclusions might arise.

A useful example is that of the smart phone market (and to an extent the wireless notebook) – *e.g.* Apple and Samsung products. While these two companies' products are competing intensely, they also reflect a duopoly in many major markets, such as the US. In the US market, while features and capabilities of the major smartphone models continue to advance (increasing value to consumers), it would not be the case that *commoditisation* of key technologies has arisen and/or demonstrated declines in prices for the full products themselves and/or for underlying technology elements across the board.

Some of the absence of price erosion can be attributed to what are known as “standard essential patents” (SEPs), which are often under scrutiny by regulators but are nonetheless characteristic of many telecommunications-based technologies and services.

Many disputes arise with respect to “fair, reasonable and nondiscriminatory” (FRAND) royalty obligations required under standard-setting guidelines in such industries, as well as in intellectual property case law contexts. Take, for example, Apple's dispute with Qualcomm, which owns standard essential patents relating to key cellular phone technology. As recently reported,

The lawsuit seeks \$1 billion in damages which Apple alleges that Qualcomm is withholding from the iPhone developer in violation of an agreement between the two companies, including injunctive and other relief. The suit, which includes breach of contract claims, patent claims and antitrust claims, was filed in the U.S. District Court for the Southern District of California (S.D. Cal.).⁷

As the official complaint filed by Apple notes, Qualcomm has been under fire recently in multiple countries for predatory business practices involving its licensing activities for tech invented by Qualcomm for the development of cellular phone and data network standards. In late December, Qualcomm was fined \$853 million by the South Korean Fair Trade Commission (KTFC) for improper negotiations of patent licenses. [Samsung is South Korea-based.] In February 2015, Qualcomm announced that it had agreed to a \$975 million fine to settle antitrust claims levied by China's [national telecom company].⁸

Estimating the inherent value associated with the adoption of one technology over another is a key element in modeling appropriate royalties for standard essential patents (SEPs)—that is, patents covering rights in technology adopted as “essential” according to standards-setting organizations (SSOs). Standards setting frequently is seen in industries relevant to the digital economy such as the markets for

⁶ The final report, paragraph 64. As another example, paragraph 78 states, “As a result of the **standardisation** and **commoditisation** of different individual resources, such as hardware, network infrastructure, and software, some businesses have been able to combine those resources and make them available through the Internet as services.” (emphases added)

⁷ 10/13/2017 Apple, FTC file lawsuits against Qualcomm over FRAND violations in processor licenses, Apple seeks \$1B award - IPWatchdog.com.

⁸ Ibid.

smart phone technology, mobile telecommunications equipment, and digital audio compression and delivery technology.

The question in the standards context is the relative value of the advantages of one technology over another, prior to its inclusion in the standard—a subsequent event that confers greater certainty to the technology owner with respect to its adoption, as well as a corresponding commitment to license the technology on terms that are FRAND according to the policies under the standard.

Arm's-length and FRAND analyses face similar problems, and the solutions posed in each context are also consistent in important respects. The problems are similar in that both FRAND and arm's length-analyses must determine what is a fair and reasonable price, such as that to which independent parties would willingly agree. Further, both seek to preserve such market-based (or arm's-length) pricing in a controlled context that otherwise likely would result in pricing distortions.

Models developed in the technology standards area share other common themes with arm's-length analysis of cross-border transactions involving intangible property. The two areas are consistent regarding the need to attribute value across different assets, activities, and functions. In a transfer pricing context, this may be with respect to the contributions of different entities within the multinational group.

In the standards context, the functional and user demand contributions of specific IP, technology, and business elements must be weighed against others. Attention must be paid to avoiding that, conceptually, the sum total of royalties attributed to any individual IP and technology elements exceeds the compensation available to all of the IP combined, given the total market value that end users are willing to pay.

Properly applied, FRAND royalty and arm's-length analysis also must take into account alternative or complementary technologies, related products or services, and the contributions of each of the parties to a licensing transaction. Viewed at this general level, a consistent set of economic and valuation principles affect both transfer pricing analysis of intangibles and this IP standards context.

Thus, the presence and process of a standard setting regime within a technology sector is not in and of itself indicative of price declines and, for holders and licensees of standard essential patents (SEPs), the opposite result may occur.

Isolating value attributable to certain IP elements is nonetheless a challenge whether in a transfer pricing, IP, or antitrust context. Difficult issues also arise around bundled technologies, products and services—wherein one may assert that a certain element is provided “for free” but the reality includes complex cross-subsidization issues. And, back to the concerns stated above, the fact that phone companies sell smart phones at lower prices or “for free” is not indicative of price erosion in either the device market or the services market. The cost differential incurred by the service provider in offering a phone at a lower retail price is factored into the expected compensation under the services contract – and therefore may be more indicative of cross-subsidization.

The terminology concerns emanate in part from frequent use of such terms in the final report that, while they may be appropriate, could nevertheless be subject to misinterpretation by tax and transfer pricing professionals less well-versed in the relevant technologies and tech sectors. when adopted to transfer pricing contexts.

For example, in the report the term *commoditisation* is used more frequently than the term *standardisation* but in similar contexts that make the terms seem almost interchangeable. But in the

technology sectors discussed in the ICT context, a technology standard is far from a commodity—even if both are considered widely accepted and widely available—their availability comes at a price. Commodities have no differentiating features—e.g. a vegetable or mineral of a similar quality. But technology standards are developed for best in class delivery of certain capabilities, with an eye toward interoperability and compatibility—but these features may still be advanced and differentiated (or allow for future advancements and differentiation) quite unlike the features of a commodity.

The author has written further on the subject of standard essential patents (SEPs) that are the subject of substantial disputes in commercial intellectual property matters.⁹

Thank you again for the opportunity to comment on this important project. I look forward to future opportunities to share input as the TFDE and OECD continue with their progress.

Sincerely,

Pat Breslin

Washington, DC

October 13, 2017

(Delivered via email)

⁹ See also, "A Tale of Two Technologies: Transfer Pricing of Intangibles in the Digital Economy," by Patrick Breslin, Tax Management Transfer Pricing Report Vol. 21, No. 23 (April 2013) available at: http://breslinconsulting.com/assets/Breslin_TP_Report_Tale_of_Two_Technologies.pdf

13 October 2017

CBI RESPONSE TO REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITALISED ECONOMY

Background

As the UK's leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

Thank you for the opportunity to provide input on the questions you are considering as part of your continued work on Base Erosion and Profit Shifting ("BEPS") under Action 1: Addressing Tax Challenges of the Digital Economy. The period made available for businesses to consider these questions and provide input has been relatively short. So, we will be very happy to host a meeting with you so you can hear the views of our members in more detail if that would be helpful. Similarly, if there are any areas where you would like us to provide additional written information then please don't hesitate to get in touch.

We are keen to stay very closely involved in this initiative, in particular with the dialogue by which governments become more informed about how digitised businesses work.

General remarks

The CBI are members of BIAC and we support the messages made in their response to your request for input. We especially support their statement that there is a need for *"a serious and sustained conversation, not just between governments but with the businesses, large and small, that are driving, and accelerating this digital revolution."* We will be happy to support your continued work by sharing viewpoints from the businesses amongst our member base.

We expect that the OECD will have received a limited amount of input from small and medium sized businesses ("SMEs") so far and this consultation, with its short response period, will be challenging for SMEs to participate in. We highlight below the importance that we think this group of businesses have in this policy area and so we strongly encourage the OECD to take sufficient time to ensure everyone has had a chance to contribute to this debate.

Before responding to the specific questions that have been posed, we would like to outline some general points relating to digital as a driver for growth and taxation of the digitised economy, which our members are keen to raise.

Digital as a driver for growth

We are pleased to see that the OECD is taking a strong interest in the impact of digitisation on the economy. For example, with the Going Digital project stating an ambition to "give policymakers the tools they need to help their economies and societies prosper in a world that is increasingly digital and data-driven".

We are in absolute agreement that the digitisation of our economies will be a major driver for growth in the world economy. For us, it is then incredibly important that tax measures applicable to digitised businesses can facilitate rather than hinder this growth.

We are concerned about the tendency for governments to be more protectionist in their stance towards tax policies. In the context of the policy debate on taxation of the digitised economy, we are worried by the risk of multiple countries implementing unilateral uncoordinated measures as resulting economic costs will likely have a negative impact on global trade and investment. We have some fundamental concerns about the compatibility of some of the proposed tax measures with trade obligations and European Union (“EU”) law. Further, we recognise that where multiple countries seek unilateral action, businesses are likely to experience increased compliance burdens, uncertainty over tax positions and risks of multiple taxation on the same profits.

We think the OECD has an important role to play in helping governments to understand the potential macro-economic impact of the new tax measures being proposed.

Some of the key points impacting growth that have been consistently raised in the discussions with our members are:

- 1) It is commonly perceived that highly digitised businesses have large profits, but it is often the case that such businesses are not profitable until they reach sufficient scale. We believe start-up businesses must be supported in order to drive competition, fuel growth and increase the number of these businesses that reach profitability.
- 2) Digital developments can have a particularly beneficial impact on the economies and societies of developing countries; and
- 3) Digital technologies are enabling all businesses to evolve in the way they operate and in the goods and services they deliver and we believe this is a key driver for economic growth. A difference in treatment between taxation of digital and non-digital operations could create a bias towards traditional ways of doing business.

Taxation of the digitised economy

As stated by the OECD in their Going Digital ambition, the world is becoming increasingly digitised and data-driven. We remain in agreement with the recommendation in the OECD 2015 BEPS Action 1 report that the “digital economy” should not be ring-fenced for tax purposes. The variety of business models amongst our member base demonstrates that it is increasingly difficult to separate what might be described as a “digital business” from more traditional businesses and this trend will only continue.

It seems to us that there is currently confusion on what the problem is to which a solution is sought. For instance, is the current question one of

- whether tax avoidance continues within multinational companies;
- whether there is something going undertaxed in new operating models of digitised businesses; or

- whether digitisation enables greater centralisation of activities such that profits are allocable to fewer jurisdictions?

The appropriate solution depends upon which of these one is seeking to address and with greater clarity on the question that is being posed, we think businesses can provide more information targeted towards that endeavour.

Our initial thoughts on each of these questions are set out below for your consideration.

Tackling any remaining tax avoidance practices

There may be a perception from some countries that tax avoidance continues due to a gap between the tax regimes of other countries, in particular the US tax regime. Substantial work has been undertaken to tackle tax avoidance practices through the OECD BEPS project and this needs more time to take effect. In addition, if US tax reform is delivered this could ease the concerns that some countries are expressing.

With regard to the progress made under the OECD BEPS project, we believe it is too early to prove whether substantial tax avoidance opportunities continue to exist following the BEPS conclusions being agreed upon and implementation commencing. We think there are tools at the disposal of governments that are not yet fully utilised or which have been introduced but have not yet had time to take effect. We would encourage governments to explore these further before developing new measures. For instance, this may include introduction of updates to the Transfer Pricing guidelines or anti-hybrid legislation (where countries have not yet done so) and full utilisation of increased information and powers to rigorously apply transfer pricing principles (e.g. proper evaluation of Country by Country ("CBC") reports which companies have not yet been required to submit).

If in due course the BEPS measures are fully reviewed and seen as unsuccessful, the question of why they failed would need to be carefully considered before next steps could be agreed. We think it is important that the consensus achieved over the BEPS principles is not readily abandoned, given the time and investment that governments and businesses have already invested in this process.

Perception of undertaxed activities in digitised businesses

A fundamental issue at the heart of the debate on taxation of the digital economy is the pressure that digitisation places on the concept of having a "presence" in a market. Some will argue that this presence is currently going undertaxed.

We see the need for a detailed review of whether such market presence should be recognised within our corporation tax framework. If the interaction between consumer (or user) and the business does not result in value creation for the company (and associated enterprises), then in our view these interactions should not be taxed within the corporate tax framework. Corporation tax is currently based on the principle of taxing a company on profits where those profits arise, i.e. where value is created. If, on the other hand, the interactions in-market do create value for the company above the value created elsewhere in the group, then it might be considered appropriate to capture this within the corporate tax system but only to the extent of that value creation and with no force of attraction. However, there are clear issues of measurement and so this might not be a workable solution.

Centralisation of profits and a new allocation of taxing rights

The process of digitisation, which includes an increased reliance on IP, may enable centralisation of profit generating activities in fewer countries. This concentration of profits and, accordingly, taxing rights can create pressure from some countries to agree upon a new allocation of taxing rights.

In this debate, we think it is important to recognise the range of taxes that countries have available as instruments of fiscal policy. Even where there are sales in a country, if there is no value creation there then we consider there should be no corporation tax due in that country. Instead income tax has been paid on the money spent and VAT/sales tax likely paid on the sale. As a result of the changing economy, countries might choose a different mix of tax. We think there is an important role that the OECD can play in increasing understanding amongst stakeholders about the range of taxes that apply to digital businesses.

Just one example are the changes that have been made to indirect tax rules that ensure countries can continue to raise tax revenue from digital supplies of goods and services. These are important developments and should be widely recognised.

Next steps

There is mounting political pressure from some countries on the need to introduce new tax measures for digital or digitised businesses. Despite this, we would strongly encourage the OECD to refrain from progressing rapidly to build consensus around any one of three options from the 2015 BEPS Action 1 report (a digital PE, a withholding tax, or an equalisation levy). All three of these models have fundamental challenges and they therefore cannot be concluded on at an early stage. We believe the OECD should take a longer term and considered approach in assessing what could be an appropriate measure for multilateral adoption.

It seems there has been little evidence collated from business on the implications that such measures could have. A lot more economic analysis and inter-governmental discussion is needed on them, as any of the measures would drive a major change in the approach to computation of tax revenues and their allocation to countries that would presumably not be acceptable to any country without proof that their public expenditures will not be left unfunded. Further, each model involves potentially dramatic double taxation implications which existing dispute resolutions mechanisms may be technically or practically powerless to resolve in any comprehensive, transparent and therefore acceptable way.

We welcome the OECD commencing a meaningful conversation between governments on taxation of the digitised economy now, but we urge the conversation in the immediate term to be focussed on reaching consensus on the way forward to build a suitable multilateral option. In our view, the OECD has an incredibly important role to play in preventing a wave of unilateral uncoordinated actions being taken in the short term.

Despite the views shared here on the options from the 2015 OECD BEPS report, we have shared in this paper some more detailed viewpoints on each of these options.

Comments on draft outline of the interim report

Thank you for sharing the proposed outline for your report. It is helpful to understand the direction of the OECD's work. We have a couple of comments on the outline interim report provided, as follows:

- We note the intention for the options (either existing or newly proposed) to be described in the report. We would encourage such description to include an assessment of the pros and cons of the measures. Given that the information in this report will undoubtedly be considered by policy makers in deciding whether or not to pursue certain unilateral actions in the short term, we think it is important for the pros and cons to be clearly documented and in the public domain. This should also support further meaningful debate on the different options in the near term.
- We think it is helpful that the topic of digital tax administrations has been captured in the report. This is an area of increasing interest to our members given that more and more tax authorities are starting to explore the use of digital. We hope that inclusion of the topic within this framework will help to drive consistency in approach. Digital tax administration is also a topic which is inextricably linked to new digital business models and taxation of them. There is an increasing number of examples where tax administrations want corporates to play a role in administering tax on their behalf, so it is important that business is brought into the discussion on this topic early.

Responses to specific questions posed

A. Digitalisation, Business Models and Value Creation

A.1 The process of digitalisation has become one of the main drivers of innovation and growth across the economy. Please describe the impact of this process on business models, and the nature of these changes (e.g. means and location of value creation, organisation, supply chains and cost structure).

A.2 Highly digitalised business models are generally heavily reliant on intangible property (IP) to conduct their activities. What role does IP play in highly digitalised businesses, and what are the types of IP that are important for different types of business models (e.g. patents, brands, algorithms, etc.)?

A.3 Digitalisation has created new opportunities in the way sales activities can be carried out at a distance from a market and its customers. How are sales operations organised across different highly digitalised business models? What are the relevant business considerations driving remote selling models, and in which circumstances are remote selling models (as opposed to local sales models) most prevalent?

A.4 Digitalisation has permitted businesses to gather and use data across borders to an unprecedented degree. What is the role of data collection and analysis in different highly digitalised business models, and what types of data are being collected and analysed?

A.5 In a number of instances, businesses have developed an architecture around their online platforms that encourages the active participation of users and/or customers from different jurisdictions. Is the establishment and operation of such global (or at least cross-country) user networks new and specific to certain highly digitalised business models, and what are the potential implications for value creation?

A.6 The digitalisation of the economy is a process of constant evolution. Please describe how you see business models evolving in the future due to advances in information and communications technology (e.g. Artificial Intelligence, 3D printing).

The questions raised in this section are very business specific. In the time available it has not been possible for us to provide a general view point of our member base on these questions. We welcome

that the OECD have provided some forums for businesses to provide direct input on their business models and the evolution they are going through. We strongly encourage the OECD to continue to keep a dialogue with business on this topic as the tax policy debate evolves.

B. Challenges and Opportunities for Tax Systems

B.1 What issues are you experiencing with the current international taxation framework? (e.g. legal, administrative burden, certainty)

We consider that the work already done by the OECD, has brought about important clarifications and improvements to restrict opportunities for BEPS that some businesses exploited. The main task ahead is for national governments to implement the BEPS recommendations on a consistent basis, including BEPS dispute resolution procedures.

In terms of BEPS implementation so far, businesses have found that there are increased instances of tax controversy. For example, the changes to transfer pricing under Actions 8 – 10 which have been enacted have resulted in many countries trying to assert that value associated with intangibles is created in their country. For businesses that already locate their intangibles and the associated DEMPE (Development, enhancement, maintenance, protection and exploitation) functions in a jurisdiction which taxes these profits, this controversy requires time and attention from businesses to defend against multiple taxation of the same profits. Measures that can avoid similar subjectivity and instances of controversy would be welcomed.

In general, there is significant uncertainty being created for many international businesses because of the rapid changes to taxation that are being introduced by bodies such as the OECD, EU and governments that mean it is hard for businesses to make decisions about investments and transactions with certainty. For instance, the changes to interest deductibility (under Action 4) and CBC reporting require effort, monitoring and additional compliance responsibilities for all large businesses. In the UK, the legislation and guidance on interest deductibility alone runs to hundreds of pages and when this is multiplied by the number of territories that many groups do business in will run to thousands of pages of legislation for them to work through. This is for just one of the BEPS action items. The prospect of further uncertainty for business as a result of continued changes to tax measures is worrying. Restricting the amount of additional change and bringing consistency to any change (e.g. in what the OECD and EU may introduce / recommend) is vital.

SMEs have a particular challenge in complying with a complex and changing tax system, e.g. because they have limited specialist resources internally. Further fast-paced change would be difficult for SMEs to adapt to.

It remains the case that the tax profiles of multinational corporations are not well-understood by a broad range of their stakeholders. Businesses are starting to need to spend more time on compliance requirements to increase transparency, e.g. the UK has introduced a requirement for large businesses to publish a tax strategy. This is another area where real care over the chosen measures (to check they will be fit for purpose) and consistency in country approaches will be important if there are further reporting obligations of this nature introduced.

B.2 Digitalisation raises a number of challenges and opportunities for the current international tax system. In particular:

- a) What are the implications of highly digitalised business models and their value chain on taxation policy? In particular:***

(i) What impact are these business models having on existing tax bases, structures of tax systems and the distribution of taxing rights between countries?

In assessing the impact that business models have on existing tax bases it is very important to consider the full range of taxes that apply across the supply chain. We think that the OECD could helpfully play a role in increasing the understanding of this amongst a broad range of stakeholders.

As an example of the range of taxes that can apply to a digital business model: Collaborative platform models can connect spare capacity and demand, enable individuals to share “access” to assets or access on-demand services efficiently and transparently. The business models of such platforms vary widely, e.g. monetisation through fixed / variable fees, a subscription model, etc. Regardless of the business model, we understand that almost all the value being transferred tends to be between the buyer and seller and remains with the seller. That income, is then subject to personal or business tax. The transaction could also be subject to VAT. The fees charged by the platform tend to represent a very small portion of the value transferred. These fees may also be subject to VAT. In some sectors of the collaborative economy, there may be additional taxes generated, e.g. tourist tax, excise duties, other local taxes etc. In respect of collaborative platforms, it is also worth noting that they encourage people to make more economic activities visible, instead of conducted as less transparent cash transactions.

VAT is one example where governments have recognised the impact that digitisation has had on their ability to tax the supply of digital goods and services and the BEPS process has been key in addressing this. We discuss some of the practical considerations related to implementation of those changes below based on businesses’ experiences.

In comparing digital business models with some more traditional models it may often be considered that the cost base for the digital business model is lower, e.g. less reliance on the high street may reduce their exposure to high property costs. Often, it is the case that the cost base is different rather than necessarily lower. For instance, businesses running an IP platform will have significant IP costs for build and maintenance of the platform. Also, in e-commerce, the storage, delivery and logistics costs that may potentially be incurred under third party service providers to achieve the “last-mile” can be substantial. For certain businesses, who have digitised their product and delivery model, it is the case that these IP costs and an inability to increase revenue (because the customer expects certain features as standard) can squeeze operating margins. It is a general trend, that customer expectations are increasing, e.g. speed of delivery, which creates the need to continually improve services and innovate and this can also squeeze margins.

Accordingly, it is common for there to be low business profits or even losses within new digital businesses until sufficient scale is achieved. It follows that tax measures which would hinder growth and prevent companies reaching this scale, could have a material consequence on competition and the number of businesses who ultimately achieve profitability and the ultimate capacity to pay taxes.

(ii) Are there any specific implications for the taxation of business profits?

To provide an example from one sector, e-commerce has been boosted by consumer’s access to the internet and allows retailers to make sales without displaying goods to consumers in a physical shop. The goods may then be delivered to the consumer from another location. As a result, there is a perception that a retailer may no longer need either a shop or warehouse in the jurisdiction of the

consumer to fulfil a sale. Under the traditional notion of PE, such a business may not have a PE in the consumer's country whilst a "bricks and mortar" equivalent would. The perception is that the corporate tax base of the remote sellers can be more readily concentrated in a few number of countries and therefore could be easier to locate in a lower tax country. However, as noted above, customer expectations for speed of delivery are increasing. Therefore, if a retailer does indeed not have storage, delivery and logistics functions in country (either in-house or outsourced to a local third-party provider in country) then they will be at a competitive disadvantage in not being able to meet customer expectations for delivery times.

When it comes to corporate income tax base of a country, this example demonstrates that there is a perception that in this sector traditional retailers may contribute more to the corporate taxes in the consumer's country than digitised equivalents. This creates public perception of inequity in the system and pressure for change. However, that perception may not be aligned with reality.

Also, to reiterate our messages in the previous section, it is important not to forget that corporation tax is just one tax applicable to this business model. For example, the jurisdiction where the consumer is located should still be able to raise indirect taxes, e.g. VAT/GST. The corporation tax model should not be seen to have failed if no corporation tax is due in the location of the consumer because no value is generated there. However, it might mean that countries want to look at their mix of tax revenue and place more reliance on other taxes.

b) What opportunities to improve tax administration services and compliance strategies are created by digital technologies?

A more digitised tax administration could bring benefits to both tax payer and tax administration, for instance, simplification and automation of tax compliance, remote e-filing, more real time working, etc. For businesses, the reality is that these benefits may take a long time to materialise.

The experience is that governments have a limited amount they can invest in IT infrastructure spend. The systems they are developing are not always built effectively for the long term.

There are also concerns that governments are all starting to explore technology independently so the range of different approaches being taken can vary widely. We would encourage governments to work with each other and with business in determining how best to digitise the tax administration and the whole infrastructure that surrounds that. For example, increasingly third-party software providers must be employed and quality standards could be brought in to ensure that the solutions they develop are fit for purpose in considering the tax and regulatory requirements a business must adhere to.

C. Implementation of the BEPS package

C.1 Although still early in the implementation of the BEPS package, how have the various BEPS measures (especially those identified as particularly relevant for the digital economy – i.e. BEPS Actions 3, 6, 7 and 8-10) addressed the BEPS risks and the broader tax challenges raised by digitalisation? Please feel free to support your answers with real life examples illustrating these impacts.

We highlighted above the importance of IP within all businesses. The BEPS package included a number of measures that limited opportunities for avoidance relating to IP, of particular importance were the changes to transfer pricing within Actions 8-10 as well as the anti-hybrid legislation within Action 2.

Once these measures have been adopted widely, there should be minimal opportunities to undertake aggressive tax avoidance and there is evidence that some businesses are already bringing IP activities and profits “on-shore” in response to the legislation that has been introduced (such as Action 2, Actions 8 -10 and CBC reports).

It is very hard at this stage to prove whether significant BEPS risks remain in the international tax system given that tax administrations will not yet have had the opportunity to review tax returns or CBC reports that demonstrate “post-BEPS” results. We are also still at a stage when not all countries have adopted the BEPS recommendations in legislation. For instance, noting Action 2 legislation as a critical development in preventing tax avoidance relating to IP, countries within the EU have until 2020 to introduce the anti-hybrid rules relating to mismatches between the EU and third countries under the Anti-Tax Avoidance Directive (II). Before seeking to introduce new measures, governments should first ensure they are using all of the tools already at their disposal, especially under existing BEPS recommendations.

In a “post-BEPS” environment, we would expect it to be rare for companies to choose to establish DEMPE functions (and accordingly, associated IP profits) in no (or very low) tax jurisdictions. However, it is plausible that this could still occur and it may be for non-tax reasons e.g. where commercial drivers lead to business being done or assets being owned in a low tax jurisdiction.

What is clear from the BEPS implementation process so far, is that there is judgement required in application of many tax rules (for example, in transfer pricing analyses) and this is leading to significantly more tax disputes (for example, over how much value creation originates in each territory). The balance between source and residency taxation is being put under considerable strain by certain countries. Mechanisms to ease such disputes will be very important for business to have access to. Moving forward, we should try to limit the amount of subjectivity or inconsistency in administration of the rules between different countries.

Given the amount of uncertainty and tax controversy that businesses are currently experiencing from the BEPS implementation process we think it is important to allow sufficient time for tax administrations and tax payers to properly work through these reforms before new measures are introduced.

C.2 A growing number of countries have implemented the new guidelines and implementation mechanisms relating to value-added tax (VAT)/ goods and services tax (GST) that were agreed in the BEPS package to level the playing field between domestic and foreign suppliers of intangibles and services. What has been your experience from the implementation of these collection models (e.g. compliance, impact on business operations)? What are some examples of best practice in this area?

A growing number of countries have already implemented new VAT/GST rules to tax digital services provided by foreign suppliers to local customers, and many other countries have announced plans to do so in the near future. Instances where countries aren’t adopting the rules, results in complexity for businesses and “sticking” VAT costs in these countries whenever services are invoiced cross-border. It should be encouraged that all countries adopt the changes and do so in a consistent fashion.

Whilst the new rules generally follow the broad framework principles of the OECD’s VAT/GST International Guidelines, the huge volume of changes together with the inconsistent implementation of the rules (at a detailed level) into national laws has resulted in a wide variety of legal and administrative practices established by different countries. This brings significant challenges for businesses operating cross border in a globalised economy, even if some governments have tried to implement a simplified system for foreign suppliers – i.e., complying with even simple rules becomes

complex when this is done at scale across many different countries and with great speed. Therefore, we would ask for more international co-ordination to ensure greater consistency and efficiency in addressing what is a global issue. Businesses would also encourage more certainty on the rules at an early stage in their implementation at a national level.

Some of the specific examples provided by businesses on implementation challenges are:

- The collection and validation of tax numbers. In some cases, leading to manual work-arounds needing to be introduced which are resource intensive.
- Increases in IT costs and challenges in resourcing to support with implementation of changes that have a short lead time. This is particularly felt in the case for new invoicing requirements.
- Challenges around determining if you need to register, registering, obtaining and validating customer information needed for the tax determination, producing a 'valid' invoice, and filing and remitting the tax.
- Some businesses have experienced certain countries adding very localised requirements, e.g. the new KSA VAT rules requiring Arabic translation of all invoices, some countries requiring links to specific exchange rate databases or integration with local systems.

Please refer to the Appendix where we have summarised some areas for improvements that could be made when implementing the BEPS recommendations.

In terms of best practices, businesses have experienced and would recommend the following:

- Critical to success is the implementation of simple and flexible rules in order to encourage growth in the digital economy and, therefore, also maximise tax revenues. In this context, flexibility does not mean promoting inconsistency in the setting of rules, but flexibility in terms of the way businesses can comply and collect the tax due.
- Partnership and consultation with business is key so that appropriate rules can be designed with full understanding of the business context in which they will apply.
- Sufficient lead time should be allowed for both business and tax authorities to prepare for implementation which often requires major organisational changes (people, processes and systems).

Please refer to the Appendix where we have outlined some comments on particular tax regimes which businesses have experienced.

In line with these recommendations, we would like to highlight the importance of the work on the OECD VAT/GST implementation package. The forthcoming report will be a critical reference point for the consistent implementation of OECD VAT/GST International Guidelines and we would encourage all governments to review the package in detail – those that are considering applying new rules and those that already have rules in place that could be further improved. When considering the implementation guidance, it is important to bear in mind that business models across all industry sectors are constantly evolving and so no one size fits all approach is likely to succeed. Therefore, it is crucial to re-emphasize that addressing the challenges of the digital economy requires the

development of appropriate responses that collect VAT/GST efficiently and effectively without negatively impacting economic growth.

This question (C2) has focussed on whether the new VAT rules have levelled the playing field with regard to domestic and foreign supplies of the same product or service. Whilst a slightly separate point, we would like to note that some businesses are finding that the new VAT rules have created anomalies in treatment of their products (i.e. an unlevel playing field which is not in line with the Ottawa taxation framework conditions on neutrality). E.g. where VAT is now applicable to the “digital version” of their product the consumer is unlikely to be willing to bear this extra cost.

D. Options to address the broader direct tax policy challenges

D.1 The 2015 Report outlined a number of potential options to address the broader direct tax challenges driven by digitalisation. Please identify and describe the specific challenges associated with the application (e.g. implementation, compliance, neutrality) of these options. What are the advantages and disadvantages of these options, including from an administrative and economic perspective, and how might some of the disadvantages be addressed or mitigated through tax policy design? In particular, comments are welcome on the following specific issues:

a) Tax nexus concept of “significant economic presence”:

A tax nexus based on “significant economic presence”, is essentially expansion of the existing treaty definition of a permanent establishment (“PE”) to include activity carried on by digital means.

If a digital PE concept would be applicable to all businesses, there would need to be careful consideration of the impact that an expanded PE definition would have on both pure digital businesses (to which transfer pricing principles for profit allocation may not be readily applied) and traditional businesses (who may have an existing PE).

As outlined in our general remarks at the start of this paper, we are of the view that the existing principle that businesses should pay corporation tax where value is created should be respected.

If the concept of a digital PE is further explored, it must be determined in which circumstances an economic presence is established that creates value for the company. Some types of presence in a country, e.g. the pure act of making the sale does not generate the value for the company. Whilst data collection is a common example of perceived value generated at the point of sale, there is great variety in whether and how companies exploit data and therefore what value, if any, raw data has. Further commentary is provided below on data collation and exploitation.

We strongly recommend that a suitable de minimis level is set for a digital PE in order to help manage the compliance burden for business. Whether large or small, businesses may be discouraged from entering new markets or may exit existing markets if the compliance burden is too great.

(i) What transactions should be included within its scope?

The only transactions which should be within scope are those which generate value for the company via the digital PE. That is, it should only capture the value creation which is over and above value created in other parts of the related business that are carried on elsewhere.

(ii) How should the digital presence be measured and determined?

(iii) How could meaningful income be attributed to the significant economic presence and how would such an approach interact with existing transfer pricing rules and profit attribution rules applicable to the traditional permanent establishment?

Conceptually, this option could potentially deliver a new means by which profit is allocated between source and residence countries. In light of the challenges experienced under BEPS Action 7, we think it is incredibly important for the definition of PE and profit allocation to the PE to be considered together.

Delivering this option is reliant on determining a suitable factor (or factors) to define digital presence that goes beyond a mere sale. To us, it doesn't feel appropriate for revenue generation alone to be determinative that a non-resident is participating in the economic life of the source state with a sufficient degree of permanence.

We are unconvinced that data collection can be a suitable secondary (or primary) factor given the knock-on consequences of the use of data collection for profit attribution purposes. Data collection is not a new activity, but one that has been carried out by traditional businesses for a long time. It would be incredibly hard to determine how much value should be attached to data collection. The general view amongst our members is that data collection in its self is not valuable, but it is the analysis and decision making in respect of data that generates value. Accordingly, this value creation would be attached to the location of the people who are analysing and making decisions using the data. This would, therefore, not likely create a very different result to the existing profit attribution position.

If there is a desire to further explore this option, we strongly recommend that more work is done on the factors that in combination could point to a suitable threshold of significant economic presence.

In discussing profit attribution, it is important to note that many highly digitised businesses will be loss-making until they reach sufficient scale. Accordingly, it should be considered whether source countries will be sharing in these losses as well as subsequent profits that may be realised. If not, such businesses may be subject to taxes on profits within the digital PE whilst facing system (i.e. whole supply chain) losses. This is likely to negatively impact their growth.

(iv) How could such a measure be efficiently and effectively implemented in practice?

Once an appropriate presence is established under this method, then it seems logical that implementation would be consistent with the approach to taxation of profits earned by a PE of a "traditional business".

Fundamentally, we would suggest that any changes in the area of a digital PE should be better addressed through transfer pricing. Any future OECD work focussed on a new allocation of taxing rights between source and residence countries, e.g. to give more recognition to the local market would be a departure from the arm's length principle. To avoid a large compliance burden for multi-nationals it would be better delivered via transfer pricing.

If the digital PE option were further explored, we think it is critical for a de-minimis threshold to be included.

In seeking to define a de minimis, some experience can be taken from the Israeli approach. The digital PE concept which has been introduced in Israel only applies where there is already some form of fixed place of business or dependent agent and a "substantial" number of contracts. This is helpful, although

we would recommend that more clarity is given on what “substantial” means in practice as this is not covered in accompanying guidance.

We expect that there would be significantly increased risk of double taxation and tax controversy for businesses under a digital PE concept. For example, for some of the largest businesses we represent who operate in a vast number of countries, there is a prospect that they could have something in the region of 100 digital PEs (depending on exactly how the threshold were set). Each of these could have a different approach to profit attribution. If that were the case, this causes a huge risk of multiple taxation which would be very difficult to resolve via dispute resolution.

It would be helpful to increase capacity and skillset in tax administrations to improve their capability to audit application of these rules for digitised businesses and reduce the potential for tax disputes.

b) Withholding tax on certain types of digital transactions:

In general, the withholding tax looks more like a tax on a transaction than a tax on profit. This exacerbates the potential for double tax, therefore we recommend that this approach is not pursued to the detriment of profit-based solutions.

As noted in the OECD 2015 report, if a withholding tax would lead to domestic and non-resident suppliers of similar products and services to be treated differently there are expected to be significant issues regarding trade obligations and EU law (for example, Hungary’s advertising tax found to be incompatible with State Aid rules).

A withholding tax on a gross basis would apply universally to businesses irrespective of their margins. Setting the rate at a very low level may be able to mitigate some of the downside. However, there may still be a significant detrimental impact on loss-making (or low profit margin) businesses who would not be able to claim a (full) credit. Unfortunately, it seems unfeasible for those withholding the tax to know whether a group is loss-making in order to exclude such companies from the regime. The likely actions businesses could take would then be to pass the cost on to the consumer (if possible) or withdraw from markets. Neither of these are good outcomes for consumers or growth.

It is also very difficult for this sort of tax to be introduced into a Business to Consumer (“B2C”) context, given this would place the compliance obligation on consumers and / or payment processors, card schemes or issuer banks. It is not expected to be easily possible for them to be able to ascertain whether or not the tax is applicable.

(i) What transactions should be included within its scope?

Given the challenges identified above with this option, it is not clear to us what transactions should be included within the scope of this measure.

(ii) How could the negative impacts of gross basis taxation be mitigated?

As mentioned above, gross basis taxation particularly impacts loss-making or low margin businesses. Potentially a repayment mechanism could be designed that would allow such businesses to reclaim tax withheld. This creates a compliance burden for those businesses, but at least would provide an option to have tax repaid.

(iii) How could the threat of double taxation be mitigated?

It is not currently clear whether current tax regimes would allow credit for a withholding tax like this. Accordingly, it would be critical to determine how such a withholding tax could be included within double tax treaties in order to mitigate the risks of double taxation and negative impacts on international trade. It is worth reiterating that even if credit is theoretically available, for loss-making or low profit margin businesses without tax base, off-setting the credit becomes irrelevant.

If explored further, our recommendation would be a globally consistent withholding tax and for it to be made clear how this would fit within the model tax treaty, as there is a substantial risk of failing to achieve credit relief if there is ambiguity or inconsistency in treatment between different countries. It should be in the interest of the source state as much as the residence state for clarity on this matter, so that in practice the split of taxing rights is in-line with expectation.

(iv) How could such a measure be efficiently and effectively implemented in practice?

It is impossible to say how such a measure could be implemented without that measure being defined. There would certainly need to be a transparent mechanism demonstrating how the measure was delivering fairness across consumers, businesses and government revenues.

Presumably it would be necessary to have a digitised system for collection of the taxes. It may fall to third parties, such as payment processors, to administer such systems which squeezes the margins of another business. Governments need to think very carefully about the practicalities and costs involved in introducing such measures into B2C flows.

c) Digital equalisation levy:

In general, an equalisation levy looks more like a tax on a transaction than a tax on profit. This exacerbates the potential for double tax, therefore we recommend that this approach is not pursued to the detriment of profit-based solutions.

If an equalisation levy would lead to domestic and non-resident suppliers of similar products and services to be treated differently there are expected to be significant issues regarding trade obligations and EU law.

As described above in respect of the withholding tax, there is real concern over the feasibility of this type of levy if it were to apply to B2C transactions due to the complexities in administration and collection of the tax. Accordingly, we would recommend that any such equalisation levy is restricted in scope to Business to Business (“B2B”) transactions only. Even with this restriction some challenges would remain (such as risk of double taxation), which are described in sections (ii) and (iii) below.

(i) What transactions should be included within its scope?

Given the challenges identified above with this option, it is not clear to us what transactions should be included within the scope of this measure.

One suggestion could be for a further restriction in scope being that the levy is only applied to transactions where it is considered that the non-resident is not being sufficiently taxed elsewhere on the income. This would need to be carefully targeted at instances where tax avoidance is present. If this were explored further, objective measures should be designed that could be used to identify in which circumstances a levy should be applied to enable consistency in application of such a rule. It is not clear to us whether it would be possible to reach agreement on a globally consistent set of measures.

(ii) How could the negative impacts of gross basis taxation be mitigated?

As described above, a levy applied on a gross basis could be damaging where it applies universally to businesses irrespective of their margins. This can have a significant detrimental impact on loss-making (or low margin) businesses who would not be able to claim a (full) credit.

Our suggestion above to limit this levy to transactions that are otherwise undertaxed would help to limit the impact on loss-making and low-margin businesses.

Also, potentially a repayment mechanism could be designed that would allow such businesses to reclaim tax paid. This creates a compliance burden for those businesses, but at least would provide an option to have tax repaid.

ii) How could the threat of double taxation be mitigated?

It is not currently clear whether current tax regimes would allow credit for an equalisation levy. Accordingly, it would be critical to determine how such a levy can be included within double tax treaties to mitigate the risks of double taxation and negative impacts on international trade (for example, if there were a series of reciprocal levies on imported services this would effectively be a hidden trade tax and could impact business decisions on whether to enter new markets).

It is worth reiterating that even if credit is theoretically available, for loss-making or low profit margin businesses without tax base, off-setting the credit becomes irrelevant. If the costs of operating in a market are too great, likely actions businesses could take would then be to pass the cost on to the consumer (if possible) or withdraw from markets. Neither of these are good outcomes for consumers.

If pursued, our recommendation would be a globally consistent levy and for it to be made clear how this would fit within the model tax treaty, as there is a substantial risk of failing to achieve credit relief if there is ambiguity or inconsistency in treatment between different countries. For example, businesses are experiencing ambiguity in the credit relief position for the Indian equalisation levy. A repeat of this should be avoided.

(iv) How could such a measure be efficiently and effectively implemented in practice?

It is impossible to say how such a measure could be implemented without that measure being defined. There would certainly need to be a transparent mechanism demonstrating how the measure was delivering fairness across consumers, businesses and government revenues.

D.2 A number of other tax measures have been proposed, announced or introduced by various countries that seek to address the direct tax challenges of highly digitalised business models (e.g. diverted profit taxes, new withholding taxes, turnover taxes).

a) What are the advantages and disadvantages of these approaches? Where possible, please share any direct experience from the implementation (e.g. compliance, impact on business operations) of these approaches.

Turnover taxes

We have highlighted above some of the concerns we have with withholding taxes and equalization levies and these would equally apply to the EU proposals for turnover-based taxation, which have been put forward.

The experience of the Indian equalization levy is that costs are passed on to the purchaser of advertising services under contractual agreements. Start-up businesses with less contractual power may not be able to do this, so their profitability would be negatively affected. We expect such unilateral measures would thus hinder competition and international trade.

Some of our members have practical experience of the operation of provincial turnover taxes, e.g. in Argentina (not introduced for reasons of digital business models). The system there includes mandated withholdings from supplier and customer payments. This is not to be recommended as a tax model for the future.

Diverted Profits Tax

A diverted profits tax ("DPT") can create considerable uncertainty for businesses unless it is closely targeted at abusive situations. This is true of the UK DPT which has been introduced.

The UK DPT was originally advertised as a tax targeted at digitized businesses. Whilst capable of applying to digital businesses, it is applicable to all. This wide drafting of the legislation means many businesses are needing to invest time and resource in understanding details of the regime and its interaction with other measures in the wider tax code. It was suggested early on that the legislation would apply only to a handful of cases, e.g. the most egregious avoidance cases. However, we understand there are many cases currently under review given the relatively broad scope of the legislation and subjectivity in its application.

The UK DPT is an example of a unilateral measure that can lead to double taxation. Whether DPT is creditable will vary by country. Unless a jurisdiction has made an explicit statement, there may be uncertainty in ascertaining whether credit is available. There may be knock-on implications, for example, whether mutual agreement procedures are available for disputes relating to DPT. If other countries introduce regimes which are similar to the UK DPT regime, this will further increase the complexity for multinational taxpayers as they grapple with trying to understand the specific rules for each new regime and the interaction with other tax systems of other countries.

b) How might some of disadvantages of these approaches be addressed or mitigated through tax policy design?

More narrowly targeted rules aimed at instances of demonstrable avoidance.

c) What are the specific impacts of these unilateral and uncoordinated approaches on the level of certainty and complexity of international taxation?

In our view, such unilateral measures will have the effect of hindering start-ups to reaching the critical scale that ensures their profitability in the long term.

There are also likely to be more instances of double taxation and tax controversy. Which ultimately, will be damaging to international trade and investment.

Finally, un-coordinated action undoubtedly increases the compliance burden on business meaning resource must be focussed towards managing compliance rather than something else.

E. Other Comments

E.1 Are there any other issues not mentioned above that you would like to see considered by the TFDE as part of its work on taxation and digitalisation?

There is a fundamental need for tax authorities to come to a mutual agreement on the abuse that is being targeted by any measure arising from this initiative, the extent of that abuse and the likely financial impact of those measures on government tax revenues, consumers and businesses before any are implemented.

Those measures need demonstrably to be very targeted to the abuse identified, and measures to avoid double taxation clearly and universally agreed.

Any measures increasing tax take are likely to result in increased cost to consumers and thereby a dampening of the economic growth potential of the digital market place.

Appendix

Experience of VAT/GST regimes

In terms of best practice from states we would highlight the approach of:

The Australian authorities, noting in particular:

- The relatively high threshold implemented in the Australian law, consistent with the existing “domestic” threshold
- The efforts of the Australian authorities to provide clear guidance on the new rules, targeted at different user groups with both high-level and detailed guidance available on the internet
- The significant efforts of the Australian authorities to identify, in advance, foreign businesses likely to be impacted by the rules and to proactively reach out to those businesses directly to highlight the possible impact of the new legislation
- The establishment of dedicated points of contact within the Australian tax authority for foreign businesses likely to be impacted significantly by the new legislation

The EU MOSS scheme, which has the following features:

- Single reporting obligation/registration requirement with the local tax office
- Single payment
- No additional requirement for bank accounts
- A B2C regime only
 - B2B – reverse charge already existed
 - B2B – easy way of validating status via VIES
- Light touch invoicing requirements
- Low value invoicing requirements
- Although, it should be noted that MOSS has no threshold for registration.

The India GST regime, which has the following helpful features:

- Single reporting obligation
- Low Value invoicing threshold

Other parts of the regime are less desirable:

- Multiple rates of GST
- Registration Threshold applied, but was low
- IT readiness
- Very short implementation timelines – 3 weeks for Service Tax implementation
- Government customers not afforded the right to recovery, resulting in sticking Tax

The South African regime, which made no distinction for B2C or B2B.

Suggested improvements to implementing the BEPS VAT recommendations

Clarity on when and how to register:

- B2C regimes only
- Reasonable registration thresholds
- B2B would be subject to
 - Reverse Charge
 - Easy and robust way to verify B2B status

Minimal Invoicing requirements, if required at all. Where required;

- Limiting local requirements, e.g. language, currencies, local tax references, requirements for paper invoices or digital signatures
- Low value invoices / receipts

Electronic

- Registering and filing as many jurisdictions still require paper forms to be completed and paper returns to be filed
- Less frequent filing obligations, quarterly versus monthly
- Allow email correspondence
- People support / out of hours (this was available for a short time in Australia, but no longer exists)

Reasonable periods to file after the period end (e.g. in some countries it is very short at just a matter of days)

Limited or no local agents/representation requirements

Overall, better consultation and improved engagement.

- Improved IT readiness and longer implementation lead times

No “use and enjoyment” provisions

OECD Request for Input on Work regarding the Tax Challenges of the Digitalised Economy
Response by the Chartered Institute of Taxation

1 Introduction

- 1.1 We refer to the Request for Input on Work regarding the Tax Challenges of the Digitalised Economy published by the OECD in September 2017 and welcome the opportunity to input into this important work.
- 1.2 The CIOT has previously responded to the OECD's work in this area, submitting a response to the Request for Input published in November 2013 and also to the Discussion Document published in March 2014. We include these responses as appendices to this response as many of the comments made remain relevant to the current discussion.
- 1.3 In particular, we agree with the OECD's conclusion in the 2015 report, reiterated in this Request for Input, and it remains our view that it would be very difficult, if not impossible, to ring fence the digital economy and identify digital businesses to which any new rules should apply because of the pervasive nature of digitalisation within the majority of businesses.
- 1.4 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.
- 1.5 In our view objectives for the tax system should include rules which translate policy intentions into law accurately and effectively, without unintended consequences. The tax system should aim to provide simplicity and clarity, so people can understand how much tax they should be paying and why and also to provide certainty so that businesses and individuals can plan ahead with confidence.

2 Addressing the tax challenges of a digitalised economy

- 2.1 We agree that digitalisation does not produce unique BEPS issues and that many BEPS Actions (particularly Actions 3, 6, 7 and 8-10) are likely to substantially address the BEPS issues exacerbated by digitalisation. We take the view it is important to define why further work on the challenges of the digital economy is required. The BEPS project as a whole was driven by a concern that substantial profits made by multi-national enterprises (MNE's) were not taxed in any jurisdiction, or were taxed at artificially low rates. The various BEPS recommendations made in the final reports in 2015 were intended to resolve such issues. We would thus ask whether further work is considered necessary because the BEPS proposals are thought to be inadequate? Or is it the case that the BEPS proposals are expected to lead to MNE profits being taxed, but the complexity and, indeed, novelty in some cases, of the value chains of digital businesses, mean that further work is required to ensure that the allocation of taxation between jurisdictions is fair and reasonable? Defining which of these is the primary aim of further work is, in our view, critical to arriving at the right solutions. In particular we consider that BEPS Actions, such as Actions 3, 6, 7 and 8-10, need to be given time to take effect, so that a clearer picture emerges of any remaining issues that need to be addressed.
- 2.2 We can thus only see merit in further work on the digitalised economy at this point which considers how profits are allocated between jurisdictions. We acknowledge that whether the application of the existing arms-length principle to a digitalised economy is appropriate is worth further consideration, as is whether existing principles properly measure the value chains of digitalised business. The CIOT would like to see a long term global solution to this question. The challenges should not be underestimated and time should be taken to investigate and consider the difficult and complex decisions that may have to be taken in this area.
- 2.3 It is noted that a number of countries have introduced unilateral and uncoordinated domestic measures aimed at tackling the digitalised economy. Different countries have different aims and objectives in relation to the digitalised economy, so this is inevitably leading to less alignment of tax bases globally. However, the fact that some countries are doing this is not a reason to rush into global proposals that may cause more problems than they would solve. It is suggested that analysis of the impact of such unilateral rules, the extent to which they create disincentives for investment, and result in increased double taxation, especially where taxes levied are not creditable and are outside the scope of Double Taxation Treaties, would be helpful. This may help to articulate the question or problem to be solved which is surely a prerequisite of this work.
- 2.4 In our view two of the proposals in the Request for Input - withholding taxes and an equalisation levy - are short term fixes that would lead to a complexity and double taxation, and are likely have a negative influence on further innovation. The third, (Tax nexus concept of '*significant economic presence*') whilst having greater theoretical merit, has significant practical challenges around the attribution of profits. We suggest that progress towards a longer term solution is likely to be slower than some may like. It is important to recognise that a proper consideration of options, even if the conclusion from doing so is that other options are required, is still progress.

3 A. Digitalisation, Business Models and Value Creation

- 3.1 It is difficult for us as a professional body to respond to the specific questions posed in the Request for Input because the business models, types and sizes of businesses impacted by digitalisation are hugely varied and arise across all sectors. However, we agree that (as noted at paragraph A.1) digitalisation is a main driver of innovation and growth and this should be encouraged. Changes to taxation should seek to ensure that this innovation and growth is not discouraged or inhibited by double taxation, or the fear of double taxation, and seeking to prevent double taxation should continue to be a fundamental aim of work in this area.

4 B. Challenges and Opportunities for Tax Systems

- 4.1 While noting the challenges presented by digitalisation, the current international taxation framework is currently undergoing significant change and whilst the BEPS minimum standards and recommendations encourage consistency across the globe it remains to be seen how this will turn out in practice.
- 4.2 We suggest that the OECD's work in this area should include discouragement of unilateral action by jurisdictions (or groups of jurisdictions), focus on the consequences of unilateral rules that have been introduced, and seek to provide recommendations for best practice in this area.

5 C. Implementation of the BEPS package

- 5.1 As noted above, we expect that the BEPS actions which are in the process of being implemented will go a long way towards mitigating the effect of mismatches and missing elements of the international tax system that some highly digitalised businesses may have been able to take advantage of. Tax authorities have not yet received their first country by country reports and are not, therefore, yet in a position to assess the effect that these measures will have. We suggest that these changes should be given time to be fully implemented and take effect throughout the international tax system before further changes are recommended in regard to base erosion and profit shifting as such. Any work now should focus on considering whether the definition of and attribution of value to supply chains with a significant degree of digitalisation can be improved.
- 5.2 We would also note that the results of BEPS Action 7 regarding attribution of profits to permanent establishments (PEs) has increased the compliance burden on tax authorities and taxpayers. The OECD has recognised (in its final report on BEPS Action 7) that the administrative burden may arise even in circumstances where no profits are attributable to a PE. The threshold issues associated with BEPS Action 7 remain the key concern of businesses as a result of the potential compliance burden and risk of double taxation that may result.
- 5.3 The Request to Input notes the VAT changes that have arisen from the BEPS project with the aim of levelling the playing field between domestic and foreign suppliers of intangibles and services. These changes demonstrate the difficulties of trying to address one problem and acting too quickly or inconsistently. Despite the OECD's VAT/GST International Guidelines, changes countries have made to tax the import of

digital services into their territory have led to significant complexity and uncertainty even where those countries have tried to simplify registration and other compliance obligations. One example is an inconsistent approach between digital and other versions of broadly the same product or service, which is unhelpful. The OECD's decision to work on implementation guidance ('Design and operation of efficient foreign vendor VAT/GST collection mechanisms') illustrates the nature of the range of issues businesses have faced.

6 D. Options to address the broader direct tax policy challenges

- 6.1 As noted above, we believe that it is important to separate the direct tax policy challenges of the modernising economy and allocation of taxing rights from concerns of non-taxation. The tax nexus concept of significant economic presence could be seen as a method of allocation of profits between states, rather than a way of taxing profits not taxed at all. However, withholding taxes and equalisation levies appear to us to be blunt instruments that are likely to give rise to double taxation and risk stifling innovation. They might have a role to play to tackle non-taxation, if certain states persisted in under-taxing profits to a point where it could be regarded as seeking to obtain an unfair advantage, but now is not the time for that to be considered, as discussed above.
- 6.2 While the BEPS actions were rooted in the existing underlying principles of international taxation, the digitalised economy proposals could represent a potential change in direction. We continue to believe that the fundamental question to ask is where value is created, and not have value ascribed automatically to metrics such as data, its creation and exploitation. The concept of attributing profits to the point of sale or market or customer base for a product is a fundamental shift in approach to the taxation of profits which would undermine the Transfer Pricing Guidelines, and could negatively impact the countries supporting growth and value creation.
- 6.3 Highly digitalised business models are a product of advancing technologies and a shift in interactions with customers. Digitalisation may shorten the supply chain and can broaden the reach of a business' products, but this will generally occur alongside a growth in the market and additional economic activity. Generally a presence will still be required in a country where a business is making a material level of sales to deliver products, to maintain relationships and understand the market. Thus taxing profit according to the value chain of a product or service should still be fair in the modern market, and the countries in the value chain where the value is created should continue to have taxing rights on the generation of profits. In our view the starting point for profit attributable to a country where a sale is made but there is no physical presence should be zero, because the value of the item in that market is not changed by its mere sale.
- 6.4 Further extension of the PE concept so that it encompasses a digital rather than a physical presence thus relies on determining a factor that goes beyond the mere sale of a product or service. The collection of data in a territory is often suggested as such a factor; however data without analysis is of little value. Nevertheless, we would accept that it is possible to conceptualise the collection of data in a territory, and the deployment of the data back in the territory as part of the supply chain. The amount of value attributable is likely to be small in all sectors, (compared to the analysis and organisation of the data) and may be only material for the very heaviest users of data in consumer facing businesses. The application of such PE's though does in theory provide a basis for improving the allocation of profits within the supply chain, and

allows for double taxation to be dealt with by existing treaty methods, and dispute resolution procedures.

- 6.5 As noted above, the BEPS Action 7 measures have increased the compliance burden as a result of creating additional PEs. Any further measures which would result in additional 'digital' PEs would exacerbate these burdens, and should be weighed against any theoretical improvement in the accuracy of profit attribution, especially where such attribution is likely to be small. We would like to suggest therefore that, if these proposals are developed, there should be suitable de minimis thresholds, so that the measures do not impose a prohibitive compliance burden on companies with only very few transactions in a jurisdiction, and that consideration is given to encouraging countries to adopt other domestic legislation, such as remote e-filing, that would reduce the administrative burdens.
- 6.6 Both withholding taxes and the digital equalisation levy are in our view blunt instruments likely to lead to double taxation. Taxes which are directly calculated from revenues will only reflect profit attributable to the territory where sales are made in a minority of cases. The imposition of such taxes is likely to lead to double taxation in many instances, as states where 'production' takes place are unlikely to want to compensate for over-taxation where sales are made. Whilst this could, in theory, be tackled by setting the rate of tax at very low levels, this is likely to lead to a tax with disproportionate collection and administration costs. Even then it is likely many tax treaties would need to be revised before these taxes, particularly a digitalisation levy, could be fully creditable. Revenue based taxes are also likely to load additional costs onto businesses in a start-up phase and slow down development, as they will generally be levied before profits are made.

7 Acknowledgement of submission

- 7.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

8 The Chartered Institute of Taxation

- 8.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 18,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation
17 October 2017

APPENDIX 1

CIOT Response (20 December 2013) to OECD's Request for Input Regarding the Work on Tax Challenges of the Digital Economy published in November 2013

20 December 2013

OECD
BEPS Project
Task Force on the Digital Economy

via e-mail: CTP.BEPS@oecd.org

Dear Sirs

Tax Challenges of the Digital Economy

In November 2013 you published a Request for Input Regarding the Work on Tax Challenges of the Digital Economy. This letter is in response to that request and, in particular, paragraph C asking for general comments.

We suggest that the first question that should be considered and answered is whether digital businesses are sufficiently different from non-digital businesses such that the OECD, and the international tax community, should support an approach enabling countries to tax them differently.

The factors that are important in making a corporation successful and profitable are many, varied, and evolve with time. Some businesses are asset rich, some employ many people, some leverage funds or take on risks, some are based on a single bright idea (of someone), and others are reliant on what products or services individuals want to buy or use. Globally businesses – digital and non-digital - have different combinations of each of these factors in each country in which they operate and business models are diverse and constantly evolving.

The position is complicated further as most digital businesses have some physical infrastructure or activities. Indeed, many traditional businesses have a digital element. For example, a retailer with physical stores may also have an online business. Newspapers, for a subscription, offer individuals a hard copy delivered to their homes together with an electronic copy on their notebook. It would be hard (if not impossible) to split the results of an integrated business into two parts, to enable the digital part to be taxed in a different way. So, in the event that the debate concludes that digital businesses should be taxed differently there are two further questions that must be addressed:

- When does a business become a digital business? and
- What position can or should be taken in relation to those countries that decide they should levy tax on a different basis?
-

We suggest that digital businesses are not sufficiently different from non-digital business to merit a distinct set of tax rules. There may be specific issues around permanent establishments (PE) and profit attribution, but these are capable of resolution by existing law and principle.

That said, any changes to the definition of PE based on recognition of a new kind of 'digital' PE which lowers the threshold of what constitutes a PE should be approached with caution.

Any changes should only be adopted once there has been full consideration of the impact on a full range of businesses. This is an area where, without due care, there is scope for many countries to claim taxing rights over the same profits, resulting in double taxation.

Similarly, any change to the methodology under which profits are allocated to a PE, to incorporate as a factor, for example, the customers or market place, needs very careful consideration. The UK, the OECD and a large part of the international tax community have endorsed the separate entity approach, together with the transfer pricing guidelines, and the latter's increasing focus on Significant People Functions. An approach based on global formulary apportionment has been rejected, and even in Europe between those countries that wish to adopt the CCCTB, the formula for apportioning profits continues to be debated. It is hard to see these two approaches to tax the profits a multinational group of companies as anything other than mutually exclusive.

A significant issue with any new approach will be the bilateral nature of treaties. With the recent revisions to the business profits articles, we already have a situation where a PE in one country could be treated for tax purposes as earning more profit than the company of which it is a part earns. If there is a lowering of the PE threshold and scope for multiple countries to claim there is a PE, some form of multilateral mutual agreement facility may well be needed. By their very nature tax treaties are bilateral instruments and should several countries be able to contend that a PE exists, some form of order will need to be established.

We are at best at an intermediate stage in the development of the digital economy. The first phase of selling things previously sold physically to selling them online (either through online stores, or more fundamentally in the case of e-books, iTunes music, streamed services etc) has progressed to a second phase where companies are selling distinct digital products such as music subscription services (for example where you are sent a selection of music every month). However, these are still 'creator driven' products. It is not currently possible to know whether there will be further progress into a third digital phase of consumer led products: where consumers effectively monetise their own 'digital signatures'.

We do not think at the moment that it is possible to reliably measure network effects. Networks offer a platform for selling advertising and subscription services, but do they create value between participants? Although data is an important aspect of digital businesses, data itself has no intrinsic value. Value is created by properly analysing data, and knowing what data to throw away.

There is a danger of assuming the digital economy is moving into a more consumer led environment and designing a tax system with that in mind – only to find the digital economy goes in a different direction altogether.

Digital technology has definitely removed certain stages/items from the supply chain: for example, it is no longer necessary to capture music in a physical form to distribute it. However, whilst this change may have resulted in some taxing opportunities to be lost, it is not a reason to necessarily create new ones, when fundamentally the supplier/customer relationship is still the same.

The development of digital technology has altered the relationship between supplier and customer. Notably, there is now often an on-going relationship because the customer expects the supplier to retain a copy of the information supplied (in perpetuity) and provide updates etc. Thus the relationship does not end at the time of a single point of sale of a physical product. However, it is still a relationship based on the delivery of valuable content (whether physical or digital) and remains fundamentally the same.

17 October 2017

Consequently, we do not think the digital economy is at a point which demands a re-write of the tax system. As mentioned above, specific issues around PE and profit attribution can be resolved by existing law and principle.

Yours sincerely

Glyn Fullelove
Chairman, International Taxes Sub-Committee

cc: Zoe Leung-Hubbard, UK Government HM Treasury – zoe.leung-hubbard@hmtreasury.gsi.gov.uk

APPENDIX 2

CIOT Response (14 April 2014) to OECD's public Discussion Document regarding BEPS
Action 1: Address the Tax Challenges of the Digital Economy published on 24 March 2014

BEPS Action 1: Address the Tax Challenges of the Digital Economy Response by the Chartered Institute of Taxation

14 April 2014

1 Introduction

- 1.1 We refer to the public discussion document published by the OECD on 24 March 2014 regarding BEPS Action 1: Address the Tax Challenges of the Digital Economy.
- 1.2 We welcome the opportunity to comment on this work being done by the OECD and do not underestimate the challenges arising from the digitalisation of global markets. However, as we explain in more detail below, many of the challenges identified do not involve Base Erosion or Profit Shifting – they are consequences of advances in technology.
- 1.3 The document provides a good analysis of the growth of the digital economy, and illustrates that some of the specific BEPS concerns will be met by other work streams. In our view the challenges identified and discussed in Parts VI and VII of the document open up profound questions of how taxation should operate in a world of increasing digital commerce. We suggest these questions would best be discussed and debated outside the framework of the BEPS project. This is necessary to ensure sufficient time to consider difficult and complex decisions.
- 1.4 The BEPS project is very much focussed on direct taxation. We consider that indirect taxation has a contribution to make in enabling the territory of the customer to levy tax – albeit that it is collected from a digital supplier with a presence in a different country, and potentially borne by the consumer. An increased focus on indirect tax may assist to at least partially address the concerns that have been raised. However, it should be recognised that simply because a jurisdiction is entitled to levy VAT, does not mean that it is or should be entitled to a tax on business profits.

2 What is the digital economy?

- 2.1 Parts II and III of the Discussion Document provide good background information on the development and influence of information and communication technology, and how the 'digital economy' has become an increasingly large part of the whole economy. These parts, therefore, provide important context for the rest of the document.
- 2.2 In particular, it is our view that these parts of the Discussion Document deal comprehensively with the first three bullet points raised in paragraph 10 in Part I of the Discussion Document (the particular issues on which the OECD requests comment). They illustrate that it is not possible to ring-fence the digital economy from the rest of the economy and there would be substantial difficulties in creating special rules for digital business.

3 Are there any BEPS issues presented specifically by the digital economy?

- 3.1 Parts IV and V of the Discussion Document illustrate what, in our view, is an important point: BEPS is, largely, a feature or result of mismatches and missing elements in the international tax system. MNE's that work in the most 'digitised' areas of the economy or use primarily digital methods to trade may be better placed to take advantage of such mismatches and missing elements; however, none of the BEPS issues are exclusive to such digital companies, and, in our view, there are no such 'exclusive' issues.
- 3.2 In relation to the fourth bullet point of paragraph 10, the other actions contemplated by the BEPS project will address BEPS for digital and non-digital companies alike.
- 3.3 In addition, the current work on VAT/GST (in Europe and the US) should also address BEPS issues. This is particularly so in relation to larger enterprises. In our view it will prove very difficult to eradicate a loss of VAT from smaller enterprises trading cross-border, as enforcing registration and collection may be impossible.
- 3.4 In relation to the fifth bullet point of paragraph 10, we do not see any value in other measures beyond those identified for direct taxation. In relation to indirect taxation, we would take the view that compliance would be encouraged if VAT/GST on digital transactions was set at lower levels.

4 The real challenges of the digital economy

- 4.1 We suggest that the broader challenges of the digital economy raised in Part VI of the Discussion Draft would exist even if the mismatches and missing elements of the current system were all eliminated. These challenges do not involve Base Erosion or Profit Shifting; rather they are a consequence of advances in technology.
- 4.2 We do not under-estimate these challenges, nor suggest they should not be debated. However, in our view, they open up profound questions of how taxation should operate in a world of increasing digital commerce. Thus, in relation to the sixth bullet point in paragraph 10, we suggest that these questions need to be discussed and debated outside the framework of the BEPS project. This is necessary to provide time to investigate and consider difficult and complex decisions in this area.
- 4.3 What is not addressed in the Discussion Document is the extent to which tax challenges are perceived to be greater in countries that have been somewhat slower to adopt digital technologies, and thus may have a lower level of 'digital exports'. The Discussion Document does not, in our view, sufficiently question whether the tax challenges of the digital economy could be more a matter of timing rather than permanent, and as digital exports become more evenly spread, the challenges recede.
- 4.4 If the challenges are a 'timing issue', any adaptations to the international tax system that entrench the current differences between economies are likely to lead to issues persisting rather than being solved.
- 4.5 Part VII of the document sets out potential options to address the tax challenges purportedly raised by the digital economy. We propose these should be debated

separately from the BEPS action points. None of these recommendations should be introduced under the BEPS umbrella, as they are not addressing questions of Base Erosion or Profit Shifting.

5 Options to address the broader tax challenges and cost of compliance

- 5.1 As noted above, our view is that the issues discussed in Part VI of the Discussion Document should be addressed separately to the BEPS project. However, on the particular questions posed by bullet point seven (the options to address the broader tax challenges and eight (cost of compliance) we comment as follows.
- 5.2 A direct tax on profit attribution based on sales, which is what the 'New Nexus based on Significant Digital Presence' represents, goes against principles that value is created where a product is created not simply by a market for that product; it would be a fundamental - and in our view, inappropriate - shift in the international tax system. There appears to be some confusion with fragmentation issues in Paragraph 214, as these are mentioned in the fourth bullet point in that paragraph. These should be dealt with by other strands of the BEPS project.
- 5.3 A system based on a New Nexus based on Significant Digital Presence would also be very complex to administer and substantially increase compliance costs for business through increasing the number of returns required and the complexity of attributing profit to various jurisdictions.
- 5.4 The approach does also not fit well with a central concept of the BEPS project as a whole which is that value is created where significant people functions are located.
- 5.5 This is particularly relevant if a digital presence is considered to be created from collecting data – data collection itself, however massive, is generally useless. Although data is an important aspect of digital businesses, data itself has no intrinsic value. Value is created by properly analysing data, and knowing what data to throw away. This analysis will be done by people or, possibly, in part by people and in part by algorithms designed by people. The crucial question is thus where the significant people functions' analysing the data or creating the analysis tools exist.
- 5.6 Turning to the three 'virtual PE' models – the first is rendered impossible by technologies that allow transactions to be made from multiple server locations; the second seems to be a restatement of the 'New Nexus' concept, and the third would seem to be a logical extension of current rules, but would be of limited application.
- 5.7 Applying a withholding tax to digital transactions raises similar concerns to the 'New Nexus' idea, in that it marks a shift in taxing where sales are made rather than where product is created. If the withholding tax is a substantial amount (certainly anything above 10% and probably anything above 5%) double taxation is highly likely to occur as the state where the product is created is unlikely to give full double tax relief on **profits** for the withholding on **revenue** to be fully compensated.
- 5.8 A withholding tax also transfers the burden of compliance/payment from producer to consumer, with the difficulties noted in the Discussion Document.
- 5.9 In our view, none of the options proposed address the question of increasing 'digital exports' in those countries currently lagging behind. Such an increase is likely to reduce international tensions over taxation of the digital economy.

6 Smaller enterprises

- 6.1 We suggest that specific consideration should be given to small and medium enterprises when considering any measures. There will always be a greater challenge of compliance for small and medium enterprises. The emergence of the web makes it much easier for quite small businesses to send goods or services internationally but compliance with some of the measures proposed would be challenging.
- 6.2 We suggest that there should be a sensible threshold for any compliance measures that are proposed.

7 VAT/GST

- 7.1 The Discussion Document raises a Consumption Tax Option. A 'consumption tax' (such as VAT) is best suited to the concerns about digital economy operators in market countries where they may have customers but no other presence. On the other hand, corporate profits based taxes, as origin based taxes, are less well suited because the tax is on the source of the profit rather than where the customer is based.
- 7.2 We would broadly agree that the principle effect of the Consumption Tax Option would be to require non-resident suppliers to register and account for VAT in states of consumption. Detailed consideration needs to be given to the compliance issues which would be much more significant for a global system than for the EU (where a single portal is being adopted).
- 7.3 As noted above, such a system would present a particular issue for small enterprises. It would be too much of an imposition to require them to register for VAT in another jurisdiction where they undertake a single transaction or very few transactions (digital or otherwise). Having a low threshold for registration would be a potential barrier to small businesses competing in a global market.
- 7.4 There are significant steps being taken in the EU in this respect. The EU has introduced changes to its place of supply rules that will affect businesses providing telecommunications, broadcasting or electronically supplied services within the EU. This change comes into effect on 1 January 2015. The aim is to move revenue from the supply state to the consumer state and negate the incentive for suppliers to move operations to countries with low VAT rates. We do not yet know whether the change will lead to increases in consumer prices.
- 7.5 We suggest that the EU experience will be informative and will, in due course, inform the debate on what a combination of VAT and BEPS changes could mean.
- 7.6 We suggest that this analysis is done before layering on additional measures and compliance burdens beyond those already contemplated by BEPS.

The Chartered Institute of Taxation
14 April 2014

OECD – REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITALISED ECONOMY

Inputs from:
CONFCOMMERCIO – IMPRESE PER L'ITALIA
Italian General Confederation of Enterprises, Professions and Self-Employment
www.confcommercio.it

SECTION A. DIGITALISATION, BUSINESS MODELS AND VALUE CREATION

Question

A.1 The process of digitalisation has become one of the main drivers of innovation and growth across the economy. Please describe the impact of this process on business models, and the nature of these changes (e.g. means and location of value creation, organisation, supply chains and cost structure).

Answer

Over time, digitalisation has led to structural changes in the market service sector represented by Confcommercio. The value creation that was once realized through personalized and face-to-face (or postal/phone) services is now achieved for a large part on line, and the intermediation service between producer and consumer, for the distribution of goods, digital products and services, and the related income, are now issued through the internet, reducing living space to brick-and-mortar service enterprises. Just to mention the most striking examples, bookstores or travel agencies are drastically decreased.

The multichannel business model option, which is often referred to as an earning opportunity for traditional business services that are willing to keep up with the change, is not viable (or is not profitable enough) for many SMEs, which are not able to take advantage of the new technologies, or which should reorganise the whole structure of their business model, with too high costs. The worldwide growth of the so-called "sharing economy" erodes revenues and incomes to traditional enterprises by transferring profits to private non-professional people and foreign-based on line platforms.

Question

A.2 Highly digitalised business models are generally heavily reliant on intangible property (IP) to conduct their activities. What role does IP play in highly digitalised businesses, and what are the types of IP that are important for different types of business models (e.g. patents, brands, algorithms, etc.)?

Answer

Not applicable to our members

Question

A.3 Digitalisation has created new opportunities in the way sales activities can be carried out at a distance from a market and its customers. How are sales operations organised across different highly digitalised business models? What are the relevant business considerations driving remote selling models, and in which circumstances are remote selling models (as opposed to local sales models) most prevalent?

Answer

The first and second question are not relevant to our members, since Confcommercio mainly represents enterprises which follow traditional, not highly digitalised sales models.

The circumstances in which remote selling models are most prevalent depend on the customer demand (renowned brands or specific products and related services) and the accessibility and/or inexpensiveness of the offer (low cost products and services, international selling or exchange platforms, where customers can find anything they are looking for, from anywhere)

Question

A.4 Digitalisation has permitted businesses to gather and use data across borders to an unprecedented degree. What is the role of data collection and analysis in different highly digitalised business models, and what types of data are being collected and analysed?

Answer

Not applicable to our members

Question

A.5 In a number of instances, businesses have developed an architecture around their online platforms that encourages the active participation of users and/or customers from different jurisdictions. Is the establishment and operation of such global (or at least cross-country) user networks new and specific to certain highly digitalised business models, and what are the potential implications for value creation?

Answer

Not applicable to our members

Question

A.6 The digitalisation of the economy is a process of constant evolution. Please describe how you see business models evolving in the future due to advances in information and communications technology (e.g. Artificial Intelligence, 3D printing).

Answer

Our member basis (Micro and SMEs in the service sector) could take advantage from the digitalisation, for instance, developing forms of digital collaboration, national or international networks to access opportunities so far reserved to large companies, bureaucratic digital simplification, and so on.

SECTION B. CHALLENGES AND OPPORTUNITIES FOR TAX SYSTEMS

Question

B. Challenges and Opportunities for Tax Systems

B.1 What issues are you experiencing with the current international taxation framework? (e.g. legal, administrative burden, certainty)

Answer

The business models of multinational companies have deeply evolved in search for greater margins of competitiveness, in order to stay in the market.

In particular, large holdings have re-converted traditional country-specific patterns (where companies belonging to the same holding, controlled by one or more *sub-holdings*, conducted in parallel the same activities in different territorial realities) in the so-called global models, based on centralization of functions, fragmentation of production (for stages and functions), and vertical integration of all the structures of the holding.

Individual companies in the same holding no longer carry out all the phases of the business activity (research, production, marketing and sales), but each one specializes in a phase in order to maintain adequate levels of competitiveness. This results in a progressive autonomy between the concepts of "legal" organization and the "economic" organization of the holding, so that the legal nature of the holding combines a more complex decision-making organization, involving all the companies in the group and going far beyond the single legal entity.

The multinational enterprise is, more and more, a multi-functional unit. This new reality puts in innovative terms the problem of fiscal sovereignty, which has been limited to national sphere of each jurisdiction; while the group presents itself as a single taxpayer who operates, with its own rules, "riding" between different jurisdictions, being able to use any legal gaps and asymmetries, and above all, to take advantage from any aid granted by Governments.

This phenomenon is causing strong impacts on the actual level of taxation and challenges the traditional principles of "international taxation", mainly with the concept of "legal establishment", "site of profits generation" (with the related distribution of taxation rights in the involved State or States), "actual beneficiary" and "permanent establishment".

One of the most important issues facing businesses is the so-called "tax inversion". Tax inversion is a fictitious location of the tax residence of a natural person or a company, in order to avoid fulfilling the tax regime of the country where incomes are actually generated. Thereby, companies are frequently claimed in order to verify where their activities are actually based.

Another issue is the "actual beneficiary": a concept created to contrast any abuse of conventional benefits in terms of applicable retention – as an expression of the tax authority of the State from the source of income – on shares, interests and royalties. This is particularly problematic for holdings operating on regular basis at transnational level.

The "tradeoff of transparency and certainty" should therefore become the guiding principle of relationships between transnational business groups and tax authorities.

Question

B.2 Digitalisation raises a number of challenges and opportunities for the current international tax system. In particular:

a) What are the implications of highly digitalised business models and their value chain on taxation policy? In particular:

(i) What impact are these business models having on existing tax bases, structures of tax systems and the distribution of taxing rights between countries?

(ii) Are there any specific implications for the taxation of business profits?

Answer

Information and Communication Technology (ICT) has improved business models and strengthened innovation in all sectors of the economy, leading to the birth and development of the Digital Economy. Mobile Devices, Social Networks, E-commerce, Cloud Computing and other technologies are deeply transforming relationships between companies and customers.

Companies also have new ways to create competitive advantages, including in taxation: through advances in digitalization, measurement and data transfer, it became easier for companies to delocalize in remote locations, in order to exploit all possible fiscal advantages. Multinationals operating on the net, modifying their organizational structure with ease and speed, put the tax system in crisis, increasing the need for timely adaptation of national and international legislation in order to fight tax evasion.

Elusive behaviors consist of the creation of "entities" in countries with favorable tax systems, and of the modification of transfer prices in transactions among entities of the same holding. The latter is aimed at minimizing the tax burden of the host country and maximize the company's overall profit by altering its tax base. In particular, while transferring profits between countries, multinational firms establish a lower price for goods/services sold in countries with higher tax rates and a higher price for goods/services sold in countries with lower tax rates.

As a general rule, with regard to direct taxation, the main problem raised by the digital economy is the territorial connection: the continuous increase in potential of the digital technology, the reduced need to have a physical presence, coupled with the growing importance of the Internet and a greater interaction among customers, may question the effectiveness of current legislation regulating the connection to tax jurisdiction.

For Public Administrations, there is a huge risk of revenue losses and commercial distortions.

Question

b) What opportunities to improve tax administration services and compliance strategies are created by digital technologies?

Answer

Digital technologies can surely bring to benefits for taxpayers, when they are used by the financial administration to ensure simplification and rationalization of administrative compliance and high-quality services that can increase the level of spontaneous fulfillment and the perception of the fairness and proportionality of Tax Administrations.

Simplification of tax compliance would specifically grant more competitiveness to Italian companies and greater attractiveness for foreign investments in Italy.

Transparency and rapidity of communication between taxpayer and tax administration are the goals to be achieved through the use of digital technologies and innovative telematic tools.

SECTION C. IMPLEMENTATION OF THE BEPS PACKAGE

Question

C. Implementation of the BEPS package

C.1 Although still early in the implementation of the BEPS package, how have the various BEPS measures (especially those identified as particularly relevant for the digital economy – i.e. BEPS Actions 3, 6, 7 and 8-10) addressed the BEPS risks and the broader tax challenges raised by digitalisation? Please feel free to support your answers with real life examples illustrating these impacts.

C.2 A growing number of countries have implemented the new guidelines and implementation mechanisms relating to value-added tax (VAT)/ goods and services tax (GST) that were agreed in the BEPS package to level the playing field between domestic and foreign suppliers of intangibles and services. What has been your experience from the implementation of these collection models (e.g. compliance, impact on business operations)? What are some examples of best practice in this area?

Answer

Law no. 147/2013 (art. 1, paragraph 33) was a first attempt to implement the BEPS package in Italy. It proposed the introduction of a first version of the so-called “web tax”, through the imposition of a series of obligations on B2B taxation, for purchasing advertising space, as well on search advertising services.

These services could have only been purchased by bank transfer or by other traceable ways, indicating the VAT identification number of the beneficiary.

The entry into force of this law was eventually repealed, since the European Commission highlighted a potential contrast with the EU Treaty on fundamental freedoms and VAT standards.

As a second attempt, a new law was discussed, proposing a new definition of a “stable hidden virtual organization” (*stabile organizzazione occulta di tipo virtuale*), and the application of financial withholding from financial intermediaries.

In particular, it was proposed to introduce a presumption of existence of a “permanent organization” where, irrespectively to any tangible presence, a non-resident person is constantly carrying on fully digitized/dematerialized activities into the territory of the State.

However, this proposal was unlikely to be concretely applied, since in contrast with international agreements on double taxation, particularly with reference to the definition of a stable organization.

The Italian legislator then changed its approach. Law 50/2017 (D.L. April 24, 2017, art. 1-bis) introduced the so-called “transitional web tax”, consisting in establishing a cooperative compliance to determinate the existence of a stable organization in Italy, also valid on

previous taxable periods. A more targeted approach to tax compliance was set to encourage multinationals (digital and non-digital) to dialogue with the tax administration, formulating possible tax bases, linked or not to the existence of a stable organization on the territory.

In particular, the cooperative compliance is initiated by request of the taxpayer and carried out in accordance with the rules established by the procedure, provided that the taxpayer has not previously received any formal inspection or administrative control or criminal proceedings linked to this infringement.

Otherwise, the Fiscal Agency proceeds to the inquiry and, if it proves the existence of a stable organization and its related incomes, issues a formal inspection (in coherence with Law no. 218/1997, art. 5.1), and shall indicate the taxable period of taxation, any higher taxes requested, penalties and interests, together with all the relevant motivation.

This methodology allows the company, by paying the sums identified within the cooperative compliance, to get a significant reduction on administrative sanctions (reduced till a sixth of the total due) and to avoid further accusations.

In case of failure of any cooperative compliance agreement, all benefits and reductions in administrative and criminal penalties are excluded. The Fiscal Agency can then proceed, even on derogation of any legal limitation term.

The rule has just come into force, so there is no practical cases addressed and resolved by this system.

SECTION D. OPTIONS TO ADDRESS THE BROADER DIRECT TAX POLICY CHALLENGES

Question

D. Options to address the broader direct tax policy challenges

D.1 The 2015 Report outlined a number of potential options to address the broader direct tax challenges driven by digitalisation. Please identify and describe the specific challenges associated with the application (e.g. implementation, compliance, neutrality) of these options. What are the advantages and disadvantages of these options, including from an administrative and economic perspective, and how might some of the disadvantages be addressed or mitigated through tax policy design? In particular, comments are welcome on the following specific issues:

a) Tax nexus concept of "significant economic presence":

(i) What transactions should be included within its scope?

(ii) How should the digital presence be measured and determined?

(iii) How could meaningful income be attributed to the significant economic presence and how would such an approach interact with existing transfer pricing rules and profit attribution rules applicable to the traditional permanent establishment?

(iv) How could such a measure be efficiently and effectively implemented in practice?

b) Withholding tax on certain types of digital transactions:

(i) What transactions should be included within its scope?

(ii) How could the negative impacts of gross basis taxation be mitigated?

(iii) How could the threat of double taxation be mitigated?

(iv) How could such a measure be efficiently and effectively implemented in practice?

c) Digital equalisation levy:

(i) What transactions should be included within its scope?

(ii) How could the negative impacts of gross basis taxation be mitigated?

(iii) How could the threat of double taxation be mitigated?

(iv) How could such a measure be efficiently and effectively implemented in practice?

D.2 A number of other tax measures have been proposed, announced or introduced by various countries that seek to address the direct tax challenges of highly digitalised business models (e.g. diverted profit taxes, new withholding taxes, turnover taxes).

a) What are the advantages and disadvantages of these approaches? Where possible, please share any direct experience from the implementation (e.g. compliance, impact on business operations) of these approaches.

b) How might some of disadvantages of these approaches be addressed or mitigated through tax policy design?

5

c) What are the specific impacts of these unilateral and uncoordinated approaches on the level of certainty and complexity of international taxation?

Answer

We proceed here to consider the three options developed by OECD to address the problem of taxation of digital economies.

The first option is the introduction of an "equalization tax" on "non-taxed" or "insufficiently taxed" profits. This taxed amount could then be used as a tax credit in the country where it is due.

This tax would apply to revenues realized by foreign companies operating on the domestic market and without any stable organization in it.

It would not act like a substitute tax (if it would replace the tax on stable organizations, the problem of changing the definition of a "stable organization" should be resolved first). In Britain, the legislature introduced a quite similar tax, the so-called Diverted Profit Tax (DPT), which was presented as a "special tax", so not covered by the EU treaties.

If the same definition would be also used for the "equalization tax", this should avoid the rules of the Double Taxation Conventions currently in force.

It is true, however, that a conflict with the EU Treaty, which prevents the creation of taxes on turnover other than VAT, may be considered. EU countries, such as Ireland, might well then appeal to the European Court of Justice.

In addition, the way in which the tax is applied remains pending. The retention scheme can be easily imposed on tax substitutes, but not on natural persons. However, natural persons generally pay by using financial intermediaries. In this case, the withholding should burden on the person who proceeds to execute the payment order.

Another reference model could be that of the Indian equalization tax (the so-called equalization levy). In that case, the tax should result in a tax applicable to digital service providers who are not resident and do not have a permanent establishment in the State in which they sell such services. For simplification requirements linked to the taxation mechanism and to avoid excessive penalties against private consumers, India chose to tax only B2B transactions, if the total business volume exceeds a certain threshold; leaving out of the scope of the tax provisions to private consumers.

As regards the measure of the proposed levy, the rate should be fixed to a level taking into account the fact that the withholding tax applies to the charges and therefore gross of the production costs, thus comparing the "effective" impact of the tax on income incurred on the same activities, if they were carried out through a stable organization.

The problem of double taxation in Italy, with a view on income tax, could be solved by providing total exemption for the considered revenues; however, double taxation would appear in the country of residence of the supplier, if the credit for the taxes paid abroad would not be accepted by the local tax authority. The problem of double international taxation and how to avoid it would thus remain on the table, without neglecting the fact that bilateral treaties against double taxation presuppose the income nature of the taxes to which they apply.

The second hypothesis outlines a retention applicable to some payments made to non-residents selling goods or services online.

This option assumes that the non-resident provider realizes a certain volume of his or her economic activity in a given state without having a stable organization. Invoicing criteria may be the number of queries to a search engine, or the number of clicks on a market platform, or alternatively the unit value attributed to each "traced" user.

Since generally international payments for Internet transactions are made through credit cards or other electronic means of payment, the OECD considers that the withholding may be made by the financial institutions involved in such payments. They should be keeping the taxation of such digital transactions and transfer it directly to tax authorities.

The adoption of this measure would result into overwhelming bureaucratic burdens on financial operators as tax substitutes, electronic payment instruments and credit cards, and - when payment is not made through them - the difficulty of taxing the sale of digital products directly to final consumers, which cannot operate as tax substitutes.

If adhering countries would modify their internal legislation in such perspective, it would remain ineffective in respect of those States with which they have signed double taxation treaties, since those treaties prevail over national rules.

According to these Treaties, national taxation can only be possible where revenue-producing activity is carried out through a stable localized organization in that State. Since all EU countries have signed treaties with each other and with the United States, such legislation would be ineffective. Even then, the tax should be defined as a special tax or a separate tax.

The third option provides for a levy on amounts paid to non-residents on "remotely" concluded transactions with resident persons if the non-resident operator shows a "significant economic presence" (albeit not physical), i.e. a certain business volume within the EU territory.

"Significant economic presence" could be determined on the basis of a constant interaction with the economy of a particular country. In principle, revenue generated by a multinational system in a country could be considered one of the clearest and most powerful indicators of the existence of a significant economic presence. This is because even companies using only internet networks can "define" a tangible market share in a country.

Revenues could also be considered in combination with other factors. For companies operating in the digital economy, the ability to establish and maintain an interaction with potential customers depends, in fact, on various factors; these factors could be evaluated, along with the revenue, to give meaning to the expression "significant presence". For example, when the company uses a local internet domain (.it), or local digital platforms that take into account local language and local uses, and also the number of contracts concluded through the use of such digital platforms.



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Opinion Statement FC 08/2017

Response to OECD REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITALISED ECONOMY

Prepared by the CFE Fiscal Committee

Submitted to the OECD on 13 October 2017

The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 30 professional organisations from 24 European countries with more than 200,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.

The CFE is registered in the EU Transparency Register (no. 3543183647-05).

We will be pleased to answer any questions you may have concerning CFE comments. For further information, please contact Stella Raventós Chair of the CFE Fiscal Committee, or Mary Dineen Advisor to the CFE Fiscal Committee, at brusselsoffice@cfe-eutax.org.

1 Introduction

This Opinion Statement by the CFE Fiscal Committee is in response to the OECD request for input on work regarding the tax challenges of the digitalised economy published on 22 September 2017.

We will be pleased to answer any questions you may have concerning our comments. For further information, please contact Ms. Stella Raventós, Chair of the CFE Fiscal Committee or Mary Dineen, Adviser to the CFE Fiscal Committee, at brusselsoffice@cfe-eutax.org.

2 General Remarks

CFE supports the conclusion reached by the BEPS Action 1 Report that because “the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes”. The BEPS process involved long and detailed consultations with a broad spectrum of stakeholders, however, none of the three options identified in the BEPS Report were recommended at that stage nor was ring-fencing the digital economy endorsed. The digital economy cannot be ring-fenced and it is still not clear that the targeted taxation matters identified in the BEPS report, are appropriate. In particular, they violate the principle of neutrality, efficiency, certainty and simplicity espoused by the Ottawa Framework for designing tax policies for the digital economy.

Ideally, CFE believes the sensible approach is to allow the BEPS Project take effect and subsequently assess how problems which persist can be addressed in light of the new post-BEPS taxation framework. In practice we recognise the imperative that governments feel to be seen to “be doing something” but we would strongly recommend that the OECD needs to build a clear international consensus before it puts forward any clear recommendations. Not to do so would risk undermining all the consensus building that has surrounded the BEPS project itself.

CFE welcomes the publication of the Outline of the Interim Report for the G20 Finance Ministers and in particular Chapter II which will contain “Analysis of heavily digitalised business models and their value chains to shed light on how and where value is created” and a “Discussion of the tax system (both direct and indirect taxation) and the issues raised by the new business models, including the impact of digitalisation on a number of traditional tax bases and on tax systems generally (i.e. beyond BEPS)” . This will bring up to date the really helpful description and analysis contained in the 2015 BEPS Action 1 report and can form the basis for a detailed analysis of how there could be modifications, or additions, to existing tax regimes to address any lacuna in the taxation of the highly digitalised parts of national economies and international business.

It is important that any new taxes do not stifle the growth of the digital economy or discourage innovation. Further, any new laws should be restricted by threshold to only very large highly digitalised companies. Any new measures must focus on the formulation of growth-orientated approaches, which exploit the opportunities of digitalisation for economic growth.

In addition, any new tax which deviates from settled tax practice and the international tax framework will inevitably lead to great tax uncertainty for all stakeholders. Uncertainty will result in non-uniform application to entities and practices beyond the anticipated scope of the new laws. To mitigate this risk, any new legislation should be aligned, as much as possible with existing international practice and norms. Net income taxation within digital economy structures should be pursued to the maximum extent possible.

Double non-taxation is a problem, this is indisputable, equally indisputable is the problem of double taxation – and its negative effect on the world economy, consumers and taxpayers. It is extremely difficult to design a new tax that is not going to have unintended consequences and lead to double taxation. Any new tax must be designed in a manner to avoid double taxation, and must come within the ambit of double taxation treaties, otherwise the whole tax treaty system, which international taxation is built upon and network will be completely undermined.

In the event that any new measures are implemented, it is vital that more robust dispute resolution measures are implemented as envisaged in Action 14 of the BEPS project. Access to effective dispute resolution mechanisms has been identified by all stakeholders as a significant problem for taxpayers. The addition of one of these new taxes will further exacerbate scarce resources to deal with disputes, increase waiting lists before appropriate fora and ultimately contribute to increased tax uncertainty.

Finally, taxpayers' rights must be safeguarded. Implementation of any new tax must be done in a manner to avoid uncertainty for taxpayers, ensuring that sufficient information is provided. New tax obligations should not be overly onerous on taxpayers and proper controls should be exercised over tax obligations (particularly in the context of a withholding tax).

3 Response to section B

3.1 Question B1

What issues are you experiencing with the current international taxation framework? (e.g. legal administrative burden, certainty)

After a time of immense change in the international tax environment, CFE believes that establishing legal and tax certainty in the international taxation framework is of the utmost importance and must become a priority of policy makers. Whilst CFE appreciates the importance of measures to tackle aggressive tax avoidance schemes and base erosion and profit shifting (BEPS), the balance of legislation must be redressed to promote certainty for taxpayers, and tax administrators. In addition, access to effective dispute resolution is a prevalent issue for business in the current time. It is probable that the introduction of a new tax on digital transactions will lead to increased disputes and uncertainty for taxpayers. The introduction of unilateral actions by states have led to increased uncertainty and despite the unilateral nature still have a global impact given the universality of the digital economy. Uncertainty is also arising due to problems with characterisation of transactions and income e.g. due to the *servicification* of production in the increasingly digitalised world.

3.2 Question B2

Implication of highly digitalised business models and their value chain on taxation policy & systems

It is clear that difficulty has arisen with aligning existing bases on which countries seek to establish their taxing rights with taxing highly digitalised business models. This is evidenced from increased disputes regarding value chains and profit attribution, such as the recent high profile case before the French Supreme Court in which the French tax authorities failed in their attempt to assert the existence of a PE by Google's Irish entity (Google Ireland Limited) in France and consequently levy 1.2 billion euro in tax.

Opportunities to improve tax administration services and compliance strategies created by digital economies.

With respect to the opportunities for the tax system, it must be stressed that digitalisation is a prime opportunity to develop an improved tax system, that is less burdensome and more fair. For example, the potential of blockchain technologies should be explored in this respect.

4 Response to section C

4.1 Question C1

Although still early in the implementation of the BEPS package, how have the various BEPS measures (especially those identified at particularly relevant for the digital economy – i.e. BEPS Actions 3, 2, 7 and 8-10) addressed the BEPS risks and the broader tax challenges raised by

digitalisation? Please feel free to support your answers with real life examples illustrating these impacts.

It is simply too early to give an informed opinion on how the BEPS package has addressed the BEPS risks and the broader tax challenges raised by digitalisation. For example, within the EU the Anti-Tax Avoidance Directives¹ (“ATAD”) and the proposed amendments to ATAD pursuant to the second Anti-Tax Avoidance Directive² (“ATAD 2”) have not yet been implemented in Member States, and will not be for a number of years³. Great uncertainty still exists as to how new guidance, principals and practices espoused under the BEPS Action Plan will work in practice, be interpreted by tax authorities or ruled upon by the courts. It needs time to take effect, to assess its impacts, positive and negative.

As an example, great uncertainty exists over the profit allocation rules in light of the changes made by BEPS Action 7 and the interaction with BEPS Actions 8-10. Introducing new methods of allocation to the digital economy would lead to further confusion without having a clear view of how the changes under the BEPS project may have impacted the digital economy.

4.2 Question C2

VAT/GST changes agreed in the BEPS Package to level the playing field between domestic and foreign suppliers of intangibles and services.

These changes demonstrate the difficulties of trying to address one problem and acting too quickly. The result is an inconsistent approach between digital and paper versions of the same product, which is unhelpful.

It should be noted that in relation to VAT the issue is very often misunderstood. While it is clear to tax practitioners that VAT is neutral in B2B transaction, and therefore even in case a B2B transaction between a non-resident digital business and a resident business is not taxed, VAT will be fully collected at a later stage, policy makers tend to believe that that case would result in a loss of tax. The focus should be addressed mainly on B2C transactions.

¹ Council Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

² Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

³ ATAD provisions must be implemented in Member States before 1 January 2019, or 1 January 2020 in the case of exit taxes. The provisions of ATAD 2 must be implemented by 1 January 2020 or 1 January 2022 for reverse hybrid mismatches.

5 Response to section D1

As regards the three proposed solutions in this section before detailed comment can be made the proposals need to be enhanced with more substantial detail; more concrete details are required on key concepts such as applicable thresholds, to the extent this is possible.

In addition much greater information must be ascertained on the serious impact that is to be expected. As results in the OECD Taxation Working Paper No. 32 2017⁴ demonstrate, not always the tax burden is not always is held by the person who is legally responsible for the payment.

"In practice, the discussion regarding who bears a tax is often linked to the assumption that the economic burden may align with the legal tax liability. In reality, there can often be large and unintended differences between legal tax liability and ultimate economic incidence. In fact, legal tax liability often bears little relationship to who actually bears a given tax. Moreover, the dynamics whereby a tax burden is reallocated among different actors in the economy are not reflected in tax collection amounts, making economic incidence difficult to analyse".

Being an organisation of tax professionals and not economists, CFE is not in the position to assess whether and to what extent any of the proposed "digital tax" will be effective with respect to it being borne by the intended targets. Nevertheless, by considering the OECD study, it is clear that to some extent (document says from 30 up to 50% for CIT and from 100 110% of any other indirect tax) any additional tax charged to the Digital economy will end up to an increase of costs for consumers and/or for workers.

Therefore, policy makers should assess these policy options in the context of the actual incidence of the chosen digital tax, and bear in mind that the effect will not be a mere increase of tax collection; most likely digital business will simply pass on part or the whole of that tax to consumers, with adverse consequences for consumers.

5.1 Tax nexus concept of "significant economic presence"

General remarks

This concept is at variance with the conclusion reached by the BEPS Action 1 Final Report, which CFE agrees with, that the digital economy cannot be isolated from the economy as a whole. Given the

⁴ Milanez, A. (2017), "Legal tax liability, legal remittance responsibility and tax incidence: Three dimensions of business taxation", OECD Taxation Working Papers, No. 32, OECD Publishing, Paris.
<http://dx.doi.org/10.1787/e7ced3ea-en>

novel and nebulous nature of this concept, double taxation is invariably going to occur, along with increased level of disputes, increased tax uncertainty and opportunity for new arbitrage.

Specific Answers

- I. It will be very difficult to select the extent a transaction must be “digital” and fall within the scope. It would be very important to clarify the relation between digital presence and significant economic presence. Every website, digital transaction and element of a digital transaction has at some point human involvement at a physical location. When deciding what transactions should be included within the scope equal consideration should be given to start-up companies and SMEs which also rely on digital platforms to carry out their business. Further, it should be noted that any possible changes and increased administrative and compliance cross-border burdens will disproportionately affect the ability of smaller enterprises to carry out and expand their business domestically and cross-border. Similarly, the cost of double taxation will adversely affect SMEs far more than MNEs. In this context, at EU level new minimum thresholds are being introduced as part of the changes to the MOSS system to alleviate compliance burden for small business providing online B2C e-commerce services across borders. Further simplification measures are also proposed to alleviate the burden on SME.
- II. Similarly, defining or imposing a threshold under which a digital presence will be established will be problematic. Regardless of how it is measured or determined, once it is based on the concept of “significant economic presence” it will lead to a two-tier system of taxation with a complete divergence in the basic principles underlying that taxation of the digital economy and “traditional economy”.
- III. Similarly in relation to attributing value, emphasis purely on where goods are supplied to, deviates from the current OECD and international tax principles that value should be attributed to criteria such as where functions are performed, risks assumed and assets utilised.
- IV. CFE believes that the imposition of taxes based on something as vague and imprecise as a “significant economic presence” will result in double taxation. In the case that this option is pursued it is vital that the issue of double taxation is equally addressed.

5.2 Withholding tax on certain types of digital transactions

General Remarks

Whilst, this proposal may *prima facie* appear to be the most straightforward, on closer examination the administration of such a tax poses major obstacles, namely who should bear the burden of applying the withholding tax. In addition to the fundamental problem of administration, this proposal would increase the compliance burden on all parties to a digital transaction, result in unequal tax treatment of the same goods sold cross-border via digital or in the traditional means and will lead to double taxation.

The adverse impact on SMEs and start-ups could be detrimental to profitability and future growth, and it is likely to disproportionately affect SMEs in comparison to MNEs.

Finally, as highlighted at above, in reality this tax will be passed onto the consumer in the form of higher prices or lesser service offering.

Specific Answers

- I. As outlined above in the context of the concept of a “significant economic presence” it is very difficult to delineate transactions which should come within this definition. It is likely that no matter where the line is drawn, it will appear arbitrary and will encompass some transactions not suitable to a withholding tax. If implemented the definitions should be drawn in as narrow a manner as possible so as not to capture unintended transactions. This is particularly at the beginning test phase of the new tax.
- II. The threat of double taxation could be mitigated by ensuring that an appropriate clause is negotiated into double taxation treaties or a clause inserted to the OECD Multilateral instrument⁵ to allow an appropriate credit / exclusion but again quantifying this in practice will be very difficult. It will lead to an increase in disputes and increased administrative burden.
- III. The primary issue on implementation is choosing an appropriate withholding tax agent. The obvious choice is financial institutions but when ones delves deeper it becomes clear that this would be an impossible task for financial institutions. How are they to assess which online payment transactions fall within the ambit of the withholding tax? How are they to carry out the function? Given this tax is largely aimed at B2C transactions it is wholly impractical to require the customers to withhold the tax. Finally, as previously stated in practice it is highly likely that the cost of any withholding tax will ultimately be borne by the consumer and not the MNEs which the measure aims to tax.

⁵ At the 2017 IFA Congress in Brazil, Mr. Saint-Amans identified the MLI as a viable tool in implementing future changes where general consensus is reached.

- IV. In terms of implementation it may be instructive to examine the commentary and debate relating to the 2017 introduction of Article 12A into the U.N. Model Tax Convention allowing for a gross source tax on payments for technical services at bilaterally agreed rate. Instructive also was the necessity to introduce alternative options in the relevant Commentary due to failure to reach full consensus.

5.3 *Digital equalisation levy*

General Remarks

CFE is opposed to the introduction of a digital equalisation levy. A levy based on turnover would ignore different operational models that could distort competition further and result in an over burden on some business models whilst having no impact on others targeted.

In particular, CFE believes the introduction of a digital equalisation levy would:

- I. Undermine the long established transfer pricing principles and undermine the assumptions on which OECD transfer pricing guidelines are based (people functions risk) if different allocation keys are used.
- II. Lead to a two-tier tax system, / means of allocating profit – one for the “traditional economy” and another for digital.
- III. Adversely impact smaller consumer economies (i.e. smaller countries) if it is heavily weighted in terms of sales.

6 Comment on domestic tax measures which have been introduced to address the direct tax challenges of highly digitalised business models

6.1 U.K. Diverted Profit Tax

The UK introduced a Diverted Profits Tax (DPT) with effect from January 2015, in the middle of the BEPS Action Plan, to prevent the artificial avoidance of a Permanent Establishment or the diversion outside the UK of what would otherwise have been UK, taxable, profits. The measure was designed to discourage such behaviour and included a higher rate of tax on such profits, 25 compared with the headline corporation tax rate at the time of 20%. The measure was introduced, so we were informed, to discourage undesirable behaviour by a very limited number of companies but the broad nature of the measures, and the lack of precise targeting, has meant that most large international businesses are potentially caught and it has created a very considerable compliance burden to demonstrate to the UK tax authority, HM Revenue & Customs, that the particular business is outside the DPT

provisions. DPT was also designed to be a separate tax, outside the existing UK Double Tax Agreement network, which seems contrary to the collaborative spirit underpinning the BEPS Action Plan.

6.2 Italian Web-Tax

Italy introduced the so-called Web Tax by virtue of Law Decree 50/24.4.2017 which came into effect in its current form on June 24th, 2017. Remarkably, the adoption of the above legislation follows two failed attempts to tax digital economy – in 2014 and 2015 – but also a number of tax dispute settlement agreements with web companies, including Apple (in 2015 for € 315,000,000 and Google (in 2017 for € 300,000,000).

The Web Tax legislation forms part of the Italian Budget Correction Law for 2017 and is structured as voluntary disclosure regime, introducing targeted procedures instead of new taxes.

In brief, the provisions are addressed to multinational corporations fulfilling the following conditions:

- i. Have consolidated revenue over € 1 billion;
- ii. Provide goods or services in Italy for total annual value over € 50 million;
- iii. Provision of goods/services in Italy is effected either directly or using an Italian affiliate;
- iv. Do not constitute subject of investigation by the Italian tax authorities.

Such corporations may activate a *reinforced cooperation procedure* with a view to identifying jointly with the Italian tax authorities any debts of potential Italian permanent establishment (PE). In essence, the corporation shall request through respective application assessment of the existence of Italian PE by the tax authorities. If a PE is indeed identified, its tax debts for past tax years shall be the subject of joint evaluation (by the tax authorities and the corporation). Once the debts are agreed and paid through the so-called *verification with acceptance* mechanism, the corporation may benefit from:

- I. reduction of applicable administrative penalties by 50%; and
- II. non-application of criminal penalties.

In addition, the corporation can access the Italian cooperative compliance regime, which provides for a number of benefits in the long term, on the basis of mutual transparency and cooperation.

Taking into account that the above described legislation has just been introduced, it is too early to assess its impact. In addition, issuance of further implementing regulations is expected to complete

the legislative framework. Nevertheless, any unwanted implications may not be expected to be important, considering that the legislation:

- I. introduces tax-related procedures (and not new taxes) and
- II. is based on voluntary compliance.

END

TFDE, Task Force Digital Economy

TFDE@oecd.org

Organisation for Economic Cooperation and Development
2 rue André-Pascal
75775, Paris, Cedex 16 France

October 13th, 2017

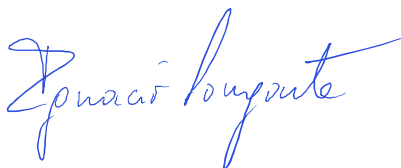
**REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES
OF THE DIGITALISED ECONOMY**

Dear acting Chair and members of the OECD TFDE

We very much appreciate the public consultation period open about this topic as we think this is a fundamental issue in today's modern economy that needs to be approached and resolved.

First: We consider there should be a green-field re-design of the international taxation system adapted to the current and future society and economic world, to be put in place not later than 2030, and have some perspectives about that, but knowing how ambitious that is, we concentrate in your questions and how to approach the short-mid term within the current environment.

We hereby present our coordinated feedback, comments and observations, following the order of your questions, remaining at your disposal for any further clarification.



Sincerely,
Ignacio Longarte
Chairman

DET3 Founders:

BBVA

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amADEUS
Your technology partner


IBERDROLA

 **PRISA**

EXECUTIVE SUMMARY

- First: We consider there should be a green-field re-design of the international taxation system adapted to the future society and economic world, and recognize the need of an “interim period” that requires immediate action now.
- The current 3 doors left open in 2015 BEPS Action 1 report, as gradually applied, producing a brutally complex and uncertain landscape for global digitally enabled entrepreneurs.
- Digital elements have an increasing strong participation in the “means of creating value”, being unique elements in some business models.
- The “value creation” and “source of income” concepts are very different.
User does NOT mean client.
But we accept a sort of reconciliation from tax perspective is needed in current stage.
- Global MNEs in general moving to:
 - Interactive fast multidisciplinary cooperation between functions/departments
 - Customer centricity yes, but with a trend towards stronger central degree
Governance model over the key elements of the business model, especially big deals pricing Governance.
- IP and intangibles:
 - Data as a new class asset.
 - Most of hard/fixed assets will be “digitalized”.
 - Digital platform, as a central element concentrating value creation in any industry: either “Around - or in”.
- Transfer Pricing:
 - Need to cover and map the data journey across the value chain and set relative contribution to the business.
 - Need to evaluate impact of A.I. and D&A in the Significant People Functions BEPs analysis.
 - Integrating the above with current TP guidelines, Treaty regs, EU Directives and BEPS measures, far away too complex for any tax payer.

PROPOSED OPTIONS TO ADDRESS DIRECT TAX POLICY CHALLENGES

- **DIGITAL NEXUS: SIGNIFICANT ECONOMIC PRESENCE (SEP):**
 - Clear objective definition of SEP needed but option has fundamental issues and practical implementation to generate extreme complications when co-existing with other closely related tax figures.
 - Due to the special features of the data class asset, refrain from any attempt to consider remote raw data collection as a Tax PE in the current digitalized economy.
- **WT ON DIGITAL TRANSACTIONS:**
 - Has also technical / treaty law fundamental issues.
 - Should only affect “stateless tax-income” (see elaboration).
 - Only in B2B. Consensus based agile double taxation elimination for “good tax citizens” would be a MUST.
 - We do not support double taxation, but expect also no “non-taxation” or “minimal nominal taxation” distorting the level playing field.
- **EQUALIZATION LEVY:**
 - Only pre-defined remotely concluded B2B sales transactions, that achieve a significant threshold. Reduced rates.
 - Only “Stateless Tax-Income (see elaboration).
 - Full sensitivity to frequency of transactions / recently created companies / or market penetration strategies.
 - Ensure good citizen tax payers with digital business models/transactions can recover this extra cost in the effective beneficiary entity corporate income tax return or in any other feasible way on an agile basis.
 - Smooth on-line reporting tool.
 - We do not support considering intermediate players as the solution to the collection issue.
- **VAT:**
 - We appreciate a positive trend here with the OECD and EU suggested measures, with mindful gradual European implementation, but a clear focus on LATAM consistency is needed now.

Request for input topics:

A. Digitalisation, Business Models and Value Creation

A.1. Please describe the impact of this digitalization process on business models, and the nature of these changes (e.g. means and location of value creation, organization, supply chains and cost structure).

The impact of Digitalization is such that it is affecting, transforming, and evolving every single industry business model and enables never existing before alternatives to bring new products/services and value propositions to the market.

In essence, digital elements can:

- make the **current business model much more efficient** and controlled, and
- **enable completely new business models**

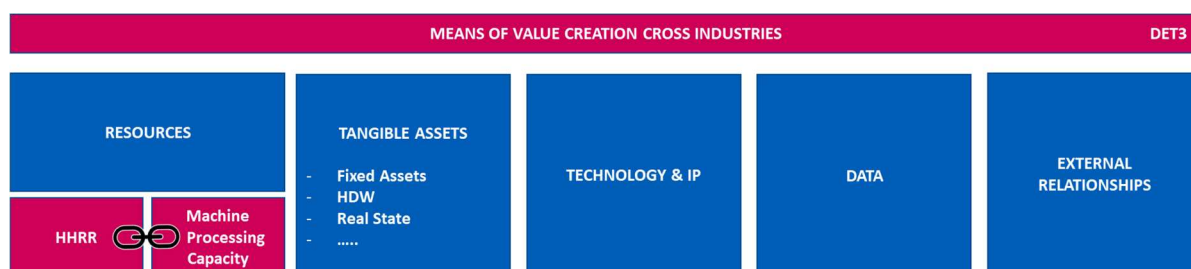
In the new design thinking era, the trend that will come is clearly that most MNEs will combine this enhanced evolution of their traditional business models, with try and fail controlled pilots of very disruptive digitally powered business model launches. The pure digital-play companies, either start-ups or relevant-sized companies, might be more agile and used to this environment, but the playing field in every industry will be driven by these forces.

This will make very difficult in about 5-10 years from now to find any international business model that is not heavily depending on a seamless real-time use of technology across its whole value chain, and in the relationships with its key stakeholders.

A.1- Means of Value Creation and cost structure:

We think that there are some common elements we can carve out that will likely apply to any MNE in the current and future context and considering digital environment is pervasive.

The following elements will be the key building blocks:



Relative value of one element/block versus the other, if we apply current regulation, can be inferred, but, considering how business models are evolving and the pace of change, it is becoming increasingly difficult or at least highly resource consuming and conflict oriented when discussed with tax administrations.

A pure-digital-play company will have different relative weight of those mentioned elements in the value creation process than a more “traditional” company, but that is going to happen in any case. External relationships are gaining weight in the open innovation era. The role of the client in value co-creation and its participation in the value chain is more incisive than ever.

This brings a need to evaluate impact of A.I. and D&A role in the significant people functions BEPS analysis.

In terms of the new business models impact in the MNEs **cost structure**, clearly the cost of the HDW, Software and Cybersecurity management will increase significantly versus what use to be 10 years ago in any industry. Either directly or indirectly as traditional relevant big Technology CAPEX investment models are evolving to flexible cloud models.

The more this happens the more will it be difficult to differentiate IT from pure business costs, as marketing people will have to work hand by hand with the UX strategists and programing experts of that company or third parties.

This has to be considered in any Value Chain Analysis.

Although there will be temporary relevant costs of transforming most multinationals’ culture to embrace digital age, part of that big incremental impact in the balance sheets / P&L is here to stay.

In some industries, the tangible assets block will have a bigger weight in the balance sheet, like network investments in Telco’s, factories in OEM / automotive manufactures, or power plants in energy & utilities, sometimes with big annotations on it. But the clear trend is that from factory product lines, to telco or electricity networks, all those tangible/fixed assets will be real time connected & operated through digital technologies, getting tangible and intangible components tied up operationally.

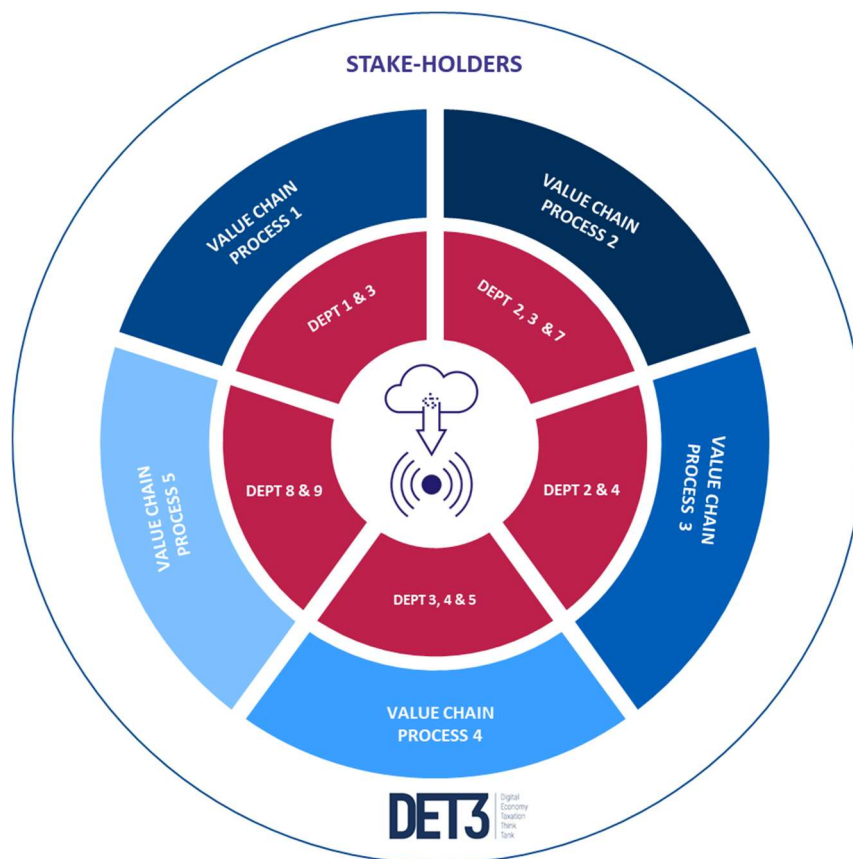
This has indeed to be part of any TP analysis, considering that digital companies, or even traditional companies investing huge amounts of money in technology (data centers, software R&D, IOT analytics, cloud....) like a global bank for instance, are not always able to light up said investments in their balance sheet because of the traditional accounting way of recognizing intangible assets. Something that will have to evolve also.

A.1- Location of value creation and organization

We have taken these two questions jointly. A critical element of the new business models is they are much more collaborative, cross-company walls, and outdoors. A globally scattered team can create joint value and the impact of each team member contributions might never see a reflection in income obtained in the same country where the team member is. This is not new but is highly exacerbated by new technologies, and we see new collaboration cultures fostering more “autonomous and cross-functional teams” as a clear trend. In some of our company members, different teams collaborate across the globe in a follow-the sun-mode, or splitting parts of the very same project. Job levels are less important in the collaborative mode, which is sometimes generating a review of the number of highly rated executives in MNEs.

From that perspective, the human centered value creation can be pretty scattered across the globe, in a very iterative and difficult to follow process, because the new collaboration paradigms are moving away from the typical linear chronogram of tasks. This trend not only affects any function/department or business unit of an MNE itself (i.e. on a “functional basis”), but for what relate to Tax analysis, implies an entangled way of co-create value between departments where businesses would like that borders or legal entities are not a distorting element of the process. Technology makes it possible, connects all the dots, and allows a new level of decision making processes.

More and more, especially in disruptive pure-play digital companies, when we try to map the value chain generation, we explain it better as a circular ecosystem rather than the traditional lineal flow:



Nonetheless, it is fundamental to mention that we also identify a trend in a good number of relatively big and global MNES towards structuring a degree of governance over the key elements of the business model, in a much stronger way than before, and much more stringent than small start-ups for several reasons, and under a much more agile technology driven framework that is changing the way Headquarters operate.

The functional org-chart is therefore becoming flatter, but the ones who stay in control want to be on it deeper and more frequently, meaning, in some cases, almost a real-time control to manage the business model ecosystem.

In essence, a relevant part of value creation will happen “around or inside a digital platform”, as an exponential trend.

Understanding impact of these changes in the Value Chain, Tax & TP analysis is fundamental; Difficult, but possible.

Reconciling the “value creation concept” versus “source concept” is also key.

A.2. What role does IP play in highly digitalized businesses, and what are the types of IP that are important for different types of business models (e.g. patents, brands, algorithms, etc.)?

- The foundation of the business model of most highly digitalized MNEs is predominantly intangibles, it's all about talent and intangibles.
- Most digital companies will use a combination of the different intangibles at play, with different intensity depending on their specific business model and industry and the casuistic is wide. Unless we completely change the current international tax and transfer pricing framework, understand the role of IP in value generation is needed and it is useful to place some indicators as you are asking, with the caveat of the need for a qualitative specific value chain and business model objective analysis.

These few indicators, should be prudently taken just as general guidance:

- When business model is predominantly digital, and there is a lack of physical product or physical assets network, brand impact, in the way Marketing profession tends to look at it, tends to be not negligible but less relevant. The value drivers of the brand are going to be informed in a big part by the different digital and technological elements of the business model.
- Patents are important but due to the lack of homogenous approach on the patentable elements across the globe, not always the key indicator in digital business models. A software, a business model or a business process can be patented in the US while not in certain EU jurisdictions, placing potentially EU companies in a more difficult situation to compete. There is a need to review IP protection and enforcement in digital era and we strongly advocate for a common framework, which is a must for the digital economy.
- Software and Algorithms are most of the time the veins of the digital company flows, becoming increasingly important these days, especially when many new products/services are delivered through mobile / APPS in B2C and / or API rest structured in B2B. But prudence needs to be observed when assessing these elements of the business, considering the vast amount of software and high-end applications easily available in the market, when aiming to identify potential unique assets within this class.
- Consideration needs to be provided to both economic funding and relevant development resources and technological committees. Place of legal registration of the intangibles, by itself, has not a strong profit potential attached.

- A new intangible asset class is in our opinion strongly emerging and required to be identified due to its relevance: the “data rights”.

Let us finish mentioning that the way things evolve, and the advent of Internet Of Things, will connect part of the traditional industries / economies hard assets to the “one/zero” culture, with the consequence of increasing the routine potential consideration of those hard assets stand-alone basis. The other side of this coin is that the relative value of the intangible digital elements will increase.

A.3 How are sales operations organized across different highly digitalized business models? What are the relevant business considerations driving remote selling models, and in which circumstances are remote selling models (as opposed to local sales models) most prevalent?

- Clear trend: client centricity, which translates to client proximity. However, if that proximity needs to be physical/local /human centered, or not, depends on the product/service powered digitally.

Client proximity yes, but trend towards a loss of local economic empowerment and strong central pricing governance, based in central guides, with a given level of flexibility to accommodate local market needs for smaller deals, and strong relevant deals central or regional portfolio governance.

- The more the product is powered through a central digital engine/platform, the more the business unit demand remote selling models, or when the product is predominantly non-physical and in a not very regulated sector.

The Financial services / Insurance industry currently has the technical capacity to serve a number of products globally, highly optimizing their business model and capital use, for instance clearly in Private Banking, but that optimization is mostly happening within country borders where physical bank offices tend to be reduced in number and headcount, but is not happening cross border at the pace desired due to the different local banking regulations that require a local legal “front end” to protect the local investor and due to tax/legal regime uncertainties.

But the reality in some business units of global banks, is that the credit risk management, the liquidity risk management and a good number of financial products portfolio oversight is highly and actively managed out of the headquarter, with growing special properly staffed units. So, some banks are actually more and more accounting for part of the revenue on those central units in their global trading of financial instruments done with the commercial assistance of their branches, which is something commensurate with the economic reality of the case and what indeed the recently born native digital banks aim to do.

In some real cases we see in other industries, the business could perfectly be run out of the headquarter or the “direct model” revenue generation country, but is not because local small / medium B2B clients in some jurisdictions are not used to deal with foreign entrepreneurs. This will change gradually and an international simplification of tax rules MUST help here.

- User does not mean client: Some digital companies, especially those playing in the B2C arena, but is also possible in B2B, invest significant efforts and amounts of money not in a traditional sales force, but in recruiting users for its app, product or digital service. This is done sometimes remotely through social media interaction or local media investments (TV commercials etc) or sometimes they develop a local market development workforce specialized in making potential users understand the benefits of joining the network. Incentives can be provided either through free access to the Digital Platform that is hosted out of the country, or in some cases the central foreign entity provides economic incentives to promote the use of the platform and load traffic on it.

In a relevant number of cases the core business of the Digital Platform is not selling anything to the platform user in that country, but to other parties elsewhere that get something different through the platform in another side/angle of it (In a two-sided or multi-sided platform). In other words, in these cases the client to whom any revenue is generated has nothing to do with the user of the platform.

For instance, in the Media business, we can have an American based agency that hires advertising space in Spanish media publisher for LATAM originated branded products, and the part that finally monetizes it is the Colombian company selling to Spanish clients or Argentinian clients that were reading/accessing the media. The user is not at all the client and the advertising revenue flows to Spain from north-America.

The monetization models can vary significantly for the digital companies and they evolve everyday (i.e. B2B2C models) as these companies pivot in their business model. Understanding monetization model and mapping real economic flows is relevant starting point of any tax/transfer pricing analysis.

Important to highlight that there are cases where the acting tax officials confused a user with a client in their review, leading to incorrect tax interpretations.

In a number of cases in the digital world, client gives away (information most of the times), and client receives (products and services), but for a good number of reasons it is very difficult to trace a co-relation back, and we strongly advise not to try it from a purely tax perspective. It would be too cumbersome and many times inaccurate.

We note nonetheless that individuals /users are every day more conscious of the privacy of their personal data, that clearly belongs to them and has to be protected.

- But the key game changer in our view is that in the new world of client centricity, a relevant part of the interaction with client or potential client has moved to the digital space and brands in any segment/industry and market level, are re-designing their customer touch-points strategies to adapt to the new digital channels, that will co-exist with other channels.

Omni-channel management is what companies are forced to do to play in most markets, especially in some industries. That has a significant cost, and many times the cost of related resources managing that budget and activity is away of the market country where consumer is based.

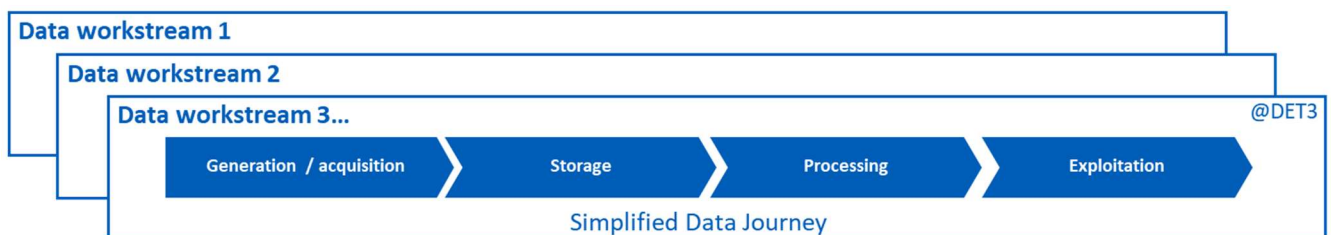
A.4 Unprecedented degree of data collection. What is the role of data collection and analysis in different highly digitalized business models, and what types of data are being collected and analyzed?

Unprecedented and scaling at a pace whose growing curve was not seen before in human history. This fact makes it necessary for most companies to invest efforts and resources (functions) in organizing and curating that vast amount of data collected as a first step, and second, to develop a culture that enable the business to think about extracting value from that data, which takes time.

Some digital native companies created only in the last 15 years are already mastering the use of algorithm driven business models working predominantly with data, and being completely relying on it for every turn of the key in their business model (see the case of some Live Stream content value propositions or E-Market places).

But most other companies, in any industry, will be soon reaping the benefits of the last part of the data journey, which is the exploitation and use of the data to produce value.

See below simplified data journey:



There could be 4 different legal entities of the same group, involved in each step, as well as hybrid models with third parties.

Data is used for almost ANYTHING in HDBMs (Highly Digitalized Business Models), but this is not just a digital companies pattern, it is changing now the status quo in most industries. Now, means change is happening TODAY, not in 20 years.

Global value chains depend on seamless, dynamic, continuous information/data flows across the legal entities and the different functions/departments. We go to a multinational company type where data is used real time everywhere across the value chain.

That is why we talk about knowledge base capital, that is not in the balance sheet but is indeed a key element of any Transfer Pricing analysis and likely a unique and valuable tax asset. Data ownership across the value chain needs to be mapped, but at the right level of effort/detail.

Of course, Banks, Telco, Media companies are amongst the first of being in the middle of a transformative revolution through data driven business models, but even traditional industries that are capital intensive or where hard/tangible assets intensive are going to be relying on this pattern:

- Agriculture is being transformed through IOT, data analytics and AI that integrates sensors real time information, weather historic/predictions data, and Autonomous Vehicles that reduce human intervention significantly.
 - Automotive industry will be made of mobile hardware manufacturers of a product that releases a huge stream of data per/second that opens endless opportunities and business models, as well as challenges.
 - The well-known case of companies moving from selling big pieces of airplane engine machines into data driven cloud powered service models.
- In our view, trying to list the types of data that will be generated is an endless exercise because the data touch points that most companies will generate across their business model is vast. But we can nonetheless make 3 general categories to simplify any analysis:
 - **Class C:** Data that enhance MNE operations
 - **Class B:** Data that enhance customer relations
 - **Class A:** Data enabling New Products/Business models

While there could be some unavoidable intra-categories overlap, this type of general conceptualization, would allow at least an initial approximation to the subsequent topic of how much could data be worth.

- In terms of valuing data, we see two clear facts:
 - Raw data has limited value.
 - The different stages in which data can be, needs to be factored in any value chain analysis.

A.5 Architecture around online platforms: Is the establishment and operation of such cross-country user networks new and specific to certain highly digitalized business models, and what are the potential implications for value creation?

First, in our opinion, it is not appropriate extrapolating the situation of a few global digital giants owning digital platforms that are in a monopolistic / duopolistic situation, to the rest of market players. Nonetheless, playing field must be leveled and we have to analyze the situation at the scale and reality that most multinationals will face, ensuring tax law is adapted to real world.

Having said that, almost every company is in the process of building up a digital platform itself. In some cases, it will be an instrument to inform, support, control and optimize the business model, and in other cases the digital platform will be the business model itself, but more and more the lines will be blurring. The more the digital platform is the business model itself, the less local legal entities you need to execute your business model, unless you are very regulated, or are heavily invested in fixed assets in a jurisdiction.

In our view, we can define a **Platform** as a *“Digitally enabled business model, composed of hardware, software, data, talent and relationships. The platforms are built to create “community” and facilitate value exchanges that generate economic flows”*.

The pragmatic daily reality is that the different elements can be contributed from different legal entities of the group placing complexity in the analysis, increased by cloud as an accelerator of these situations.

Like anything in our debate, there were previous more rudimentary ways of building those platform elements, but the different new digital evolvments and the quasi “real time” platform stile, brings new elements/angles to the plate that can add relevant value to any MNE and will in many cases all together likely be a unique asset.

We go to a platform based world when we talk about MNEs business models, for highly digital businesses and also for traditional sectors, and that should be integrated into the value chain analysis of any international company building it up.

Leaving aside legitimate tax credits or pendent to recover taxable bases, we should remember that when the platform “is the business” the different sides of the platform and the owner should pay their own taxes. The system gets unbalanced and biased when one side/part of a platform recognizes/allocates a relevant part of the digital platform revenue to the corporate tax base of a substance-less or state-less company.

A.6 Please describe how you see business models evolving in the future due to advances in information and communications technology (e.g. Artificial Intelligence, 3D printing).

In short, all those elements will enable the always connected enterprise, where:

- A.I. and data analytics will have strong influence in the decision-making process of any group
- Tasks automation through RPA, but new skills needed
- Physical and digital elements will be blurring
- Data as the key component of most innovative business models, opens endless possibilities
- Increase of “everything as a service” business models

We have analyzed and observed the business model of a number of disruptive start-ups in the industries of our members and in others, and tried to infer how things can evolve when most MNEs start to open their own R&D system to a “venture” arm of the group that will infuse capital to smaller companies with a culture of fast try and go to market.

Some points to share from that analysis when thinking about future tax policy:

- Much faster paced R&D and better capacity to measure risk and assess early stage value.
- External contributions to the business model through strategic alliances of a relevant size will complicate finding comparables for such unique value propositions.
- Most Highly Digitalized Business models will gradually incorporate and need hard elements through IOT disruption, omnichannel strategy, and the advent of other technologies (biometrics etc).

B. Challenges and Opportunities for Tax Systems

B.1 What issues are you experiencing with the current international taxation framework? (e.g. legal, administrative burden, certainty)

Roadblocks in many countries as unilateral measures grow. Tremendous uncertainty & complexity.

High difficulty to characterize traditional services when they are incorporated into a cloud value proposition, or as SaaS, IaaS, PaaS etc.... difficult to segment each component but income qualification and VAT/Sales Tax taxation, needs to be decided.

Clear guidelines that do not compromise international business should be provided for this, considering the “everything as a service” trend. This relates to the later discussed options.

B.2 Digitalisation and digital business models raise several challenges and opportunities for the current international tax system.

In our perspective, the key implication is that the international tax system will need to be fully re-written and while that happens we need to manage what we call the “interim period”, that we anticipate being in a range of 10-15 years aprox, in the most respectful way for all stakeholders interest, accepting that the situation will not be perfect for all players during it.

C. Implementation of the BEPS package

C.1 How have the various BEPS measures addressed the BEPS risks raised by digitalization?

- Not enough experience yet. Mostly used in audits when it goes in favor of reviewing administration.
- Action 6: MLI and effective income beneficiary based rules are positive, although not easy to interpret for fragmented digital flows.
- Action 3 and action 7 reconciliation not easy and conflict prone.
- Actions 8,10 and 13: The clear message of IP profit attribution requiring real activity and substance is very positive, although it was always the case.
Positive impact in transparency and tools to perform analysis and determine where there is objective value creation/substance, but overall framework far away too complex.

C.2 New BEPS guidelines and implementation mechanisms relating to value-added tax (VAT)/ goods and services tax (GST) to level the playing field. Experience?

This area seems to be going in a more aligned and consistent direction, mainly in Europe and we appreciate the focus. The same level of consistency is highly required in EU to LATAM transactions and EU to Asia transactions. LATAM region is specially concerning from this angle in the B2B as there are many countries taking measures in the same general direction but with countless different implementation nuances, over-complicating a consistent global approach for certain mostly digital flows. This needs to be tackled.

D. Options to address the broader direct tax policy challenges

The current 3 doors left open by October 2015 BEPS Action 1 report, as being gradually applied, it is producing a fragmented, complex and uncertain landscape for global digitally enabled entrepreneurs.

Maximum immediate focus on highest degree of international consensus about any path forward is needed right now. Also, as the 3 following options have fundamental application and implementation issues, any potential enforcement should have to be considered temporary and a bridge to a more fundamental reform of the overall international tax system.

D.1.

a) Tax nexus concept of “significant economic presence”:

(i) What transactions should be included within its scope?

Difficult to carve out specific transactions.

(ii) How should the digital presence be measured and determined?

Seems that a kind of significant economic presence (**SEP**) through the use of digital elements to generate the taxing legitimacy is purported here. Digital elements are used in the cyber space and while there is an element that allows full geo-location of any hardware activity which is the associated IP address, any construction here will be against the idea of not ring-fencing digital economy, and break current international principles like the disconnection or absence of co-relation of the value creation place with the “digital connectors” or “general factors” suggested by BEPS Action 1 (Digital factors / User based factors / Revenue based factors).

It is true that local sourced revenue would indicate “monetization” by the foreign player, but in the highly risky digital business models that is not always equivalent to profit. Allocating the foreign pertaining costs belonging to this part of the SEP taxable establishment activity would be required to avoid distortions. Going back to the scattered value chain ecosystem, this would be an unwieldy exercise.

About the connecting nexus digital factors, let’s take one mentioned in Action 1 like “remote collection of data” with an specific example: In the Electricity industry, one of the digitalization impacts it’s been investments in developing intelligent electricity distribution networks through remote monitoring of production and millions IOT based sensors in downstream to build up the smart-meeting network. This will enable them a more efficient productive asset management and optimizing offer and supply when possible. It would have little sense for an international Energy company to create a local platform in every country to process the data captured locally and duplicate teams to analyze it.

The central entity would have to consider if allocating the value added to the local productive units, through a rational arm’s length pricing policy indeed but if any remote collection of intragroup raw/basic data out of the subsidiary country is to represent a PE that would be a very serious operational problem from many angles.

In any case, the potential existence of a SEP tax establishment, co-existing with a subsidiary, or a potential traditional corporate income tax PE, or even a VAT PE, will add complexity, and difficulties to manage in practice; all these figures, if co/existing, should be treated equally unless some EU fundamental principles are also broken.

For most multi/activity MNEs business models, reconcile international activity with a local digital presence and a level of local physical presence on top is difficult.

(iii) **How could meaningful income be attributed to the significant economic presence and how would such an approach interact with existing rules?**

The initial perception of this question formulation suggests certain bias. None of the drivers suggested are directly representing value added generated in the country. We know the second step of this SEP alternative would mean the attribution of profit which is no simple deal and OECD Action 1 suggested for this either a Fractional Apportionment or a Modified Profit Split method. But idea was, in our view, properly abandoned.

Reflecting on a significant economic digital presence profit attribution, coordinated and connected with the rest of the global value chain drivers, is a too complex exercise for any global MNE in any industry.

(iv) **How could such a measure be efficiently and effectively implemented in practice?**

Not without very fundamental issues in our view.

Although we recognize that an assumed non-established company that has several digital touch points with local business or consumers tax payers, can be indirectly benefiting with some of the public services of that country, establishing that relation is not easy and overall, the implementation of this SEP seems to us, as explained, complex and demanding, with difficult interaction with many of the current international tax principles and collateral impacts.

If h SEP profit allocation, relative to the rest of the MNE value chain has to be computed, it is true that leaving aside difficulties in finding the right comparables in the digital age, an appropriate well supported global value chain activity analysis, addressed with the right functions assets and risks analysis following the revised TP guidelines and Actions 8-10 of BEPS, should provide a base indeed to allocate profits between jurisdictions and intervening figures (HQ, subsidiaries, SET establishment....etc....).

But the task of that analysis is every day more difficult/subjective due to several reasons whose impact is relevant in practice.

Our opinion is that such a SEP measure may over-complicate life of the tax payer when having to interpret all the potentially applicable situations/rules and any result would have to be considered in the broader context of the global MNE to assess its rational and demonstrate no double taxation, leading likely to un-fair, difficult to objectivize situations.

Hence, clear and objective rules to determine when a SEP is existing, are more than imperative.

Two key points of the current G20 agenda are tax certainty and growth, so clarity must come with any new tax measure affecting the digital world scattered value chains.

That is why if any short-term measure has to be adopted while the full tax system is reconsidered, then, we would suggest not this option but an easy to understand / apply measure with full legal certainty on its application/computation.

b) **Withholding tax on certain types of digital transactions:**

- **What transactions should be included within its scope?**

BEPS Action 1 text suggested remotely concluded digital/electronic transactions of foreign companies with local market customers, likely B2B only, that are already monetizing (i.e. generating direct revenue).

In our view the digital elements component of the B2B income should not be ancillary, but predominant. Making any further differentiation / segmentation of digital transactions seems difficult. But two relevant caveats are needed instead:

- 1- This measure should only affect “stateless tax income”, or income that has not been declared / reported in the corporate tax base of a company that has the right level of active substance in any country in the world or to income that the primary revenue collector shares in any way (including through license) or attributes in a big portion to/with hybrid transparent entities lacking executives & commensurate operating substance or being billed out from non-cooperative countries.

It should not affect any digital income that has been declared in the country of the billing party by an “active company” with adequate level of substance/employees. In other words, this alteration of the current international system should not be purported for transparent MNES that are responsible tax payers playing in a difficult international field.

- 2- In this eventual option, the gross base for the “digital WT” should cover only predominantly digital flows with non-related local customers that are well differentiated from other types of treaty incomes. Otherwise the measure will force most MNEs to start withholding over many intercompany international services flows that are already covered by different articles of the Model Tax Treaty on their income qualification, as a good number of these services are digitally powered at different levels. Opening this door, is a tough battle.

Last, a remark is needed about data transfers if potentially are being considered “in scope” here: The vast and endless evolution of data production in the future should make all us rather extremely prudent in the international context when analyzing this concrete topic.

- **How could the negative impacts of gross basis taxation be mitigated?**

The only way is by establishing a reasonably low WT rate, and even though, for some digital low margin business models of existing MNES or for start-ups, it could slow-down their international expansion and affect their sustainability.

Therefore, a big enough minimum threshold based on overall unitary MNE entity aggregated B2B revenue by market jurisdiction would be needed.

- **How could the threat of double taxation be mitigated?**

This is an extremely sensitive issue as there are legitimate digital platforms, or MNE business models that have not been using extreme interpretations of tax/legal regulations nor tax law loopholes, nor sham structures, in their past expansion, while working extremely hard to build up a position in the market. Alternatively, there are parts of the business of some MNEs in digital sector that are or will soon be going through a digital “direct model” co-existing with a traditional locally routed business in a multichannel strategy.

The elimination of any chance of double taxation for these players out of this potential measure has to be a MUST, as well as the reduction of any potential financial impact stressing its working capital even more. Otherwise, this WT would be just a collection measure rather than a redistributive tool.

Let’s remember that such a WT construction could resemble that of an additional/duplicative consumption tax.

The key message here is we do not want/support double taxation, but we expect also no “non-taxation” or “minimal nominal taxation” distorting the level playing field.

- **How could such a measure be efficiently and effectively implemented in practice?**

Not easy to circumvent some international trade rules or requests for non-tax discrimination between resident and non-residents in certain areas like the EU.

Our strong suggestion would be to establish a process of granting automatic foreign tax credit legitimacy for “certified tax payers”: grant automated agile deduction of the source countries WT at the level of the income recipient country if certain conditions are met.

We suggest avoiding include B2C direct flows under this WT as do not endorse searching for a potential intermediary party like banks/agent platforms / payment agents / to do the retention/collection work.

c) **Digital equalisation levy:**

- (i) **What transactions should be included within its scope?**

This is another way of taxing non-resident companies with SEP in a country. Same previous considerations to firstly define the SEP would apply.

Only pre-defined remotely concluded B2B sales transactions, that achieve a certain threshold potentially representative of “SEP”.

There could be a long list of specific potential digital transaction descriptions, and some countries are trying to list those (see India’s draft proposals to evolve their current equalization levy), but in our perspective what has to be clear is that the flow must be “predominantly digital”. In other words, if someone is delivering a more traditional service that now has a little or some technology imbedded, those type of flows should be completely out of any equalization levy scope.

Only stateless income, mainly un-declared income or income declared in substance-less companies, should be included in a measure like this. See please our previous comments on a potential digital transactions withholding-tax.

Going to an extreme but also suggested position of taxing the contributions of the local users/customers or user derived parameters (MAU/active users etc) under an equalization levy model and with a separate valuation should be a sensible, difficult road, that challenges even more structural corporate tax principles. Note that a common B2C indirect tax framework is in its way in Europe, while for instance not going at the same speed in LATAM as it should be desirable.

(ii) **How could the negative impacts of gross basis taxation be mitigated?**

With a relevant enough gross revenue threshold to capture only “significant” potential economic presence. With the lowest rate possible and full sensitivity to frequency of transactions and situations like recently created companies or market penetration strategies, meaning at least the non-established company needs to have been remotely serving local clients above a certain threshold along a minimum period (Say 3 years). This would not eliminate but mitigate the chances of equalization levy completely eating the reduced bottom line margin obtained by the foreign company posing a structural business issue for some EU companies also.

(iii) **How could the threat of double taxation be mitigated?**

Not only double taxation but inequalities of resident to non-resident tax treatments would likely be produced unless same rules applied for all.

As a first condition also, the absence of a declared Corporate Tax PE in source country should be a requisite for this levy.

If an equalization levy takes the form of a non-income tax, recovering it can be extremely hard. Even if it is not approved as a corporate profit income tax regulation countries should agree a consensual treatment that applies cross borders under regular treaty networks and ensure good citizen tax payers with digital business models can recover this extra cost in the effective beneficiary entity corporate income tax return or in any other feasible way.

It would have to be clear that the equalization tax is the final tax liability of the nonresident company delivering digital products/or services, and avoiding the need for any additional transfer pricing documentation or profit attribution computation for that portion of the non-resident company business in the Equalization Levy country.

(iv) **How could such a measure be efficiently and effectively implemented in practice?**

If finally implemented, a smooth on-line reporting tool should exist, and extreme care should be observed before considering intermediate players like banks, payment companies, etc as the solution to the collection issue.

Assuming a B2B equalization levy, the minimum threshold should ensure it applies to companies more used to international trade flows.

But the real challenge is how the payer can effectively know which foreign player is subject to the levy and which one is not.

Digital Economy Taxation Think Tank, DET3, is an EU based association being formed, and the pertinent internal- external legal authorizations are in the process of being obtained/agreed. The association and the members reserve the right to adjust, change or remove the logos used under these and related materials

DIGITAL ECONOMY GROUP

October 13, 2017

VIA E-MAIL

David Bradbury
Head
Tax Policy and Statistics Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(TFDE@oecd.org)

Re: Request for Input on Work Regarding the Tax Challenges of the Digital Economy

Dear Mr. Bradbury:

The Digital Economy Group (the “DEG”) is an informal coalition of leading U.S. and non-U.S. companies engaged in commerce through digital and non-digital means.¹ We appreciate the opportunity to respond to the Request for Input (“RFI”) issued on September 22, 2017 to support the further work of the Task Force on the Digital Economy (“TFDE”). We request an opportunity to supplement these points at the Consultation to be held on November 1.

As always, the OECD (including the TFDE and the G20) has a critical role to play to encourage a consensus on international tax policy issues. That role is the cornerstone of the OECD’s position today as the multilateral organization most likely to achieve a broad, global consensus.

We believe that the TFDE should conduct the factual and analytical due diligence necessary to reach the most appropriate long term solution to the issues covered in the RFI, in spite of political pressure for rushed action. The TFDE should allow the Secretariat sufficient opportunity to develop the facts and analytical tools to assess the effects of the BEPS Project recommendations on business models, and to assess how tax policy can encourage the growth of emerging digitalized enterprises in all jurisdictions. The work of the Horizontal Project may provide useful insights on these points.

A. Digitalization, Business Models, and Value Creation

We firmly endorse the conclusion reached in the Action 1 2015 Final Report based on two years of rigorous study that the digital economy is becoming the economy itself, and that it is not possible to “ring fence” the “digital economy.” It is appropriate that the RFI refers to the “digitalized economy”. However, any proposal which

¹ The Digital Economy Group’s current membership comprises the following companies: Amazon.com, Inc.; Expedia, Inc.; Google, Inc.; Facebook, Inc.; Netflix, Inc.; Microsoft Corporation; RELX Group PLC.; Salesforce.com Inc.; Spotify AB, and Twitter, Inc.

applies only to a certain segment of the digitalized economy would constitute a clear violation of the neutrality principle.² This would include any proposal which applies only to “highly digitalized business models.”

Digitalization drives innovation and growth, and has enhanced the business efficiency of virtually every sector of the economy. In particular, it enables start-ups and SMEs from developing markets to compete in the global marketplace at low cost.

Accordingly, the appropriate focus for tax policy is to ensure that tax law enables growth and encourages the adoption of digitalized business models in all sectors.

1. Value Creation

The RFI squarely raises the question of the “means and location of value creation” in the digitalized economy. We respectfully submit that this is a critical issue, and one which has not been discussed transparently (at least in the OECD's public communications). Now is an excellent opportunity to have that discussion.

Each of the “options” first mentioned in the 2015 Final Report and in the RFI is based on the argument that “value” is created simply by the existence of the market as such, and under international tax policy that market should attract some part of the tax base of residence countries.

This argument, if accepted, would be a substantial departure from extant norms with possibly far reaching consequences for all businesses engaged in cross-border trade. All businesses have a “market.” The proposition that a market should result in the allocation of some of the tax base away from the country of development and/or production to the country of consumption cannot as a matter of policy be limited to one sector. To be legitimate as a tax policy principle, it would need to apply across all industries, from luxury goods, to automobiles, to commodities.

The only tax policy theory which acknowledges that some part of the tax base should be allocated to the state of consumption without more is formulary apportionment. The OECD has consistently maintained throughout the BEPS Project that there is no intention to adopt a formulary apportionment system.³

This foundational principle of the international tax system is reflected in the OECD's Transfer Pricing Guidelines (“TPG”), incorporating the arm's length principle. Income is allocated to those locations where the enterprise performs functions, owns and uses assets, and bears and manages risks. The TPG state without equivocation that the mere existence of a market is not an intangible asset.⁴

With respect, we believe that an enterprise creates its success through its deployment of personnel and capital resources. Innovation and production create value, consumption does not. A commercial transaction between a supplier and a purchaser is an exchange of value for value (the good or the service is supplied in exchange for money or other consideration), but that transaction creates no new value.

Digital companies compete with each other worldwide to attract the best talent, in order to design the business models, features, platforms, and analytical tools that drive their businesses. These businesses certainly utilize the internet, but using this means of connectivity does not discount the value of the personal skill needed to create

² OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, (hereinafter “Action 1 Final Report”) see reference to the Ottawa “Electronic Commerce: Taxation Framework Conditions” in, Annex C, footnote 9, and associated text.

³ OECD, *BEPS - Frequently Asked Questions*, OECD.org (last visited October 10, 2017), Q.53, 108.

⁴ OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris, at 250 (stating, “[f]eatures of a local market... are not intangibles”).

these businesses, the capital investment necessary to fund them, and the risks innovators take on them with no guarantee of success.

Endorsing the policy notion that value is created by consumption rather than production would be a fundamental shift of rights to a tax base from the country of production to the country of consumption. This conclusion cannot be limited in application to the digitalized economy, or indeed some subset of the digitalized economy. If the OECD were to endorse this shift for some subset of ordinary business transactions, it is hard to see a principled reason how to limit the expansion of this theory to apply to other export sales into a market.

2. Role of Data

The RFI raises the question of the role of data and its collection in “highly digitalized business models”.⁵ Data itself does not create value. Rather, the value is created through those processes which structure, aggregate, and analyze, and present the data in a manner responsive to the users’ objectives. Data has always existed; what is new is the ability of many enterprises (not just the “highly digitalized” ones) to structure data in ways that allow the application of analytical tools against that aggregated data. That value is created through application of the enterprise’s investments in advanced computer processing and software tools. Users and consumers of digital services are in no way involved in these structuring and analysis functions.

We understand that arguments have been made that a direct income tax is appropriate for those enterprises which obtain access to a market through digital means. This market access theory is essentially a tariff on imports. We would be surprised if the OECD were to endorse this theory of taxation.

We also understand that arguments have been made that tax should be imposed on a theory that users constitute a natural resource that is mined by enterprises. This is a novel analogy but it certainly fails to justify an extraordinary allocation of taxation rights to the jurisdiction where users reside, any more than would be the case for purchasers of luxury goods, high performance automobiles, or any other item. We also understand that arguments have been made that sales made by digitalized economy enterprises benefit from the infrastructure of the consumer’s jurisdiction. Again, this theory does not distinguish the cases of luxury goods, which are bought by educated and sophisticated consumers, or luxury cars, which are driven on roads financed by residents of the market jurisdiction. In fact, the capital investment in the hardware which supports digital connectivity has been financed, built and operated in large part by the enterprises which provide the digital services.

3. Use of IP

The RFI raises the question of how intangible property (“IP”) is used in highly digitalized businesses. Putting aside the fact that IP is used in many businesses in the digitalized (and not yet digitalized) economy, this question has only an indirect relevance to the analysis of how transactions conducted remotely through the facilitation of the internet should be taxed. The main feature at the core of all three options is the ability for an enterprise to access a market remotely. That commercial reach is possible due to the widely available internet and cloud infrastructure, not necessarily due to the IP of the enterprise selling remotely. Those infrastructure resources are essential to all remote sales models. They also are available to all enterprises. Thus, the technology which provides the highways for remote sales and the other benefits of digitalization are available to all enterprises, large and small, without distinction of geographic origin. Every innovator may capitalize on these resources at relatively low cost, enabling start-ups and SMEs in developing markets to compete in the global market.

IP does not arise spontaneously; it is the result of substantial human effort and investment risk. Statutorily protected IP such as patents, copyrights, and trademarks protect the innovative work of employees or individual entrepreneurs. To the extent that IP is viewed as especially significant to value creation in the digitalized

⁵ We note that the RFI itself engages in some ring fencing, by separately identifying “highly digitalized business models” from the rest of the digitalized economy.

economy, its role should be seen as emphasizing the value contributed by the human innovators whose work the law protects.

4. Business Models

We welcome the detailed focus of the TFDE on developing information on the typical business models used in the digitalized economy. Despite the review of business models conducted for the 2015 Action 1 Final Report, we believe that in some quarters there is still an assumption that highly digitalized enterprises operate "in the cloud". Enterprises which have managed to grow in these highly competitive sectors have done so only through heavy investment in very substantial workforces, and multi-billion dollar yearly investment in infrastructure to enable the cloud's operation (e.g., data centers, servers, network architecture, etc.). We hope that the TFDE examination of business models will demonstrate these points.

B. Challenges and Opportunities for Tax Systems

We believe that the policy issues raised in this section are treated in more depth in other sections of the RFI. We commend the Secretariat for developing information on how tax administrations themselves can utilize the benefits of digitalization and business investment in cloud infrastructure to improve tax administration services and compliance strategies.

C. Implementation of the BEPS Package

We commend the diligent work of the Secretariat to gather input on the effect of the BEPS Project on the business models which are under review by the TFDE. We also commend the thoughtful approach of the OECD to issue the mandate to the TFDE to gather input on this point for purposes of preparing an interim report in 2018, then further monitoring changes in business models before reaching a final conclusion in the 2020 report.

The BEPS Project was expected to be the most significant transformation in international tax in a century.⁶ On June 17, 2017, 68 jurisdictions signed the Multi-Lateral Instrument (the "MLI") and accepted the four minimum conditions designed to address a wide range of BEPS issues (the recommendations on harmful tax practices, treaty abuse, country-by-country reporting, and dispute resolution). The TPG have been enhanced through the results of the work under Actions 8 - 10, and many jurisdictions have adopted the changes to the PE standard arising from the work under Action 7. This was a remarkable achievement, and demonstrated the OECD's ability to develop a global consensus.

1. Changes to Commercial Structures

The BEPS Project changes are meaningful, and are having an effect on business structures. Companies have been devoting substantial resources to bring their structures into alignment with BEPS principles. These changes in commercial arrangements, however, may not yet be immediately visible to tax administrations. The changes will become clearer once they are fully implemented and reflected in tax return filings and tax administrations are able to gather evidence from their examination function. We believe that in many cases, taxpayers have had conversations with particular tax administrations about the consequences of implementing business model changes in response to the BEPS Project and related initiatives. We hope that those tax administrations will be able to share their experiences with the TFDE delegates.

We can provide some observations on the major trends.

⁶ OECD, *OECD presents outputs of OECD/G20 BEPS Project for discussion at G20 Finance Ministers meeting*, OECD.org (October 5, 2015) (in which the OECD's Secretary General, Angel Gurría, stated "The measures we are presenting today represent the most fundamental changes to international tax rules in almost a century: they will put an end to double non-taxation, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective").

a. Sales and Marketing Structures

In response to Action 7, many larger groups which formerly used a centralized sales and distribution structure are taking steps to convert their sales and marketing entities to act as resellers in each market jurisdiction. We understand that the use by some groups of remote sales structures is a principal reason the BEPS Project focused on PE under Action 7 and the tax challenges of the digital economy under Action 1. We note that the unilateral measures which have been adopted by some countries expressly encourage groups to adopt reseller structures instead of remote sales models.

As should be expected, enterprises are responding to that message, even though the reseller model creates business process inefficiencies, significant additional operating costs, and additional business risks, e.g. in the areas of systems, contracting, and similar points.

Establishing a reseller entity in a market jurisdiction creates a local point of revenue recognition for sales of goods or services into that jurisdiction. That sales revenue will be reported in that entity's local financial statements and tax return. Once the reseller has been established, any tax policy concerns relating to remote sales structures have been addressed.

Tax administrations will be able to detect the adoption of such structures through disclosures in country-by-country reports introduced under Action 13. The Australian Taxation Office has published reports indicating the adoption of reseller structures in that country.⁷ Business efficiency considerations normally dictate that a group will use a single sales model for all major market jurisdictions, so adopting a reseller structure in one major market generally means that the group will adopt reseller structures in all major markets. For large enterprises, these restructuring projects are large undertakings, involving expensive and time-consuming IT systems changes, customer relationship management, legal review and other issues which must be addressed.

Accordingly, further evidence of these changes will emerge over time.

We note, however, that in some cases a group may maintain an existing structure and be fully consistent with the principles of the BEPS Project. This is because for these enterprises, the most accurate delineation of their business structure will remain a centralized sales and distribution model. Forcing companies whose tax reporting positions are already consistent with BEPS principles into a mismatched reseller structure would be contrary to the goals of the BEPS Project.

Quite separately, in some businesses, it simply is not practical (or financially reasonable) to establish resellers in multiple jurisdictions. This would be true, for example, where a company has a small number of sales in a given jurisdiction. Forcing them to adopt a reseller structure would mean the business would no longer be viable.

b. Transfer Pricing

In response to Actions 8 - 10, companies have been assessing the application of the newly revised TPG to their commercial structures, and have made appropriate functional changes or changes to their transfer pricing positions. This includes reevaluating the location of people functions, and of the management of risk assumption and risk management. Publicly available information is now emerging as to the wide extent of these business and transfer pricing changes.⁸ A Thomson Reuters survey of tax directors in 2016 found that 66% were “proactively

⁷ Australian Taxation Office, *Multinational Anti-Avoidance Law (MAAL)*, ATO.gov, (Last modified June 27, 2017) (reporting the restructuring of 31 multinational entities).

⁸ See also European CEO, *Shifting the Rules*, (April 19, 2016) (in which the KPMG Global Head of Tax stated that the results of the BEPS Project “are nothing short of transformational”); Deloitte, *OECD’s Base Erosion and Profit Shifting (BEPS) Initiative and the ‘Global Tax Reset’: Full Results of the Third Annual Multinational Survey*, (May 2016) at 11, (in which a survey of tax directors found that 55% agree or strongly agree that their business has changed the way they conduct tax planning for cross-border transactions as a result of proposed changes arising from the BEPS project); Deloitte, *The New Transfer Pricing Landscape: A Practical Guide to the BEPS Changes*,

taking steps based on the BEPS recommendations,” with another 22% “waiting for countries to implement” BEPS changes.⁹ According to Ernst & Young’s 2017 Tax Risk and Controversy Study, 30% of all respondents “changed a transfer pricing arrangement because of tax risk,” 23% reported changing a finance arrangement, and 14% changed a functional allocation or changed a hybrid structure.¹⁰ KPMG’s Global Transformation Study found that “96[%] of organizations are in some phase of transformation.”¹¹

c. Location of IP Assets

Many groups are proceeding with plans to locate valuable intangible property assets in legal entities which are fully taxable. We expect that the reforms to the Irish corporate tax residence rules will create a strong incentive to complete many of these transactions by December 31, 2020, the date the reforms are effective. Anti-hybrid measures adopted in the Netherlands on May 29, 2017 will have a similar effect with respect to similar structures based in the Netherlands, effective January 1, 2020. These transactions are also time and cost intensive, and cannot be implemented quickly.

As evidence of this activity, we refer to the report prepared by Mr. Seamus Coffey for the Irish Minister for Finance and Public Expenditure and Reform, addressing, *inter alia*, Ireland’s adoption of the BEPS Project recommendations. The report notes the occurrence of “a number of intangible on-shoring events in recent years” and that the income arising from those intangible properties is now included in the income of Irish resident companies.¹² The report anticipates further on-shoring events in the future.¹³ The report also notes that the companies which are considering bringing IP onshore to Ireland under the current environment already have significant substance in Ireland. Significantly, the report also anticipates that “it is likely that further substance will follow” to Ireland in conjunction with the onshoring transaction. In that regard, the report cites the principles arising from the BEPS Project Action 8 - 10 work that intangible income generally is allocable to those locations where DEMPE functions are performed.¹⁴

d. Monitoring

Further evidence of these transactions will appear in country-by-country reports as mandated by Action 13. The Secretariat may wish to review in particular the further evidence of these changes which emerges between now and 2020.

The TFDE has the mandate to monitor changes to business structures in response to the BEPS Project. We encourage the TFDE to use all resources at its disposal to fulfill that mandate prior to reaching final conclusions in 2020. According to a report released by the European Centre for International Political Economy (“ECIPE”), more research is needed to empirically track base erosion, and we also support such research.¹⁵

2. Possible TFDE Actions to Encourage Further Restructuring

We note that the TFDE could encourage a broader and more rapid response along the lines above by providing more certainty to enterprises of the consequences of undertaking those changes. Specifically, companies need

(November 2015) at 21 (stating that as a result of BEPS, it is no longer possible for “a cash-rich minimally functioning entity (a cash box) from earning the residual returns associated with development, enhancement, maintenance, protection, and exploitation of intangibles”).

⁹ Thomson Reuters, *2016 Global BEPS Readiness Survey Report*, (June 30, 2016) at 5.

¹⁰ EY, 2017 Tax Risk and Controversy Series, *Tax steps into the light*, (2017) at 12.

¹¹ Brett Weaver and Jerry Thompson, KPMG, *The BEPS Ripple Effect*, (2017) at 6.

¹² Coffey, *Review of Ireland’s Corporation Tax Code*, (June 30, 2017) para. 9.3.8.

¹³ *Id.*

¹⁴ *Id.* at para. 9.3.12.

¹⁵ Hosuk Lee-Makiyama and Bert Verschelde, *OECD BEPS: Reconciling Global Trade, Taxation Principles, and the Digital Economy*, ECIPE Occasional Paper No. 4/2014, (2014) at 3.

certainty that restructuring into a reseller will not be considered evidence that a prior structure was unduly aggressive, and that the tax consequences that companies anticipate from a restructuring will in fact follow.

To encourage more enterprises to conform to the expectations of governments, we respectfully recommend that the TFDE make the following points in its interim and final reports:

- (a) Establishing a reseller in the market jurisdiction is sufficient (but, as discussed above in Section C.1.a., not necessary) to address the tax challenges of the digital economy.
- (b) Converting a remote sales model into a local reseller structure should not be considered evidence that any prior structure was abusive.
- (c) Converting from a remote sales model to a local reseller structure eliminates any policy basis for special measures or unilateral measures.

To further reduce controversy in this area, the interim and final reports should confirm that a digital services reseller and a reseller of tangible goods are treated equally under MTC Art. 5, as revised by the BEPS Project. The reports should recommend that the Art. 5 Commentary be revised to reflect this clarification. There is no plausible policy or technical basis to distinguish sellers of digital goods and services from sellers of tangible property in this area.

3. Increase in VAT Collections

We support the OECD's conclusion that an extraterritorial VAT regime requiring remote suppliers to collect and remit VAT on business to individual consumer transactions ("B2C" transactions) is the appropriate tax to levy at the point of consumption with respect to remote sales of digital goods and services. The Action 1 Final Report has had substantial impact on this point. Since 2013 many jurisdictions worldwide have enacted or apparently intend to enact such legislation, including Albania, Australia, the Bahamas, Bahrain, Belarus, Colombia, Egypt, Ghana, India, Italy, Japan, Kenya, Korea, Kuwait, Oman, Qatar, New Zealand, Russia, Saudi Arabia, Serbia, South Africa, Sri Lanka, Taiwan, Thailand, Turkey, the United Arab Emirates and Uruguay.

We suggest that the Secretariat should estimate the amount of additional VAT which will be collected worldwide, once these changes have been fully implemented.

We note, however, that these new regimes have not been consistently implemented. Particularly, very short implementation timelines, multiple rates of GST, no/low registration thresholds, and lack of accessible online registration platforms have been problematic. We applaud the OECD's release of the International VAT/GST Guidelines earlier this year, and believe continued efforts to harmonize extraterritorial VAT regimes worldwide is in keeping with the OECD's mandate to ensure the fairness, consistency, and administrability of tax regimes. This will result in more efficient compliance by companies, and higher collections for tax administrations. We especially endorse as "best practice" those regimes which allow electronic filing, limit the frequency of filing obligations (quarterly vs. monthly), and do not require local currencies, local language, local agents, paper invoices, or a local bank account. From a policy perspective, there should be right to recovery for B2B and non-profit institutions (e.g., hospitals, universities).

The consistent implementation of extraterritorial VAT regimes for B2C sales in large part equalizes the indirect tax treatment of local compared to remote sellers. Some discontinuities remain, such as the absence of any such requirement on remote sellers into jurisdictions which have not yet adopted a VAT, such as the United States.

4. US Tax Reform

Finally, we expect that US international tax reform may remove some of the frictions that led to the BEPS Project. The Trump Administration and Republican leaders released a "Unified Framework" that will serve as the basis for

U.S. tax reform legislation.¹⁶ The Unified Framework includes two elements in particular relevant to this point. First, the Unified Framework calls for a mandatory tax on all accumulated earnings held by foreign subsidiaries of US multinationals. Accordingly, the US will be exercising its authority to tax those earnings as part of the US tax base.

Second, under this plan the US also will exercise its right to tax future earnings of non-US subsidiaries. The Unified Framework states:

To prevent companies from shifting profits to tax havens, the framework includes rules to protect the U.S. tax base by taxing at a reduced rate and on a global basis the foreign profits of U.S. multinational corporations. The committees will incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies.¹⁷

This would require a US parent company to pay a minimum tax on all profits earned outside the United States which are part of the US tax base, namely profits of those entities which constitute “controlled foreign corporations” under the US “subpart F” regime. This reform thus would be consistent with Action 3 calling for strengthening CFC rules. The minimum tax would end deferral for earnings covered by that tax. This would have obvious effects on structures which include IP asset owning entities located in very low tax jurisdictions.

During an October 3, 2017 Senate Finance Committee international tax reform hearing, there was discussion regarding how to prevent foreign businesses from stripping income out of the U.S. and eroding the U.S. tax base. Witnesses suggested proposals to impose an in-bound corporate minimum tax or a base protection surtax among other options.

D. Options

1. General Comments

Each of the options is a special measure, contradicting the OECD's own conclusion that it is not possible to ring fence the digital economy. Also, we note that for the purpose of the 2018 interim report, the TFDE mandate is to review how the BEPS Project reforms have influenced taxpayer behavior. We offer some observations below on the larger tax policy implications of these proposals.

For each option, we recommend that the Secretariat perform an in depth economic analysis of whether the particular option would stimulate or retard economic growth. Particularly with gross-based taxes and any SEP PE that attributes profits to the PE when the enterprise may be incurring losses, we are concerned that these taxes will have a negative impact on growth, employment, and economic development. The TFDE Secretariat is best positioned to undertake this analysis.

We note the proposal presented at the recent informal ECOFIN meeting in Tallinn for a temporary equalization levy in the EU. We strongly believe that the TFDE work should endeavor to develop a consensus position for a long term solution. We are skeptical that a “temporary” tax would remain temporary. Furthermore, we note that short-term solutions will create huge costs for tax administrations, as well as taxpayers, to establish their own compliance and review processes and systems. One of the principal strengths of the OECD as a standard setting organization is its long history of establishing policy based on a careful review of the economic environment and a measured deliberation appropriate to developing a global consensus. Thus, we believe that the OECD should continue to follow its mandate to achieve a global consensus by 2020.

¹⁶ The U.S. White House, *Unified Framework for Fixing Our Broken Tax Code*, (September 27, 2017).

¹⁷ *Id.* at 6.

Finally, we note that the RFI frames the options for discussion too narrowly. There is a fourth option, which is to recognize that the BEPS Project has had significant effect on the business models used by enterprises operating in the digitalized economy, and those business model and transfer pricing changes are all consistent with the intended effect of the BEPS Project reforms. Any comparison of the relative merits or demerits of the three stated options must be done with reference to the success of the BEPS Project in changing the baseline of the nexus, transfer pricing, transparency, and other elements of the post-BEPS international tax system which already has started to affect the allocation of taxation rights.

a. Treaty Framework

Discussion of these options should proceed as proposed amendments to the MTC. The significant economic presence test is a special PE rule for a certain sector or certain types of commercial transactions. As such, if it is pursued, it should be debated as a possible further revision to MTC Art. 5. The OECD in recent years has been open to discussions of revisions to the PE standard, including both the introduction of a services PE as an alternative PE standard in the Commentary as well as the Action 7 changes themselves.

The profit attribution element of the significant economic presence test should be discussed as a possible revision to Article 7.

The withholding tax proposal should be discussed as a possible change to Articles 5 and 12.

Any tax should be subject to effective double tax relief under Article 23 and MAP proceedings under Article 25.

The OECD has been consistent on this point. The TFDE Final Report expressly noted that any consideration of the three options must either be incorporated in the jurisdiction's treaties, or otherwise “respect treaty obligations”.¹⁸

This point is important to avoid an erosion of the integrity of the international tax treaty network. The OECD has provided a great service to global business over the years by establishing and maintaining global standards through the MTC for the taxation of cross-border transactions. It is hard to see how the OECD could fulfill its role as the leading standards setting organization for international taxation by endorsing measures which, if adopted by governments, would contravene those governments' treaty obligations. We fear that once the OECD acquiesces to a result where expediency justifies an override to treaty obligations, other cases will arise in the future when one or more jurisdictions will consider that another special measure to operate outside the treaty framework is appropriate.

Placing any new rule within the tax treaty framework also ensures that double taxation will be relieved by the residence state, either through exemption or the allowance of a foreign tax credit. Unilateral actions which operate outside the treaty framework can easily create double taxation.

b. Allocation of Tax Base

Further, we believe that all of these options should be discussed in the framework of the proper allocation, as a matter of policy, of a tax base between the countries of development/production and the countries of consumption. In all cases, a tax imposed on normal business profits of an enterprise by the country of consumption means that a portion of the tax base arising from that enterprise has been allocated to the country of consumption. As a necessary consequence, that same portion of the tax base needs to be removed from the country of development/production, through the various methods to relieve double taxation. The public discussion so far has focused on arguments why the country of consumption should have some part of the tax base allocated to it. The

¹⁸Action 1 Final Report, 148 (para. 383).

discussion needs to include an analysis as to why it is appropriate to allocate that portion of the tax base away from the state of development/production.

One proposal to allocate “meaningful income” to a significant economic presence PE would be to adopt some sort of formulary apportionment for whichever transactions are within the scope of this rule. That means, necessarily, that the jurisdiction of production needs to agree with the application of that formula to remove that designed amount of income from the tax base of the jurisdiction of production. It is important to look at these proposals from both sides in order to ascertain whether a proposal will avoid double taxation.

c. Possible Application in other Contexts

All of the options impose tax on normal business profits. Withholding tax is not normally imposed on normal business profits, and bespoke PE rules for ordinary commercial transactions are not common. If the OECD considers that these proposals are appropriate for highly digitalized enterprises, there is no reason to suggest that they are inappropriate generally, since the overall economy itself has become digitalized. Thus, a complete review of these questions needs to involve consideration whether similar policies might or should be adopted in other contexts. A conclusion that there is no policy basis to expand these concepts to other industries or sectors should cause speculation as to why one sector should be treated differently than others in the digitalized economy.

2. Significant Economic Presence Test

The RFI asks for comments on “[h]ow could meaningful income be attributed to the significant economic presence and how would such an approach interact with existing transfer pricing rules and profit attribution rules applicable to the traditional permanent establishment”. This question reflects the central policy issue to be decided, as it is not possible to attribute “meaningful income” to the PE under the arm's length principle in the circumstances posited. Accordingly, any profit attribution rule would be a special measure, applicable only to whatever transactions are subject to the SEP PE. As such, we suggest that the following considerations are important elements of the policy discussion.

The work under Action 7 demonstrated that good tax policy development requires that any discussion of changes to the nexus threshold must be accompanied by a simultaneous discussion of the profit attribution consequences of the new nexus threshold applying. We applaud the fact that the RFI includes questions on both the scope of transactions covered and the profit attribution results. We suggest that the TFDE cannot come to a conclusion on the possible parameters of a SEP PE without a thorough articulation of the special measure that will define the attributable profits.

Since it is not possible to allocate “meaningful income” to the SEP PE under the arm's length principle, any profit attribution result presumably will be based to some degree on formula apportionment principles. The debate on this option should be explicit on that point. As noted above, it is hard to see how the TFDE could endorse that foundation for profit attribution in the digitalized economy without agreeing that such an approach could be used more widely. In any event, the amount of net income attributable to such a deemed PE should be limited to the lowest amount of income which would be earned under the TPG in comparable circumstances by comparable sales entities with similarly limited functions, reflecting the absence of functions performed in the jurisdiction.

It is critical that any discussion of the SEP profit attribution possibilities also recognize the reality that in many cases losses will be attributed to the SEP PE. This will be the case in particular with emerging companies, as the intense competition to establish a market presence in the digitalized economy frequently means that growing enterprises generate losses for a substantial period before they become profitable (if ever). There is no principled reason to allocate start-up losses to the country in which entrepreneurs develop or produce, and then allocate profits to deemed PEs in market countries only once such companies become profitable.

Any comparison of the options needs to consider the details of how taxpayers will comply with the deemed PE rule and associated profit attribution. Since the SEP PE by definition can apply even if the group has no

substance in a jurisdiction, compliance obligations need to be simple. The compliance process must be digitally enabled, to allow for remote filing, rather than requiring taxpayers to build an expensive local infrastructure where the taxpayer has none.

Consideration should be given to simplified compliance obligations where any additional income or loss can be reported on the tax returns of a local affiliate.

In any event, high per country revenue thresholds would be essential to limit the application of any such rule to cases of “significant” economic presence.

Under the equity principle, any SEP direct tax nexus should apply to all companies that engage in remote sales, not just to an arbitrarily defined business segment or group of enterprises. The OECD has been clear that it is not possible to ring fence the digital economy. Similarly, to maintain equitable treatment with other enterprises, SEP nexus cannot apply to the extent local customer sales revenue is reported in a locally taxed entity. The SEP direct tax nexus also should not apply to a nonresident enterprise that has direct tax nexus under the newly revised MTC Article 5 if incorporated in the relevant treaty, i.e., an actual or deemed PE under Articles 5(1) and 5(5).

3. Withholding Tax

The tax policy detriments of a withholding tax on gross income are well known. A tax on ordinary business profits, imposed on gross revenue, has no relationship to net income. Such taxes impede economic growth, as they impose a cost on doing business which is not correlated with profit or ability to pay. Gross revenue has no relationship to net income, and therefore such taxes are not limited to taxing the gains of an enterprise, and will drive companies into deeper losses if they are not profitable. Thus, such a tax is likely to harm younger, growing companies, or alternatively, force the cost onto the consumer.

A tax on gross revenue will disproportionately harm small and medium size businesses, since many are not yet profitable or have slim margins. We suspect that the most severe impact will be on emerging digital economy companies, without regard to their home jurisdiction. This tax will act as a further barrier to entry for these companies, and will harm their ability to expand and compete with established companies in the international arena.

Any withholding tax imposed on a loss making company will tend to drive that company out of the market. Unless the tax rates are very low, these taxes create a significant barrier to conducting cross-border business for low margin and emerging enterprises. As a matter of principle, the rate would need to be low enough to result in tax not to exceed the income tax due on the profit levels corresponding to those at the lowest end of the range of LRD comparables in the jurisdiction. In effect, such a tax is a tariff creating a barrier to market access. Even if the taxes are notionally creditable, the taxes will represent a true cost to a company that is in a low margin or loss position and does not have sufficient taxable income and sufficient domestic tax liability to fully utilize the credits. For example, cloud infrastructure services margins are low due to the significant capital investment required and the increased marginal operating costs.

4. Equalization Levy

Like the withholding tax, the equalization levy is a tax on gross revenue without regard to profits. Accordingly, the above points apply equally to this option. We note that the RFI questions for these two options are identical, which emphasizes the similarity between the two taxes.

If the equalization levy is intended to be an excise tax, we note that such taxes imposed on import transactions act as tariffs, and thus may not be consistent with existing international trade commitments. Since such taxes do not take profitability into account, companies may pass the costs imposed by the tax on to customers to prevent resulting losses or erosion of margins.

5. Unilateral Measures

The RFI quite properly raises the issue of the specific impacts of the “unilateral and uncoordinated approaches” which have been enacted recently by a few jurisdictions, notably the UK, Australia and India. At the moment, it is still the case that only a few jurisdictions have enacted unilateral measures in the corporate tax area. This contrasts with the very large number of jurisdictions which have followed the 2015 Final Report guidance and enacted VAT collection obligations on cross-border B2C digital transactions.

The one element that unites those unilateral measures is that they are designed to operate outside of the jurisdiction's treaty network. Unilateral measures that purposefully aim to avoid treaties weaken the bilateral treaty network, erode tax certainty, virtually guarantee double taxation, and ultimately discourage cross-border trade.¹⁹ The TFDE should emphasize and reinforce the statement in the 2015 Final Report that any unilateral measures must respect the jurisdiction's treaty obligations.

The TFDE should also acknowledge that in the good faith application of treaties, taxes that conflict in substance with a treaty's obligations do not avoid that conflict through formalities such as nomenclature or placement within domestic legislation.

We further note that in the case of the UK and Australian legislation, those unilateral actions are not specific to the digitalized economy. Press reports indicate that many of the companies being assessed are not even among the “highly digitalized” companies.²⁰ Accordingly, those examples seem not to be suited as a model for narrowly addressing the digitalized economy.

We note that the TFDE's mandate includes an assessment of the effect of these unilateral measures on business models and on tax collections. Both the UK and Australian governments have made public statements about tax assessments under their respective regimes. We note, however, that those regimes came into force at the same time as the TPG were being revised through the work under Actions 8 - 10. We believe that the additional assessments which have been made under those regimes reflect in considerable part changes to transfer pricing policies to bring those policies into alignment with Actions 8 - 10, as opposed to the effect of the unilateral measure itself. We suggest that the Secretariat review these assessment figures with a view towards distinguishing between assessments which are consistent with the revised TPG and those which are due solely to the unilateral action.

We further note that the Secretariat should review actual tax collections figures, not just assessments in cases which have not yet been finally resolved.

E. Other Comments

We suggest that the Secretariat determine what current research is available that identifies those social, economic and tax policies which are most effective to support the emergence of new digitalized enterprises which seek to offer their goods and services across borders. This is part of the core mission of the OECD to support economic development across the world. Again, the work of the Horizontal Project may be useful here.

In particular, it is worth noting that cloud services provided by a number of digital economy enterprises provide world class computing and communications capability, at relatively low cost, to local start-ups and MNEs

¹⁹ Stephanie Soong Johnston, *Saint-Amans Warns Against Unilateral Moves to Tax Digital Economy*, Tax Notes: Worldwide Tax Daily (Sept. 18, 2017).

²⁰ BBC News, *Diageo told to pay £107m in extra tax in profits row*, BBC.com/news (May 10, 2017)(Diageo is a global beverages company that owns Smirnoff, among other brands); Joanna Mather and Fleur Anderson, *Rio Tinto hit with \$450m tax bill; multinational crackdown to raise \$3b*, Financial Review (April 6, 2017) (Rio Tinto is a major mining company).

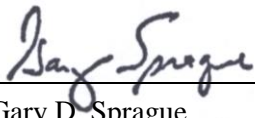
enabling them to compete effectively in the world markets. This creates a significant enabler for local economic growth.

Since the 2018 report will be only an interim report, caution must be exercised to ensure that the text of the interim report does not create an impression that the Task Force has reached a conclusion prior to completing the work necessary to prepare the final report to be issued in 2020.

* * *

Thank you again for the opportunity to provide these comments. We look forward to participating in the November 1 Consultation.

Yours sincerely,



Gary D. Sprague
Baker & McKenzie LLP
Palo Alto, California
+1 (650) 856-5510
Gary.Sprague@bakermckenzie.com



Carol A. Dunahoo
Baker & McKenzie LLP
Washington, D.C.
+ 1 (202) 452-7049
Carol.Dunahoo@bakermckenzie.com



Grace D. Meador
Baker & McKenzie LLP
San Francisco, California
+1 (415) 984-3898
Grace.Meador@bakermckenzie.com

Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age

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1. Introduction

This article examines the theory, history and operation of the question of “source of income” from the perspective of the taxation of intellectual property rights and of supplies of substantial intellectual content (“intellectual supplies”) under tax treaties and its implications and possible evolution in the e-commerce context and the digital age.¹ The article concludes that, although reform is presently premature, a new framework for taxing intellectual supplies will be required, and the article proposes a new framework for doing so.

2. Theory of Source Taxation of Intellectual Property

The conceptual frameworks of tax jurisdiction are central to comprehending the relative strength of the fiscal assertions made by states and the relationship between tax jurisdictions and tax treaties. The discussion below examines the key doctrines dealing with the assertion of taxing rights by a “source state” with respect to income derived from intellectual supplies to a resident of a pur-

chaser state by a resident of a “residence state” who has no presence in the purchaser state.²

2.1. Sovereignty doctrine

The sovereignty doctrine is based on the notion that sovereignty is the collection of rights and competences which make up a state. Jurisdiction is the right and competence of the state to affect the rights of persons through the exercise of judicial, legislative and administrative powers, which include the power to make and

* © Niv Tadmore, 2007. Partner, Clayton Utz Lawyers, Australia.

The author is also Senior Research Fellow, Taxation Law and Policy Research Institute, Monash University, Australia. The author wishes to thank Prof. Rick Krever of the Institute for his comments on an earlier draft. The views expressed in this article are those of the author and do not necessarily represent the views of Clayton Utz or the Taxation Law and Policy Research Institute, Monash University.

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The other articles based on papers presented at this seminar are:

Lang, Michael, “Article 19(2): The Complexity of the OECD Model Can Be Reduced”, in this issue of the *Bulletin*.

Rosenbloom, H. David, “US Source Rules: Building Blocks of Cross-Border Taxation”, and Andersson, Krister, “An Economist’s View on Source versus Residence Taxation – The Lisbon Objectives and Taxation in the European Union”, both in the October 2006 issue of the *Bulletin*;

Kemmeren, Eric C.C.M., “Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach”, and Halkyard, Andrew, “Source of Profits Rules in Hong Kong – Analysis of a ‘Troublingly Successful System’”, both in the November 2006 issue of the *Bulletin*; and

Easson, Alex, “Common Law Approaches to the Determination of the Source of Income: Pragmatism over Principle”, and Mössner, Manfred, “Source versus Residence – an EU Perspective”, in the December 2006 issue of the *Bulletin*.

The paper presented by Niv Tadmore at the seminar was based on his thesis entitled “*The Interaction Between Tax Treaties and E-Commerce Re-examined*”, submitted in July 2003 in fulfilment of the requirements for the degree of Doctor of Juridical Science, Deakin University, Melbourne, Australia. The author would like to thank Prof. Rick Krever for supervising his doctoral thesis.

1. In this article, the term “e-commerce” refers to transactions facilitated through or by the use of the Internet or similar media, and “e-commerce context” refers to e-commerce transactions where the seller and purchaser are not residents of the same tax jurisdiction and the seller has no physical presence or agents in the purchaser’s tax jurisdiction in connection with the transaction. E-commerce may also involve the disposal of property (e.g. falling under Art. 13(4) of the OECD Model Tax Convention), which is less common; this is not dealt with specifically in this article.

2. In this article, the term “source state” refers to the state where the purchaser resides and obtains the supply, and the term “residence state” refers to the state where the non-resident supplier resides and makes the supply. Thus, these terms may not necessarily overlap with the domestic or treaty rules on source and residence.

enforce laws, including tax laws.³ Since jurisdiction derives from sovereignty, jurisdiction can only extend as far as sovereignty exists.⁴ And since the power to make and enforce tax laws is a subset of jurisdiction, tax jurisdiction must also have limits:

...if jurisdiction is an attribute of sovereignty, then it is necessary so that the limits of fiscal jurisdiction are similar to those national sovereignty. Consequently, identifying the limits of sovereignty is tantamount to identifying the limits of every type of jurisdiction, including tax or fiscal jurisdiction.⁵

The scope of the state's fiscal jurisdiction depends on the aspect of sovereignty concerned. There are two aspects of sovereignty. National sovereignty applies to the citizens and residents of a state. National sovereignty allows the state to apply its jurisdiction, including the imposition of tax, to its citizens and residents wherever they might be.⁶ Territorial sovereignty, by contrast, is defined by reference to the geographical boundaries of a state, by reference to which the state can make fiscal assertions over non-residents: "The taxation of aliens must therefore depend upon the physical presence of the alien within the territory of the taxing state or upon the existence there of some property or interest belonging to him upon which the tax may be levied."⁷

The connecting factor of "some property or interest" may refer only to a legal nexus, not to a general economic or commercial nexus.⁸ Yet this may suffice to assert far-reaching fiscal claims. The state, through its national laws, is entitled to determine questions of the situs of rights and property.⁹ It can, for instance, determine that certain legal interests are located within its borders, thereby creating adequate fiscal links with non-residents. Accordingly, the state is entitled to assert fiscal claims over non-residents who have no presence in the state and who sell goods or services, including intellectual supplies, through the Internet to its residents, for example, by basing its fiscal claims on the situs of the rights supplied, the debt payable to the non-resident or, plainly, the payment itself.

2.2. Benefit doctrine

The core principle of the benefit doctrine is that a state has the right to tax those who derive income using the benefits it offers:

A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment Business is responsible for much of the work which occupies the courts, the police, the fire department, the army, and the navy The relationship between private business and the cost of government is a loose one, much like the relationship between the expenses of a railroad and the amount of traffic which it carries. The connection, however, is real, and, in the long run, the more business the greater will be certain fundamental costs to government ... business ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all beneficiaries of that market ... a market is a valuable asset to the social group which maintains it and communities ought to charge for the use of community assets.¹⁰

The question that arises in relation to non-residents is: What is sufficient to fiscally link a state with the non-resident? Traditionally, meaningful access to a market in

a state required a non-resident to have some degree of physical presence in the state, which in turn usually required the use of at least some public goods and services.¹¹ However, this does not preclude claims based on the use of other benefits that are independent of physical presence:

These advantages include laws establishing sound local banking institutions to support credit transactions; courts to ensure collection of the purchase price from the seller's customers; means of waste disposal from garbage generated by mail-order solicitations; and creation and enforcement of consumer protection laws, which protect buyers and sellers alike, the former by ensuring that they will have a ready means of protecting against fraud, and the latter by creating a climate of consumer confidence that inures to the benefit of reputable dealers in mail-order transactions.¹²

This line of reasoning is especially compelling when applied to e-commerce, where markets become more accessible and physical presence becomes less critical. Furthermore, a state in which revenue is sourced may invest heavily in telecommunications infrastructure which renders e-commerce possible. Most importantly perhaps, the source state provides protection for intellectual property rights. This protection does not depend on whether the vendor has a physical presence in the source state, but is nonetheless vital to dealings in intangibles, particularly intellectual supplies. It protects the value of the supplies. Without such protection, intellectual supplies may be copied, duplicated, reverse-engineered and manipulated to the extent that no real value

3. Jeffery, Ramon J., *The Impact of State Sovereignty on Global Trade and International Taxation* (Boston: Kluwer Law International, 1999), at 26; Martha, Rutsel Silvestre J., *The Jurisdiction to Tax in International Law* (Deventer, the Netherlands: Kluwer Law and Taxation, 1989), at 13-14.

4. Jeffery, supra note 3, at 26; Martha, supra note 3, at 13-14.

5. Martha, supra note 3, at 32.

6. Albrecht, A.R., "The Taxation of Aliens under International Law", 29 *The British Year Book of International Law* 145 (1952), at 158-159; Musgrave, Richard A. and Peggy B. Musgrave, "Inter-Nation Equity", in Bird, Richard M. and John G. Head (eds.), *Modern Fiscal Issues – Essays in Honour of Carl S. Shoup* (Canada: University of Toronto Press, 1972), at 63-85 and 1336-1337.

7. Albrecht, supra note 6, at 152.

8. Mann, F.A., *Studies in International Law* (Oxford: Clarendon Press, 1973), at 39; Albrecht, supra note 6, at 165-166.

9. See e.g. *Langer v. Packard*, 40 N.D. 182 (1918), at 197-198, per Christian-son J.

10. Adams, Thomas S., "The Taxation of Business", 11 *National Tax Association Proceedings* 185 (1917), at 187. A distinction may be made between "benefit" and "entitlement"; the former concentrates on the benefits arising from public goods and services, and the latter is more concerned with broader economic benefits (such as the economic environment for the production of income and the exploitation of a market in a state; see e.g. Musgrave, Peggy B., "Consumption Tax Proposals in the International Setting", in Kreyer, Richard (ed.), *Tax Conversations – A Guide to the Key Issues in the Tax Reform Debate – Essays in Honour of John G. Head* (London: Kluwer Law International, 1997), at 447, 449; Green, Robert A., "The Future of Source-Based Taxation of the Income of Multinational Enterprises", 79 *Cornell Law Review* 18 (1993), at 30; McLure, Jr., Charles E., "Taxation of Electronic Commerce in the European Union", paper presented to the OCFEB Conference, *Tax Policy in the European Union* (2000), at 4 (the paper adopted a unified approach of "benefit" and "entitlement" under the principles of the benefit doctrine).

11. See generally Skaar, Arvid A., *Permanent Establishment Erosion of a Tax Treaty Principle* (Deventer, the Netherlands: Kluwer Law and Taxation, 1991), at 111-152.

12. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), at 328, dissenting judgment by White J.

could be preserved, and thus no profits could be secured by the unshielded non-resident vendor.¹³

2.3. Economic allegiance doctrine

After the First World War, there was a growing concern that double taxation would harm the development of international trade and commerce. As a result, in 1921, the Financial Committee of the League of Nations invited four leading economists to prepare a report on double taxation ("League of Nations 1923 Report").¹⁴ One of the tasks assigned was to formulate, essentially for the first time, the "general principles as the basis for an international convention to remove the evil consequences of double taxation".¹⁵ The four economists focused on the concept of economic allegiance:

A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual's whole faculty should be taxed, but that it should be taxed only once, and that liability should be divided among the tax districts according to his relative interests in each.¹⁶

The economists outlined the following four questions by reference to which economic allegiance is to be determined:¹⁷

- Where is the yield physically or economically produced?
- Where are the final results of the process as a complete production of wealth actually to be found?
- Where can the rights to the handing over of these results be enforced?
- Where is the wealth spent, consumed or otherwise disposed of?

In its purest form, the economic allegiance doctrine would allocate tax revenue to each state that rightfully claims economic allegiance with a person. Nevertheless, the economists conceded that "income is such a composite product and such a complex conception that even theoretically it is not easy to assign in a quantitative sense proportions of allegiance of the different countries interested".¹⁸ They concluded that economic allegiance should be determined by reference to the first and the fourth questions, which essentially correspond to the concepts of source and residence.

The economic allegiance doctrine does not require physical presence in a state to sanction taxation. Production of wealth focuses on "the community the economic life of which makes possible the yield".¹⁹ The production of yield may have one physical location and another economic location. Moreover, the latter overrides the former: "Physical *situs* is one thing; origin or economic location is quite another thing; they do not necessarily coincide. *Physical situs is of importance in economic allegiance only to the extent that it reinforces economic location*" (emphasis added).²⁰

On this basis, the place of consumption – the market or the place of demand – can be an essential part of wealth production and can thus give rise to economic allegiance even if there is no physical presence: "The oranges upon the trees in California are not acquired wealth

until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them."²¹

According to the economic allegiance doctrine, a non-resident may owe significant economic allegiance to the residence state, but this does not in principle justify the exclusion of source taxation. The question is not about valid fiscal assertions, but rather about revenue allocation between the states which are entitled to assert. This logic applies to oranges and, likewise, to intellectual supplies through the Internet.

2.4. Realistic doctrine

The sovereignty doctrine suggests that without jurisdiction there is no power to tax. The realistic doctrine suggests the opposite, namely, that without the power to tax there is no jurisdiction. "No rules of international law exist to limit the extent of any country's tax jurisdiction,"²² and therefore a state's tax jurisdiction is effectively defined by reference to its enforcement competence:

In formulating the circumstances in which a state will tax when confronted with a foreign element the state is not concerned with the question whether or not it should exercise fiscal jurisdiction – it in fact assumes that. Operating from this premise it is concerned with exercising its jurisdiction in an effective manner.²³

The realistic doctrine has been fiercely criticized. It was argued that the doctrine ignores the important distinction between jurisdiction and power,²⁴ that it justifies taxes that are inconsistent with international norms,²⁵ and that it undermines international trade and cooperation.²⁶ However, there are stronger counter-arguments. The realistic doctrine does not ignore the distinction between jurisdiction and power – it equates them. More importantly, it is true that the doctrine, if strictly applied, can give rise to unfair, draconian and absurd results. But that can also and equally be said about all the other fiscal doctrines, which, as shown above, are flexible enough to

13. McLure, Jr., Charles E., "Source-Based Taxation and Alternatives to the Concept of Permanent Establishment", in *Taxes Without Borders* (2000), at 6 (paper presented to the First World Tax Conference convened by the Canadian Tax Foundation in Tampa Bay, Florida, 26 February-1 March 2000).

14. Profs. Bruins, Einaudi, Seligman and Sir Josiah Stamp, *Report on Double Taxation*, submitted to the Financial Committee, League of Nations, Economic and Financial Commission (Geneva, 1923).

15. *Id.*, Introduction.

16. *Id.* at 20.

17. *Id.* at 25.

18. *Id.* at 27.

19. *Id.* at 23.

20. *Id.* at 24-25.

21. *Id.* at 23.

22. Martin, Norr, "Jurisdiction to Tax and International Income", 17 *Tax Law Review* 431 (1962), at 431.

23. Qureshi, A.H., "The Freedom of a State to Legislate in Fiscal Matters under General International Law", 41 *Bulletin for International Fiscal Documentation* 1 (1987), at 14, 19.

24. Skaar, *supra* note 11, at 20.

25. Jeffery, *supra* note 3, at 43.

26. Skaar, *supra* note 11, at 21-22.

tax non-residents in an extremely broad range of circumstances.

Furthermore, the realistic doctrine, due to its very nature, connotes pragmatism and may best be understood on that basis. The world, according to the realistic doctrine, “is not one of total chaos or the complete antithesis of reason, but rather a competitive environment where state astuteness is the order”.²⁷ States do not exercise tax jurisdiction in a vacuum, and the ability to enforce or collect does not necessarily entail assertion, enactment or enforcement. States must coexist and exercise self-restraint, and thus must also place a limit on their tax jurisdiction.²⁸ Other theories may have more economic depth, but the realistic doctrine may best explain the actual dynamics of international taxation, as Sasseville observed:

While there can be endless discussions about what should constitute a sufficient link between an enterprise and a country for that country to have a legitimate claim to tax the profits of that enterprise, the truth is that tax authorities are probably more concerned about enforcing and collecting taxes with a minimal disruption of economic activities, than they are about what constitutes sufficient “economic allegiance”.²⁹

Given that states do not, in general, enforce each other’s fiscal assertions or judgements, under the realistic doctrine the taxation of non-residents (who have no physical presence or readily accessible assets in the taxing state) often relies on withholding tax. Withholding tax has been regarded as an effective enforcement method that enables the state to pursue assertions against non-residents by imposing intra-territorial measures:

The physical presence of taxpayers within the boundaries of the taxing authority is seen as increasing the probability of full satisfaction of their tax obligations since it is much easier to audit their accounts and enforce tax deficiencies against them. At the present time, however, this belief is of limited validity as the widespread use of withholding taxes imposed at the source on gross remittance, with liability imposed on the remitter for failure to withhold, has greatly diminished the importance of the taxpayer’s physical presence, especially where the withholding tax represents the sole or maximum tax imposed by the source country.³⁰

Since the realistic doctrine is based on actual competence to collect tax, source taxation of intellectual supplies may be qualified. As discussed below, whereas collection from local enterprises is not problematic, collection from end-users or consumers stretches the competence to withhold tax to its limits.

3. Intellectual Supplies and Tax Treaties – The Distinction Between Royalties and Business Profits

The historical analysis of the taxation of intellectual supplies indicated that the taxation of intellectual supplies has been concerned predominantly with intellectual property rights rather than intellectual content. The taxation of royalties is a direct derivative of the distinction between royalties and business profits, which has been shaped by historical processes and pragmatism more than coherent theory. Nevertheless, the distinction

is not without some theoretical foundations, although not necessarily compelling or convincing.

3.1. Broad historical context – income categorization

As mentioned above, the League of Nations 1923 Report was commissioned to address “the evil consequences of double taxation” (see 2.3.). The underlying question was: “Which Government should give up revenue, and to what extent?”³¹ The four economists explored four methods to answer that question:

(a) *Deduction for income from abroad.* The residence state deducts from the tax due by its residents any tax they paid in the source state. The four economists rejected this method on the basis that it would be unfair to the residence state in that it “throws the whole burden of increased taxation in debtor countries upon the creditor country”.³²

(b) *Exemption for income going abroad.* The source state gives up its right to tax non-residents. This method found more favour with the four economists. It reflected what governments were doing to attract foreign investment; it accorded with the economic interests of those who invested in the source state; and it did not require complex allocations of income. They thus concluded that this method was “the most desirable practical method of avoiding the evils of double taxation and should be adopted wherever countries feel in a position to do so”.³³

(c) *Division of the tax.* This method concerns the division of taxes between the states on a formula basis, so that a portion is allocated to the source state and the remainder to the residence state, which should give relief by reference to the definite amount levied in the source state. The economists noted the attractive simplicity of this method and asked whether this simplicity should override economic theory, thus whether they should “not attempt to get the exact elements of economic allegiance but to adopt a broad line and say that where double taxation of income is involved each country shall give up a flat or fixed proportion of the sum due to it”.³⁴ The economists rejected this method, however, because of the practicalities involved in actually applying it. They considered that different tax systems, different tax rates, different treatment of corporate income, administrative difficulties and limited access to information would render this method unworkable overall.

27. Qureshi, *supra* note 23, at 18.

28. Dale, Harvey P., “Withholding Tax on Payments to Foreign Persons”, 36 *Tax Law Review* 49 (1980), at 50; Norr, *supra* note 22, at 439.

29. Sasseville, Jacques, “The Future of the Treaty Rules for Taxing Business Profits”, in *Taxes Without Borders*, *supra* note 13, at 3.

30. Irish, Charles R., “International Double Taxation Agreements and Income Taxation at Source”, 23 *International & Comparative Law Quarterly* 292 (1974), at 296.

31. League of Nations 1923 Report, *supra* note 14, at 40.

32. *Id.* at 41.

33. *Id.* at 51.

34. *Id.* at 45.

(d) *Classification and assignment of income*. Income is classified into classes, and the two states allocate revenue on the basis of this classification. The four economists, who apparently favoured residence-based taxation, said unequivocally that, on pure economic allegiance grounds, this method “would be the soundest”.³⁵ However, they rejected this method because they considered that, in the real world, the classification of income and the resulting allocation of taxing rights would be fraught with difficulties. They concluded that the classification and assignment of income method is extremely limited and impractical because “simplicity only exists in a minority of cases involving income tax and that we soon get into the region of impracticability if we attempt to apply [this method] in precision”.³⁶

The work of the four economists was supposed to be the basis on which a group of nominated technical experts would draft a model tax treaty for the League of Nations. The technical experts produced their first report in 1925 (“League of Nations 1925 Report”).³⁷ They did not follow the recommendations, or the reasoning, of the four economists. Rather, the technical experts chose to draft a model treaty on the basis of the classification and assignment of income method. They proposed that personal taxes (income taxes) be allocated to the residence state and that impersonal taxes (*impôts réels*) be allocated to the source state. The technical experts openly said that their conclusion was made “for purely practical purposes and no inference in regard to economic theory or doctrine should be drawn from this fact”.³⁸

There were a few practical considerations. The first concerned collection and administration. It is easier for the source state to collect impersonal taxes than personal taxes because the collection of impersonal taxes does not involve the declaration by the taxpayer of total income. The second consideration related to the interests of the source state and the composition of the group of technical experts. One of most important background facts of the League of Nations process was that three of the four economists came from creditor nations, whereas most of the technical experts came from debtor nations. Naturally, in contrast to the economists who favoured exclusive residence taxation, the technical experts had a different take on source: “New countries which need foreign capital for their general development desire to have a share in the taxes levied on income arising in their territory.”³⁹

Third, the model that was recommended was based on precedent. It was commonly used in central European states before and after the First World War.⁴⁰ It was a familiar model. It did not mark any significant departure from the existing practice and norms. The technical experts, unlike the economists, did not seek novel solutions, but rather a solution that would be acceptable to the various members of the League of Nations. As Seligman noted: “When ... the technical experts came together, their concern was primarily to enter into some arrangement which would be politically agreeable to their respective governments.”⁴¹

The model suggested by the technical experts – impersonal taxation by the source state and personal taxation by the residence state – was incorporated into the first model treaty produced by the League of Nations, in 1927. Subsequent drafts, issued in 1928, did not distinguish between personal and impersonal taxes, but rather identified specific tax categories and allocated them (each draft on a different basis) to the source or residence state.⁴² The rest is indeed history. The classification and assignment of income method prevailed.⁴³ The work of the League of Nations continued to be based on this method. When the OECD picked up the development of model tax treaties from the League of Nations, it retained the method and based its models on it.⁴⁴ The method is now reflected in the OECD Model, the UN Model, the US Model, and tax treaties the world over.

3.2. Evolution of royalty taxation at source – the ongoing tension between source and residence

Royalties were initially not as important as other income categories. When the economists discussed intangible personal property and incorporeal movable category, they did not even mention royalties. They confined the discussion to real estate mortgages, corporate securities, government bonds and private credit, which were the “most important classes in this category”.⁴⁵ The early League of Nations drafts did not contain a specific royalty income category. In a 1928 draft, for instance, royalties were taxable by the residence state under the “other income” provision.⁴⁶

A royalty category subsequently appeared in the League of Nations 1931 draft, which provided that, in the absence of a permanent establishment (PE) in the source state, income from patent rights were taxable exclusively by the residence state.⁴⁷ In 1933, another League of Nations draft was produced, containing a separate category for royalties, which is similar to the modern definitions in that it captured the use of, or the right to use, intellectual property rights and even intellectual content:

35. *Id.*

36. *Id.*

37. League of Nations, *Double Taxation and Tax Evasion*, Report and Resolution submitted by the Technical Experts to the Financial Committee of the League of Nations (C.115.M.55.1925.II) (Geneva, 1925).

38. *Id.* at 15.

39. *Id.*

40. *Id.* at 12.

41. Seligman, Edwin R.A., *Double Taxation and International Fiscal Cooperation* (New York: Macmillan Company, 1928), at 143.

42. League of Nations, *Double Taxation and Tax Evasion Report*, presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, (C.562.M.178.1928.II) (Geneva, 1928) (“League of Nations 1928 Report”).

43. See the discussion in Avery Jones, John F., “Are Tax Treaties Necessary?”, 53 *Tax Law Review* 1 (1999), at 14-15; and Graetz, Michael J. and Michael M. O’Hear, “The ‘Original Intent’ of U.S. International Taxation”, 46 *Duke Law Journal* 1021 (1997), at 1082-1089.

44. Sasseville, *supra* note 29, at 3.

45. League of Nations 1923 Report, *supra* note 14, at 34.

46. League of Nations 1928 Report, *supra* note 42, Draft 1c, Art. 8.

47. Doernberg, Richard L. and Luc Hinneken, *Electronic Commerce and International Taxation* (The Hague: Kluwer Law International, 1999), at 16-17.

Rentals or royalties arising from leasing personal property or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using, patents, copyrights, secret processes and formulae, goodwill, trademarks, trade brands, franchises and other like property, provided the enterprise is not engaged in dealing in such property.⁴⁸

There is little information on the early development of royalty taxation under tax treaties, but this specific reference to royalty income seems to have followed the emergence of royalties as a stand-alone income category in tax treaties in the 1930s. This process lacked the relative uniformity that underpinned the development of the PE concept, although in many instances the residence state obtained exclusive taxing rights.⁴⁹

The interplay between source and residence in the particular context of royalties became a major issue in the subsequent work of the League of Nations. Following two conferences in Mexico, dominated by representatives of Latin American states, the League of Nations issued a new model treaty (Mexico Model) in 1943, which placed considerable emphasis on source taxation.⁵⁰ Art. X(2) of the Mexico Model provided: "Royalties and amounts received as a consideration for the right to use a patent, a secret process or formula, a trademark or other analogous right shall be taxable only in the state where such right is exploited."

In 1946, the Fiscal Committee of the League of Nations convened in London to review the Mexico Model and submitted a new model treaty (London Model). The Mexico Model's strong emphasis on source taxation was effectively reversed in the London Model. Art. X(2) of the London Model provided: "Royalties derived from one of the contracting states by an individual, corporation or other entity of the other contracting state for the right to use a patent, a secret process or formula, a trademark or other analogous right shall not be taxed in the former state."

The Fiscal Committee acknowledged that the provisions of the Mexico Model might appear more attractive to some states and that there was a divergence between the Mexico and London Models in relation to the royalty category, which "has always been in dispute".⁵¹

3.3. Current position and operation of the distinction

The dispute about the right to tax royalties has all but disappeared. The current operation of royalties as a category that divides and allocates taxing rights in a tax treaty is best understood by reference to the distinction between business profits and royalties. The term "business profits" typically refers to profits from commercial and industrial activities, e.g. the sale of goods. In the 2005 OECD Model Tax Convention on Income and on Capital, the term also includes profits from independent personal services.⁵² Under Arts. 7(1) and (3) of the OECD Model, the source state may only tax business profits that are attributable to a PE. A PE exists if one of two tests is met, i.e. the general "fixed place of business" test or the "dependent agent" test (OECD Model, Art. 5). In broad terms, the general test requires a fixed place of

business through which the business of an enterprise is wholly or partly carried on, and the agency test requires a person in the source state who is the long arm of the non-resident. When business profits are subject to source taxation, they are taxed on a net basis, allowing deductions to be taken into account.

The term "royalties" is defined in Art. 12(2) of the OECD Model as follows:

The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

The OECD Model provides that if the non-resident has no PE in the source state, royalty payments are not subject to source withholding tax.⁵³ However, this has not been extensively accepted, even by the OECD countries, and tax treaties in general allow a royalty withholding tax to be levied on a gross and final basis.⁵⁴ The residence state is responsible for preventing double taxation, usually by way of a credit (no greater than the amount of tax imposed at source). In practice, therefore, the real compromise concerns the rate of the royalty withholding tax, not the waiver of the right to tax.⁵⁵

48. Art. 2(d), League of Nations, Fiscal Committee, *Report to the Council for the Allocation of Business Income Between States for the Purpose of Taxation* (League of Nations Document C.399.M204.1933.II.A.), as cited and quoted in Wang, Ke Chin, "International Double Taxation of Income: Relief Through International Agreements," 59 *Harvard Law Review* 73 (1945), at 59-60.

49. See e.g. Art. IX, United States, France, 1932 Income Tax Convention and Final Protocol, 94 *Tax Notes International* 252-115, Doc. 94-30567; Art. 13(2), Denmark, Sweden, 1932 Direct Taxes Convention and Final Protocol, 94 *Tax Notes International* 252-51, Doc. 94-30500; Art. 6, Hungary, Netherlands, 1938 Direct Taxes Agreement and Final Protocol, 94 *Tax Notes International* 252-168, Doc. 95-30020.

50. Wang, supra note 48, at 96; Skaar, supra note 11, at 88-89.

51. League of Nations, Fiscal Committee: *Report on the Work of the Tenth Session of the Committee* (C.37.M.37.1946.II.A.), at 8, as quoted in United Nations, *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* (New York: United Nations, 1980), Part One, Chap. I, under B.4. See also United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2001), Commentary, Introduction, Para. 25.

52. Income from professional services or other activities of an independent character is now dealt with in Art. 7 on the basis that there are no intended differences between the PE concept and the fixed base concept in old Art. 14.

53. Art. 12(1). If the property or right which is the subject matter of the royalties is "effectively connected" with a PE in the source state, Art. 7 will apply (Art. 12(3)).

54. No fewer than 12 OECD countries have entered a reservation on the zero royalty withholding tax in the OECD Model (see the 2005 Commentary on Art. 12). The Non-Member Countries' Positions on the OECD Model Tax Convention sets out the positions of 17 non-OECD countries on the OECD Model and Commentaries. With respect to Art. 12, all 17 non-OECD countries reserved the right to tax royalties at source (see Paras. 3-4). The UN Model allows the source state to impose a royalty withholding tax (Art. 12(2)). The 1996 US Model, which does not provide for a royalty withholding tax, is a notable exception (Art. 12(1)).

55. The UN Commentary (Para. 9) on Art. 12 refers to the factors influencing the withholding tax rate and tax revenue, which include the flow of royalties between the states, foreign exchange rates, the extent of assistance provided by the developed state to the developing state, lessening tax evasion, encouraging the flow of technology between the states, and of course the relative relevance of the royalty issue in the context of the treaty. See also Avery Jones, supra note 43, at 3.

3.4. Conceptual examination of the distinction

The distinction between business profits and royalties is not, in principle, supported by the sovereignty and realistic doctrines. The sovereignty doctrine focuses on the existence of legal property or legal interest within a state's boundaries. This has little to do with the category of the income concerned. Rather, the sovereignty doctrine would have to deal with the particular difficulties associated with the situs of such interest or property. As long as the source state has jurisdiction over rights, debts or payments, it can assert fiscal jurisdiction. Income categorization is also irrelevant to the realistic doctrine. The ability or inability of a state to compel its resident to withhold tax on behalf of a non-resident is indifferent to the category of the income concerned. Withholding tax, with the notable challenges it raises in the private consumer market, vests fiscal jurisdiction.

On the other hand, the benefit and economic allegiance doctrines directly support income categorization. The rationale adopted by the OECD in disallowing source taxation of royalties assumes that the totality of the royalty payment has a much stronger connection with the residence state. This rationale is stated in the OECD Software Report:

Taxation on a gross basis occurs only in the absence of a PE; if a royalty is effectively connected with a PE, the effect of Article 7 together with paragraph 3 of Article 12 is to ensure taxation on a net basis. Paradoxically the less the connection of the payee with the state of source, the greater his tax burden there.⁵⁶

As to the PE concept, Para. 3 of the Commentary on Art. 7 provides:

... it has come to be accepted in international fiscal matters that until an enterprise of one state sets up a permanent establishment in another state it should not properly be regarded as participating in the economic life of that other state to such an extent that it comes within the jurisdiction of that other state's taxing rights.

The OECD's position on the PE concept is sound and obvious. Under all conceptual bases, a nexus that is based on immovable property, such as land or a fixed place of business situated in a state, is very strong. Under the realistic doctrine, immovable property provides the state with sound enforcement and collection abilities as the property can be readily accessed, attached and seized. As regards the sovereignty doctrine, immovable property unquestionably falls within the state's territorial sovereignty; a threshold based on immovable property provides certainty in that it avoids questions on the situs of other types of property. The benefit doctrine would also favour a compromise based on physical presence as such presence entails a sufficient level of use of public goods and services. Under the economic allegiance doctrine, in the case of business enterprises that depend directly on land, the source state is the place generating the stronger claim of economic allegiance.⁵⁷

The OECD's rationale for not allowing source taxation of royalties is not necessarily correct. A royalty payment can be divided into three types of compensation: (a) for the reduction in value of the underlying property caused

by the granting of the right to use, and the use of, that property; (b) for maintaining the underlying property and, in most cases of periodic payments, bearing the risk throughout the period of the grant; and (c) for a return on the licensed capital. The first and second types of compensation have their economic source in the residence state (where the acquisition or creation of the underlying property and its ongoing development take place), whereas the third type of compensation has its economic source in the source state (where the licensee uses the property):

The services and protections provided by the government of the country in which the licensee uses the property are quite obviously more important for this income than are the services and protections provided to the licensor by the country of his residence, the country in which the license is made or any other country that may be touched by the license transaction. Intellectual property derives its value from the right of the owner to exclude others from using it. The income from a particular use therefore is, at least to some extent, a product of the laws that provide the right to exclude others from using the property at that place and time. The laws and legal system at the place of use constitute, in sum, the governmental services and protections of greatest consequence for royalty income.⁵⁸

Thus, both the residence and source states may have a strong claim to tax royalties under the economic allegiance and benefit doctrines. In a perfect world, the taxing rights should be divided in accordance with the respective strengths of the fiscal claims made by the states. But this is not a perfect world, and such a division is obviously impossible. As a result, a "rough and ready" approach may be warranted, which is precisely the function fulfilled by gross taxation in the form of a royalty withholding tax.

The requirement to have a threshold for source taxation of business profits, but not for royalties, may be understood against that background. In the context of a mere sale of goods without a PE, the fiscal claims of the residence state are typically much stronger than those of the source state, which could merely assert fiscal rights on the basis of market demand. On the other hand, royalties give rise to powerful source claims. The source state protects the intellectual supply and preserves its value. The source state's claims over the non-resident are too substantial to be superseded by the residence state's claims. Accordingly, the source state's ability to tax business profits in the e-commerce context should not depend on the existence of a PE.

3.5. A passive/active income rationale for the distinction?

It has been argued that, broadly speaking, tax treaties seek to allocate active income to the source state and

56. OECD, *The Tax Treatment of Software* (Paris: OECD, 2000), Para. 40(c).

57. League of Nations 1923 Report, *supra* note 14, at 29.

58. Lokken, Lawrence, "The Sources of Income from International Uses and Dispositions of Intellectual Property", 36 *Tax Law Review* 235 (1981), at 241-244. See also UN Commentary on Art. 12, Paras. 6-8; and Vogel, Klaus, "Worldwide vs. source taxation of income – A review and re-evaluation of arguments" (in three parts), *Intertax* 216 (Part I), 310 (Part II) and 393 (Part III) (1998), Part II at 318.

passive income to the residence state.⁵⁹ Central to the distinction between active and passive income is an (unverified) assertion that generally passive income is primarily derived directly by individuals or closely-held entities and that active income is primarily derived by large corporations.⁶⁰ The distinction between active and passive income is, by and large, based on the considerations concerning the type of taxpayer, that is, whether the taxpayer is an individual or a corporation.

Residence-based taxation of individuals is justifiable for a number of reasons.⁶¹ First, the residence of individuals can be readily ascertained. Second, since most individuals are part of only one society, distributional concerns can be addressed most effectively by the residence state. Third, residence often overlaps with political allegiance and, in democratic jurisdictions, residence-based taxation is a proxy for taxation with representation. The taxation of corporations, on the other hand, gives rise to considerations warranting taxation at source. First, the fiscal connections, especially under the benefit doctrine, warrant taxation by the source state if the non-resident meets a threshold indicating a critical level of use of local benefits when deriving active income there. Second, the residence of corporations is a rather artificial concept which lends itself to manipulation. Third, the relationship between a corporation and its place of residence does not necessarily accord with the relationship between an individual and his or her residence state.

Another layer of considerations distinguishing between passive and active income concerns the theories of capital-export neutrality (CEN) and capital-import neutrality (CIN).⁶² In brief, under CEN, worldwide efficiency in the allocation of resources would be achieved if taxes do not affect the decision of where to invest. This goal can be achieved if a resident of any nation pays the same marginal tax rate no matter where the investment is made. CEN, therefore, focuses on residence taxation. But since, in theory, it does not matter which state collects the tax, CEN can also be achieved if the residence state grants a credit (in theory, a full credit) for the tax collected by the source state. CIN, on the other hand, focuses on neutrality in the state where the investment is made. Competitiveness in that state requires that all investments be subject to the same marginal tax rate regardless of the investor's place of residence. According to CIN, therefore, the income of a non-resident is to be taxed at source and preferably be exempt from tax in the residence state.

The taxation of passive investment, especially portfolio investment income derived by individuals, better accords with CEN.⁶³ If a foreign equity or debt market offers an investor a better return than the domestic market, the investor should invest accordingly since foreign taxation should not affect the ability to access the higher foreign return. By contrast, the taxation of active and direct investments by corporations better accords with CIN.⁶⁴ Whereas investors can readily shift portfolio investments across jurisdictions based on the returns offered, it is often not efficient or practical to shift direct

investments, which often require time to produce returns. The ability to compete in the state in which the direct investment is made is therefore important.⁶⁵

It seems, however, that the rationalization for the general distinction between active and passive income may apply to passive income that derives from debt or equity investment, but not in a framework in which the passive income consists of royalties. The factual assertion that most passive investment is derived by individuals does not extend to royalties.⁶⁶ Thus, the set of factors that distinguishes residence/individual taxation and source/corporate taxation is simply inapplicable to royalties. Likewise, the CIN/CEN arguments supporting that distinction lose force when applied to royalties (as distinct from portfolio investment income). Royalties are based on contractual arrangements specifying duration and other terms and conditions which render income derivation a completely different exercise in terms of commitment, mobility, maintenance and ongoing performance of obligations. Thus, the active income/passive income rationale does not appear to be a sound theoretical basis to justify the distinction between royalties and business profits.

4. Intellectual Supplies in the Digital Age – Operation of Existing Rules

The advent of e-commerce and the Internet has had a dramatic impact on intellectual supplies. The impact has been driven by a number of factors. First, intellectual content can now be readily digitized. Thus, intellectual content can be efficiently, rapidly and effectively transferred over the Internet and then stored, copied or otherwise processed or manipulated. Second, e-commerce enables enterprises to adopt business models that do not rely on intermediaries, but rather focus on the direct provision of intellectual supplies. Third, the basic ingredients of e-commerce – speed, bandwidth, software, hardware and applications – have started to achieve appropriate and workable levels. Consequently, access to the Internet, and thus to e-commerce, is increasing rapidly. Fourth, enterprises that make intellectual supplies require little infrastructure. They do not have to operate from their “original jurisdiction” and can easily shift

59. Avi-Yonah, Reuven S., “The Structure of International Taxation: A Proposal for Simplification”, 74 *Texas Law Review* 1301 (1996), at 1307; Graetz, Michael J., “Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies”, 54 *Tax Law Review* 261 (2001), at 262.

60. Avi-Yonah, Reuven S. “International Taxation of Electronic Commerce”, 52 *Tax Law Review* 507 (1997), at 519.

61. *Id.* at 519-520.

62. For further discussion of these theories, see Musgrave and Musgrave, *supra* note 6; Graetz, *supra* note 59; Vogel, *supra* note 58; and Frisch, Daniel J., “The Economics of International Tax Policy: Some Old and New Approaches”, 47 *Tax Notes* 581 (1990).

63. Avi-Yonah, *supra* note 59, at 1312-1313.

64. *Id.* at 1314-1315.

65. Vogel, *supra* note 58, Part II at 314-315; Frisch, *supra* note 62, at 588-589.

66. It is based on information pertaining to investments made by individuals in debt or equity markets (and not on developing intellectual property and granting licences); see Avi-Yonah, *supra* note 59, at 1309-1310; and Frisch, *supra* note 62, at 587.

their operations to locations that offer a more favourable environment, including low-tax jurisdictions.

4.1. Application of existing rules

In 1998, the OECD embarked on a comprehensive review and examination of various issues concerning the interaction between taxation and electronic commerce.⁶⁷ The first part of the OECD's review concerned the application of the existing rules to e-commerce rather than the broader tax policies and objectives. The second part concerned policy issues (see "OECD Final Report" below).

As part of its review of the application of the existing rules, the OECD examined two key questions. The first was whether a web site can, without more, give rise to a PE, and thus enable a source state to tax the business profits attributable to the web site.⁶⁸ The second concerned the categorization of payments arising from e-commerce transactions and, more specifically, whether a particular payment is a royalty or business profit.⁶⁹ The conclusions are now incorporated into the Commentaries on Arts. 5 and 12 of the OECD Model and, in December 2005, the OECD Technical Advisory Group issued a report entitled "*Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? Final Report*" ("OECD Final Report").

As to the PE question, the OECD concluded that, under the existing rules, a web site cannot, without more, be a PE. First, the general PE definition cannot be satisfied because a web site cannot be "a fixed place of business".⁷⁰ Second, a web site cannot satisfy the dependent agent test since, no matter how sophisticated and "intelligent" the technology involved might be, a web site is not a person.⁷¹

As to income characterization, various sub-distinctions were considered. In the e-commerce context, one of the most important is the sub-distinction between business profits and royalties which are payments for the use of, or the right to use, a copyright. The OECD's position is that, since e-commerce almost inevitably involves the use of a copyright, the focus should be on the essence of the transaction:

Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".⁷²

A distinction is also made between private use and commercial exploitation of a copyright:

This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that cus-

tomers own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties.⁷³

Another sub-distinction is between payments for services and the provision of know-how. The distinction, it is suggested, can be made by reference to a number of guidelines.⁷⁴ First, contracts for the supply of know-how concern information which already exists or which has already been developed or created and contain provisions dealing with the confidentiality of such information. Second, under contracts for the provision of services, the supplier undertakes to perform services which may require the supplier to use special knowledge, skill and expertise, but not to transfer know-how. Third, most contracts for the supply of know-how do not impose on the supplier additional substantial obligations subsequent to the supply. By contrast, under most contracts for the performance of services, the supplier is required to incur considerable expenses during the term of the supply. A similar approach may be used to distinguish between the provision of services and payments for assets.⁷⁵ In general, a transaction will involve the provision of services if, after the transaction, the customer owns the property, but the property was not acquired from the provider.

4.2. Revenue reallocation

About 60 years after the Mexico and London Models, the dispute between source and resident states has assumed a new dimension, and has intensified, due to the advent of e-commerce. When the OECD embarked on the review of e-commerce, one of the core objectives was to ensure a fair revenue allocation. The OECD Ottawa Report (Para. 6) stated:

Any arrangements for the application of these principles to e-commerce adopted domestically and any adaptation of existing international taxation principles should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from e-commerce between countries and to avoid double taxation and unintentional non-taxation.

67. See *A Borderless World: Realising the Potential of Electronic Commerce* ("OECD Ottawa Report"), Final Report, at 3-4 (report by the OECD Committee on Fiscal Affairs, as presented to the Ministers at the OECD Ministerial Conference in Ottawa on 8 October 1998).

68. OECD Committee on Fiscal Affairs, *Clarification of the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5* (22 December 2000).

69. OECD Technical Advisory Group on Treaty Characterisation of Electronic Commerce Payments, *Tax Treaty Characterisation Issues Arising from E-Commerce – Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs* (1 February 2001) ("OECD Characterisation Report").

70. Commentary on Art. 5 of the OECD Model, Para. 42.2.

71. Id., Para. 42.10.

72. Commentary on Art. 12 of the OECD Model, Para. 17.2.

73. Id., Para. 17.3-17.4.

74. Id., Para. 11.3.

75. See the detailed discussion in the OECD Characterisation Report, *supra* note 69, Paras. 32-35.

But the overall effect of the OECD's conclusions on the PE and income characterization issues operate in favour of the residence state.⁷⁶ Business profits would typically be untaxed by the source state because the vendor has no PE there, and payments which may technically give rise to royalties (typically subject to withholding tax) may now be categorized as business profits and thus escape source taxation. Where the OECD Model is fully adopted and royalties are not taxed at source at all, e-commerce income would almost exclusively be taxed by the residence state.

In response to revenue reallocation concerns, the OECD Final Report noted that it is premature to revolutionize tax treaties merely on the basis of a potential revenue reallocation:

Depending on where the disappearing functions were previously performed, a country's tax base could either benefit or lose from these changes. More likely than not, each country's tax base will gain and lose to some extent and it is impossible, at this time, to predict what will be the net effect for any given country. (Para. 118)

Unsurprisingly, there does not appear to be any evidence yet of a significant reduction of the direct tax revenues of a country that could be attributed to e-commerce. The TAG agreed that it would not be advisable to suggest any tax policy change on the basis of perceived losses of tax revenues that have not been established but it also agreed that there was a need to monitor the evolution of the impact of e-commerce on tax revenues. (Para. 112)

Other comments in the OECD Final Report, however, seem to mark a departure from the emphasis in the OECD Ottawa Report on achieving a fair sharing of the tax base:

No member of the TAG argued that tax rules should be modified to shield countries from the effect of technological developments on their tax base. Countries do not have a right to a particular level of tax revenues regardless of where business profits originate. (Para. 118)

The question was asked, however, whether or not maintaining a balance in the sharing of the tax revenues should be a general principle that the rules should promote. This, however, raises issues of international politics rather than tax policy which the TAG did not consider. (Para. 30)

Such comments are somewhat surprising. At the end of the day, a tax treaty is a bargain, a deal between two states on the allocation of revenue from the trade and commerce between them. If a significant post-deal phenomenon, such as the advent of e-commerce, operates to materially realign revenue allocation, the loser state is unlikely to agree that the deal should simply continue. If the loser state thinks that it is being denied its fair share of tax revenue, it may resort to unilateral action.⁷⁷ Unilateral action may result in double taxation of e-commerce; it may be uncoordinated and non-uniform; it may develop into a range of incompatible systems varying in form and substance; and, like other tax measures, it may be difficult to change or uproot. It is likely that if unilateral measures are adopted, further disorder will follow, as residence states are likely to take their own unilateral action, for example, refuse to grant relief.⁷⁸

The possibility of unilateral measures was also contemplated in the OECD Final Report (Paras. 107-108):

In the absence of a consensus with respect to the appropriate rules for taxing business profits, it is therefore certainly possible that some countries could decide to adopt unilateral solutions and hope that, with time, these become the new international norm. Whilst these countries may consider that this is the only way to adapt the international norms to changing circumstances, this would certainly increase the risks of double taxation and non-taxation as well as compliance burdens These countries may feel, however, that such risks are the price to pay to change rules that they consider inadequate.

Although significant revenue reallocation has yet to be seen, little will be achieved by disregarding the evolution of the commercial and global conditions under which tax treaties will operate in the future. The revenue allocation – the basic bargain on which treaties are concluded and operate – is not a mere political issue, but rather a treaty policy issue. A reform process that disregards revenue reallocation is likely to be inherently inadequate. If, as a result, tax treaties do not deal effectively with e-commerce, the growth of e-commerce will increase the occurrence of unilateral measures and correspondingly decrease the relevance of tax treaties to international trade.

4.3. Application of existing rules – evaluation of policy objectives

The OECD Final Report set out a number of evaluation criteria that it applies in examining alternatives to the existing rules, but it does not apply the criteria to the default option, that is, maintaining the existing rules in respect of royalties and business profits. Therefore, it is useful to evaluate the OECD Final Report's own recommendations – the default option – on the basis of the relevant evaluation criteria in the Report as well as other considerations. This evaluation is provided below.

(a) *Certainty and simplicity.* Tax rules should be clear and simple to understand, but the existing rules have not been designed to deal with e-commerce. Thus, their application can result in inconsistency and uncertainty:

The substitution of digital products for the more traditional physical products has led to new markets and new ways of providing access to those products Payments for these digital products are likely to differ both as to amount and as to character for tax purposes. In particular, the line traditionally drawn between royalties and payments for goods and/or services is likely to become increasingly blurred.⁷⁹

These concerns have not been eliminated by the OECD's proposed interpretation of the existing rules.⁸⁰ Identify-

76. Li, Jinyan, *International Taxation in the Age of E-Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003), at 444.

77. Forst, David L., "Old and New Issues in the Taxation of Electronic Commerce", 14 *Berkeley Tech. Law Journal* 711 (1999), at 715.

78. See e.g. the discussion in id.; Cockfield, Arthur J., "Balancing National Interests in the Taxation of Electronic Commerce Business Profits", 74 *Tulane Law Review* 133 (1999); and McLure, supra note 13.

79. Australian Taxation Office, *Tax and the Internet: Second Report* (Canberra: Australian Government Publishing Services, 1999), Paras. 5.4.3-5.4.6.

80. Tadmore, N., "Further Discussion on Income Characterization", 52 *Canadian Tax Journal* 124 (2004).

ing the essence of a payment is not always a straightforward task, and tests based on the balancing of a complicated set of factors, contractual and legal concepts and judgement calls can result in incoherence, uncertainty and inconsistency. Indeed, although the OECD Final Report observed that the OECD Categorisation Report presents “reasonable results”, it conceded (Para. 285) that:

Income characterization has long been a complicated issue, and tax authorities have struggled for decades to distinguish sales from royalties, sales from services and services from royalties. Similar questions have arisen recently in the context of software and e-commerce transactions.

Moreover, the uncertainty surrounding the OECD’s interpretation of the existing rules is fuelled by the simple fact that tax authorities, taxpayers and tax advisers may attach different weight to various criteria and considerations and that intellectual property laws differ among states. For example, an Indian committee on e-commerce took a view different to that of the OECD Characterisation Report in relation to 13 of the 28 relatively simple categorization examples discussed in the Report.⁸¹ Some states do not adhere to the OECD Commentary on software, on which the OECD’s position on characterization is based, and argue that any software purchase produces royalty income or that royalty income arises when less than all of the rights to software are transferred.⁸²

(b) *Efficiency*. The flip side of certainty and simplicity is efficiency. High degrees of uncertainty and complexity will result in high compliance and administrative costs and increase the risk of disagreements and disputes.

(c) *Flexibility*. Tax rules should be flexible and dynamic to ensure that they keep pace with technological and commercial developments. However, technologies, business models, transactional structures and market behaviour will continue to evolve. The OECD’s position on income categorization thus has a limited lifespan because it is based on the business models and technologies which may be outdated in the near to medium term. Preserving the existing rules will require ongoing adjustments, which may result in inconsistency, uncertainty and unfairness.

(d) *Neutrality*. The distinction between private and business consumers and the exclusion of the mass private consumer market from source taxation are likely to undermine neutrality. The tax treatment of intellectual supplies may be determined by reference to an industry (e.g. business consultancy or entertainment) or a product (e.g. accounting software or gaming software). Interestingly, in its criticism of one of the reform proposals (the base-erosion approach), the OECD Final Report (Para. 263) expressed similar concerns in relation to the consumer market: “This would mean that business-to-consumers e-commerce would not be affected by the proposed rule, which would constitute a serious disadvantage.”

(e) *Effectiveness and enforcement*. Tax rules should minimize tax avoidance and tax evasion. Indeed, the prevention of tax evasion is a core treaty objective. However, as

the application of the existing rules can result in uncertainty and complexity, there is a risk that the scope of tax planning opportunities will be broadened. Moreover, e-commerce creates a whole new spectrum of opportunities to structure the flow of profits through low-tax jurisdictions. An obvious scenario is the relocation of operations to low-tax jurisdictions. A pro-residence state system can backfire on some of the OECD’s core policy objectives. For example, residence taxation may be effectively deferred permanently if the attribution rules of the “ultimate” residence state do not apply to active e-commerce income or if the “ultimate” residence state has no attribution rules at all. Alternatively, residence taxation may be simply avoided.⁸³

(f) *International acceptance*. In addition to the “uncertainty” aspect of the existing rules, which may lead different observers to reach different conclusions, and the unacceptance of the OECD’s interpretation solutions by some states, a major barrier to the retention of a broadly accepted international norm is that the interpretation and application of the existing rules are likely to benefit residence states. This may induce states to adopt unilateral measures, which will further undermine the objective of achieving a broad international acceptance. Although the OECD’s current approach to income characterization favours residence taxation, market forces will eventually dictate what is acceptable and what is tolerable. The OECD Model’s zero royalty withholding tax rate, which has been subject to broad international disapproval, is an example in point. The OECD’s next significant failure to set or reflect international norms and market forces may well be the OECD’s approach to income characterization in the digital age.

5. Towards a Coherent Framework for the Taxation of Intellectual Supplies in Tax Treaties

The above discussion indicates that preserving the existing rules – the distinction between royalties and business profits – in the e-commerce context is far from optimal. The appropriateness of the existing rules will continue to be eroded. E-commerce is developing rapidly. Only 15 years ago, e-commerce was just a novel and limited phenomenon. In a few more years, today’s e-commerce and technological abilities may be viewed as embryonic and primitive versions of whatever will have been created and developed by then.

81. Indian Ministry of Finance, High Powered Committee on E-Commerce and Taxation, *Report to the Indian Government on E-Commerce and Taxation* (July 2001), at 96-145. However, a recent Indian decision seems to support one of the OECD’s conclusions; see Sanjay, S., “Indian Tribunal Holds Subscription Fees Paid to Nonresident not Taxable”, 37 *Tax Notes International* 449 (February 2005).

82. Commentary on Art. 12 of the OECD Model, Paras. 27-31; Sheppard, L., “Revenge of the Source Countries, Part 2, Royalties”, 40 *Tax Notes International* 7 (2005), at 10.

83. Li, Jinyan, “Rethinking Canada’s Source Rules in the Age of Electronic Commerce” (in two parts), 47 *Canadian Tax Journal* 1077 and 1411 (1999), at 1457.

The OECD Final Report (Chapter 4) evaluated a number of reform alternatives with respect to business profits, some of which would be a fundamental modification of the existing rules and some that would not. The essential conclusion is that, while one or two non-fundamental alternatives that may render the interpretation of the existing rules clearer should be further considered, e-commerce has not evolved to a stage justifying “a dramatic departure from the current rules.”⁸⁴ It appears that this conclusion is correct at the present time. Moreover, ill-considered and ill-informed reform processes are likely to cause more harm than good. However, given the time it takes to implement international tax reforms and the processes involved,⁸⁵ it is certainly important to consider now the way ahead. And the way ahead is likely to have at least one large milestone that will affect international taxation. It will appear when e-commerce evolves to a stage where it brings about the loss of a “critical mass” of source-state revenue. Thus, there is a need and a case for starting to outline a framework for reform and, in particular, a framework for the reform of the taxation of intellectual supplies in tax treaties.

5.1. Framework outlined

The new framework for taxing intellectual supplies may be based on an addition to the definition of royalty that will capture digital intellectual supplies and subject them to source taxation, imposed by way of a low-rate withholding tax.⁸⁶ The tax withheld will not be a final tax. The non-resident will be entitled to lodge tax returns and be taxed on a net basis.⁸⁷ The non-resident will be entitled to relief from double taxation, to be granted by the residence state. The new framework will supplement the PE concept.

5.2. Conceptual and theoretical perspective

The OECD Final Report examined some of the conceptual bases for sharing the tax base, in particular the economic allegiance and the benefit doctrines. As to the former, the majority of the Technical Advisory Group (TAG) rejected the argument that economic allegiance warrants source taxation solely on the basis of the provision of market demand. According to the OECD Final Report (Para. 41):

the mere fact that the realization of business transactions requires an interaction between the supply of goods or services by an enterprise and the demand in a market state has not historically been considered by countries to provide a sufficient link for considering that the profits of the enterprise arising from these transactions should, for purposes of income taxation, be sourced in the market state.

This argument appears to be correct. Although mere demand is, in principle, a legitimate fiscal nexus under the economic allegiance doctrine, it may be too weak to apply in practice.

The TAG could not, however, agree on stronger fiscal links. Some members considered that the use of the source state's infrastructure would sanction taxing rights only if the enterprise carries on activities in that state. Other members took a contrary view, based on the ben-

efit doctrine. According to the OECD Final Report (Para. 44):

For some members, source taxation is justified in such a case because the business profits of the foreign enterprise derive partly from the enterprise's use of important locational advantages provided by that country's infrastructure which make the business operations profitable. These may include, but are not limited to, means of transportation (such as roads), public safety, a legal system that ensures the protection of property rights and a financial infrastructure.

As a result, the OECD Final Report (Para. 46) drew no conclusions on the relationship between the benefit doctrine and source taxation: “That disagreement prevented the TAG from articulating a single comprehensive conceptual base for evaluating the current rules for taxing business profits and the alternatives to these rules.”

It is unfortunate that the OECD Final Report missed such a rare opportunity to re-examine core theories and form a position on nexus, source and taxing rights. However, it appears that the answer is not as debatable as presented in the OECD Final Report and that, in the e-commerce context, even the theories that purport to justify the distinction between royalties and business profits lose much force. First, there are two conceptual bases that support the distinction in general: the benefit and economic allegiance doctrines. This support is based on the notion that the mere sale of goods without a PE does not create a sufficient fiscal nexus with the source state; the fiscal claims of the residence state are typically much stronger than those of the source state. On the other hand, royalties justify source taxation principally because the source state provides the legal framework and enforcement to protect the value of the intellectual supply concerned. In the e-commerce context, by contrast, business profits are very much like royalties in terms of the contribution made by the source state to the production of income. The value of intellectual property rights and intellectual content depends on the source state's laws and law enforcement. Moreover, given that reproduction is so easy and cheap, there is even a greater dependence on the source state's protection. As a result, the source state has as strong a claim over e-commerce business profits as it has over royalties, which have been

84. OECD Final Report, Para. 350.

85. *Id.*, Para. 125.

86. Such a framework may partly be based on two alternatives considered in the OECD Final Report (Alternatives 4.B.a) and 4.B.b)), which will require adaptation, modification and consolidation into a single framework (mainly because the OECD Final Report concerned business profits (rather than royalties) and because the description of the alternatives is fairly brief and rigid in terms of developing possible variations of the alternatives considered). Alternative 4.B.b) is based on the “base-erosion” approach associated with the work of Prof. Doernberg; see Doernberg, Richard L., “Electronic Commerce and International Tax Sharing”, 98 *Tax Notes International* 6-43 (1998) (TNI document); Doernberg and Hinnekens, *supra* note 47, at 315-323; and Doernberg, Richard L., Luc Hinnekens, Walter Hellerstein and Jinyan Li, *Electronic Commerce and Multijurisdictional Taxation* (The Hague: Kluwer Law International, 2001), at 354-365. See also a review of the alternatives in Pinto, D., *E-Commerce and Source-Based Income Taxation* (Amsterdam: IBFD Publications, 2002), Chaps. 6-8.

87. Net-basis taxation should also be an option in the present treatment of royalties, irrespective of a PE.

historically and broadly accepted as an income category that should be subject to source taxation.

Second, e-commerce adds another set of challenges to the debate on CEN and CIN. In general, it may be assumed that electronic commerce is conducted by corporations. The difference is that there is no investment by the non-resident corporation in the source state from which income is derived. The investment is in infrastructure, hardware, administration, etc., and can be made anywhere. Residence-based taxation of corporations may therefore be warranted under CEN on the basis that source taxation is, as a matter of fact, irrelevant to the location of the investment. Yet CIN would validly suggest that e-commerce increases the importance of source taxation of e-commerce profits. Although an online vendor makes no investment in the source state, it still needs to compete with other online vendors in the same market. Different rates of residence taxation will affect the competition among different vendors in the destination markets. More importantly, residence-based taxation of electronic commerce would simply direct investment to, and the establishment of corporate residence in, low-tax jurisdictions. Low or non-taxation may be better rectified through source taxation.

5.3. Scope of framework

The definition of royalties is principally designed to capture an income category based on realizing the value embodied in intangible property, that is, “income from intangibles with a *substantial intellectual content*” (emphasis added).⁸⁸ Source taxation of royalties is perhaps best understood in that context. In the e-commerce context, however, the definition may not achieve that objective. Before the advent of e-commerce, it might have made sense to impose tax chiefly on the basis of “a letting”,⁸⁹ i.e. the use or the right to use intellectual property rights, rather than the right to use the product itself. This is ultimately because reproduction was not easy or cheap. For example, it made sense to tax the right of a local music distributor to reproduce a rock album and not to tax the occasional use by a person who listened to the album, even if she purchased it directly from abroad. The number of direct purchases was too small to warrant a broader definition of royalties. The source state taxed the vast majority of copyright use by levying a withholding tax on the payment made by the local distributor to the foreign rock band.

In the digital age, however, the local distributor is sidelined. The main use of a copyright is copying digital goods containing images and sounds, and this use is as easy and common as a mouse click. *This may be an incidental use of a copyright, but this is not the point. The point is that the use of a copyright as a threshold warranting source taxation has little material meaning in the digital age.* Intellectual content is purchased in an environment that increasingly requires the source state’s protection of the value of that content. If the purpose of royalty taxation at source is to tax income from intangibles with a substantial intellectual content, then it may be an odd

outcome if the rock band sells the same music (e.g. from the 1970s), derives the same amount of source profits, enjoys the same or more source legal protection, but pays a much lower amount of source tax. The definition of royalties should thus be broadened to apply to intellectual supplies digitally made over the Internet or similar media.⁹⁰ This will be a natural extension of the concept of royalties and its adaptation to the realities of the digital age.⁹¹

5.4. Balanced approach to revenue reallocation – a low tax rate

One-sided solutions favouring the claims of only one of the two states concerned may not be realistically achievable. At a practical level, it must be appreciated that the consent of both states is required to bring about change. True, the source state has the ability to implement unilateral measures, but the residence state does not have to cooperate and it can refuse, for example, to grant relief from source taxation. The source and residence states may need to acknowledge that the revenue division issue may only be resolved by the core principle of tax treaties, namely, compromise.

Since it is difficult, if not practically impossible, to determine whose claim is stronger in any given set of circumstances, equal sharing arrangements of e-commerce tax revenue may make sense.⁹² Essentially, the compromise suggested is an application of the “division of the tax” method considered by the four economists. The inaccurate nature of such a solution may be compensated by greater simplicity. At the end of the day, since one-sided solutions are fraught with difficulties, the likelihood of reaching an international agreement on e-commerce may significantly increase if it is agreed that there should be an arbitrary but equal division of the tax. Such a division is also sanctioned on conceptual grounds. Although the source state has a strong fiscal nexus with the income, it should not be forgotten that the residence

88. OECD Equipment Report, Para. 18(i).

89. Commentary on Art. 12 of the OECD Model, Para. 1.

90. A definition that does not rely on the use of, or the right to use, intellectual property is not novel. For example, although it may not have been originally intended to capture digital intellectual supplies, the Australian domestic definition of royalties (and the definition in some of Australia’s new treaties) also applies to payments for: “the reception of, or the right to receive, visual images or sounds, or both, transmitted to the public by: (i) satellite; or (ii) cable, optic fibre or similar technology” (Para. (da) of the definition of royalties in Sec. 6(1) of the Income Tax Assessment Act 1936).

The extended definition of royalties is also included in Australia’s tax treaties with Canada (Art. 12(8)(a)), New Zealand (Art. 12(3)(f)), the Czech Republic (Art. 12(3)(e)), Taipei (Art. 12(3)(e)), South Africa (Art. 12(3)(f)), the Slovak Republic (Art. 12(3)(f)), Argentina (Art. 12(3)(f)), Romania (Art. 12(3)(e)), Russia (Art. 12(3)(f)) and Mexico (protocol, Item 9). See the discussion in Tadmore, N., “Aspects of Electronic Commerce Taxation in Australia”, 57 *Bulletin for International Fiscal Documentation* 8/9 (2003), at 422.

91. The proposed framework does not change the PE concept. E-commerce will not do away with factories, equipment, construction projects, etc. The PE concept will continue to fulfil an important role in tax treaties. In addition, the PE concept may not be the suitable regime for reform that concerns intangibles because it is overwhelmingly a physical concept. Additionally, a framework that focuses on the taxation of digital intellectual supplies would better accord with, and operate within, the rules that are inherently designed to deal with intangibles, i.e. the rules dealing with royalty taxation.

92. See the general comment in OECD Final Report, Para. 59.

state also has strong claims in relation to that income. The residence state should not be entitled to have all the revenue shifted its way as a result of e-commerce, but the source state cannot rightfully suggest that the pre-electronic commerce tax base should be fully preserved. For this reason, the withholding tax rate should be relatively low, e.g. 3% to 6%.

5.5. Evaluation of policy objectives

The discussion below evaluates this new framework on the basis of the relevant evaluation criteria in the OECD Final Report as well as other considerations.

(a) *Certainty.* The new framework will do away with the difficulties surrounding the use, or the right to use, intellectual property and the sale or letting of digital products and will thus reduce uncertainty. Uncertainty will not be eliminated, however. The main challenge will be the distinction between (i) intellectual supplies and services and (ii) incidental intellectual supplies or mixed payments.

(b) *Efficiency.* Reduced degrees of uncertainty and complexity will result in reduced compliance and administrative costs and will decrease the risk of disagreements and disputes. Compliance costs may, however, increase if the non-resident elects to be taxed on a net basis.⁹³ Yet this cost may be part of doing business in the digital age, as compliance costs are likely to be incurred mainly where taxation on a net basis results in a lower tax burden at source.

(c) *Flexibility.* A framework based on digital intellectual supplies will be inherently more flexible than the existing rules as it will be designed to apply to e-commerce transactions.

(d) *Relationship with free-trade agreements and similarity to consumption taxes.* The OECD Final Report raised the valid concern that a final withholding tax system may be inconsistent with the principles of income taxation and the WTO rules, but conceded that the ability to be taxed on a net basis and obtain a tax credit would assist in mitigating against these difficulties.⁹⁴

Another concern correctly raised in the OECD Final Report is that ultimately the withholding tax will be passed on to source-state consumers. This would arise if the non-resident supplier refuses to sell unless it gets its asking price, which means that the consumer has to gross up the payment. However, this possibility is likely to be diminished significantly in a treaty context or where foreign tax credits are unilaterally available.⁹⁵

(e) *International acceptance.* The OECD Final Report (Para. 123) noted that the clear advantage of the existing rules is that they are the current international norms. As discussed above, however, the continuing operation of the existing rules may undermine the broad acceptance of the current international norms. An important feature of the proposed framework is that its conceptual basis is already widely accepted (although not in the OECD Model), namely, source taxation of royalties.

Extending this concept and adapting it to new and prevalent business models will be conceptually consistent with this approach and thus will be a sound springboard for a new international norm.

(f) *Enforcement.* Enforcing a withholding tax may be divided into deductible payments (business-to-business supplies) and non-deductible payments (business-to-consumer supplies). Enforcing deductible payments is readily achievable because if the tax is not withheld, the payment is not deductible.⁹⁶ In the business-to-consumer market, however, consumers have little interest, incentive or ability to comply with a withholding obligation.⁹⁷ This can significantly weaken the proposed framework with respect to private consumers. Whatever benefit or economic allegiance rights the source state has and however fair its claim about its diminishing tax base may be, as the realistic doctrine suggests, there is no point in imposing taxes that cannot be collected. *In the e-commerce context, theory, policy and collection are intertwined, and collection will dictate and shape any change to the current rules.* As Adams once said: “tax should not be assigned to a jurisdiction which cannot effectively administer and collect the tax.”⁹⁸

The advance of technology and international cooperation, and the creation of stronger compliance cultures, may ultimately address this issue by rendering feasible the collection of tax on business-to-consumer transactions. At present, however, there appears to be no satisfactory solution. For example, inconvenience can be addressed by relatively simple technological advancements. Consumers, for instance, would be able to call on an automated user-friendly virtual tax agent “working” for the local tax authority that will calculate and collect the tax at the time of the transaction. However, short of draconian enforcement measures, this will not address the second barrier to direct collection, namely, lack of incentive. Another possibility is collection by the residence state, but this would require an unprecedented degree of cooperation. Indeed, assistance in the collection of tax is not a new concept. Such assistance was suggested in 1928 by the League of Nations when it published its first model treaty.⁹⁹ Not much progress has made in this area since then.¹⁰⁰ Perhaps close coopera-

93. OECD Final Report, Para. 263.

94. Id., Paras. 99, 259 and 278. See also Rosenbloom, David H., “Source-Basis Taxation of Derivative Financial Instruments: Some Unanswered Questions”, 50 *University of Miami Law Review* 597 (1996), at 597; Doernberg and Hinnekens, *supra* note 47, Para. 16; and Avi-Yonah, *supra* note 60, at 540.

95. OECD Final Report, Para. 278.

96. This is the essence of the “base-erosion approach” associated with Prof. Doernberg; see note 86, *supra*.

97. OECD Final Report, Para. 262.

98. Adams, Thomas S., “Interstate and International Double Taxation”, in Magill, Roswell (ed.), *Lectures on Taxation 101* (1932), at 112, as quoted in Graetz and O’Hear, *supra* note 43, at 1101.

99. League of Nations 1928 Report, *supra* note 42, Part IV (Bilateral Convention on Assistance in the Collection of Taxes).

100. The recently added Art. 27 of the OECD Model, dealing with assistance in the collection of taxes, can enhance cooperation. Art. 27, however, seems to be designed to deal with specific instances where assistance in collection is required rather than creating an ongoing mutual collection and remittance mechanism.

tion will be more feasible if states are closely associated in blocks, such as the European Union.¹⁰¹ A more viable alternative, which requires careful consideration and planning, may be collection by intermediaries, such as source-state financial institutions.¹⁰² A consumer buys a product online and instructs the financial institution to transfer funds to a foreign bank account, and the financial institution withholds a portion of the payment and remits it to the tax authorities. The main advantage of this method is that it radically reduces the number of tax collectors and the compliance burden at the consumer level. Its main disadvantage is that it is somewhat draconian and would involve considerable practical difficulties with respect to its actual operation as well as avoidance opportunities.

(g) *Revenue reallocation.* In the absence of viable collection solutions with respect to private consumers, the framework will essentially be modelled on the base-erosion approach suggested by Prof. Doernberg and others

(but only to the extent that the approach applies to digital intellectual supplies). The approach goes a long way to address the revenue reallocation brought about by e-commerce by “permitting increased source state withholding on payments that erode the tax base of the source state”.¹⁰³ However, it will obviously not address revenue reallocation in the rapidly growing business-to-consumer market.

(h) *Neutrality.* Because there are no viable collection solutions with respect to private consumers, the framework would only apply to deductible payments. Thus, neutrality will be compromised. The impact on neutrality will not only be constant, but will also accelerate. The growth of the business-to-consumer market will create ongoing pressure to increase the low withholding tax rate imposed on deductible payments to avoid further erosion of the source state’s revenue base. This may require setting an even higher withholding tax rate on deductible payments.

6. Conclusion

The source state is entitled to tax intellectual supplies. Source taxation of royalties reflects that entitlement. In practice, source taxation of royalties is a product of the historical hangover underpinning income categorization and the bargaining process between source and residence states. The advent of e-commerce, in particular digitization, is creating new commercial realities that warrant source taxation at two levels. First, the resulting profits depend heavily on source-state benefits. Second, reliance on the traditional rules will exclude source taxation of intellectual supplies in the digital age and is likely to result in revenue reallocation. At some point, this is likely to undermine the core bargain between the states as well as the current international norms.

A coherent framework for taxing intellectual supplies should be based on adapting the royalty definition to include digital intellectual supplies. It would impose a low rate of source tax on such supplies, taking into account the need to balance the fiscal claims of both the source state and the residence state. Ideally, the

tax will apply to all digital intellectual supplies, but the main challenge of this framework will be enforcement in the mass consumer market. Viable solutions may be adopted as technology evolves, but in the absence of such solutions, the framework will have to be confined to deductible payments, which will compromise neutrality.

Nonetheless, the default option – to continue to use the existing rules – would compromise neutrality at least to the same extent. Moreover, it would also come with all the *additional* costs and consequences associated with its diminishing relevance and competence. Applying the existing rules that emanated from the realities of the 1920s and 1930s can only go so far in the digital age.

The proposals made above would make tax treaties more responsive to technological changes, and thus enable tax treaties to remain effective and meaningful fiscal arrangements as the economic changes brought about by new technologies continue to emerge. Treaty history shows that treaty policy and development are followers of international commercial trends. The digital age may well reverse that position by forcing treaty policy and development into a leadership role.

101. VAT within the European Union is an example in point; see Jensen, P., “VAT Levied on Digital Sales within EU”, 30 *The International Tax Lawyer* (No. 1, 2004).

102. See generally the report by the OECD Technology Technical Advisory Group (December 2000), Paras. 22-32 (in relation to indirect taxes).

103. Doernberg, Hinnekens, Hellerstein and Li, *supra* note 86, at 357.

David Bradbury
Head of Tax Policy and Statistics Division
Center of Tax Policy and Administration
Organisation for Economic Cooperation and Development
By e-mail: TFDE@oecd.org

October 13th, 2017

SUBJECT: REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITALISED ECONOMY

Dear Sir/Madam

EY appreciates the opportunity to comment on the OECD's request for input on work regarding tax challenges of the digitalized economy, which was issued by the OECD on 22 September 2017, and to contribute to the public consultation and discussions regarding this fundamental and important topic.

EY would first like to express its concern about the current environment, where individual countries and potentially the European Union are moving in a direction that has led, or may lead, to taxation that may conflict with long established international principles, such as the principles embodied in more than 3,000 existing bilateral tax treaties. These principles are designed to prevent double taxation and provide for a neutral platform on which companies can perform their critical business activities without being discriminated against, or favored, based on residence, industry sector, or forms of commerce. Furthermore, these principles, which have evolved over several decades, have contributed greatly to worldwide economic growth. A departure from these principles in a non-coordinated fashion is not conducive to the prevention of double taxation and, therefore, to sustained economic growth.

As pointed out within the Action 1 Final BEPS Report, the digital economy is the overall economy. The digital economy cannot be ring fenced or separately distinguished. The trends of digitization are pervasive in companies within all industry sectors, and the business models we see today are likely to see wide spread adoption in various forms in nearly all global enterprises. This means that special measures may inconsistently and haphazardly become generally applicable rules. Taxation policy that specifically identifies businesses based on the level of reliance of these businesses on digitalization — which seems to be implied by the term “highly digitized” in the invitation to comment — is therefore likely to be arbitrary and discriminatory. Developing tax policy for a few companies that are perceived today as “highly digitalized” deviates from the important policy of neutrality (i.e., the view that taxation should be targeted at specifically defined activities, without making a distinction between the type of businesses performing such activities and the country of residence of these businesses).

EY also notes the importance of the conclusion of the Action 1 Final Report regarding the impact BEPS measures will have on the issue of the non-taxation of corporate profits, which appears to be the key catalyst for considering new, special taxation regimes for the digital economy. In the invitation to comment, the OECD requests comments on the impact of the overall BEPS measures on the taxation of highly digitalized business models. EY observes that the myriad of new measures following from the BEPS Final Reports are approximately two years old and implementation began only in 2016; moreover, certain measures such as the OECD's Multilateral Instrument (MLI) and the EU Anti Tax Avoidance Directive (ATAD) are only expected to broadly enter into force as of 2019. Therefore, these measures are too new to objectively evaluate in terms of their effectiveness. However, there is no reason to believe that, following the introduction of the BEPS measures, the OECD's Inclusive Framework members will be lacking the means necessary to ensure that corporate profits are taxed in the appropriate source or residence country. The appropriate country of taxation will be determined by the existing agreements and obligations reflected in the many bilateral tax treaties. The interaction between these treaties and domestic tax legislation (including for example controlled foreign company rules and the rules introduced by ATAD) determine the division of taxing rights between source and residence countries. If new measures are introduced which are in tension with these existing source-residence rules, only dialogue and consensus between the countries impacted by these changes will prevent double taxation. EY therefore stresses the

importance of a global dialogue in relation to these complex issues and that the OECD is the best forum to assist countries in working through these matters, which will require time to appropriately evaluate.

Moreover, specifically targeted taxation regimes outside of tax treaty frameworks or international principles (including equalization levies, targeted withholding taxes and similar structured regimes focused on certain activities or a small group of companies or regimes) will be perceived as being selective, will lead to double taxation and will not promote equality and growth within the global economy.

In summary, EY would like to stress the importance of:

- a thorough and principled analysis of the issues at stake,
- a measured, coordinated approach by all the Inclusive Framework members that gives recent related BEPS measures sufficient time to be assessed and adheres to long-established international principles, and
- a recognition of the potentially destructive nature of company- or industry- or business model-specific tax regimes.

Yours faithfully,
On behalf of EY



Alex Postma

If you have any comments or questions, please feel free to contact any of the following:

Arlene Fitzpatrick	+1 202 327 7284	arlene.fitzpatrick@ey.com
Channing Flynn	+1 408 947 5435	channing.flynn@ey.com
Jeff Michalak	+1 313 628 8460	jeff.michalak@ey.com
Alex Postma	+1 201 872 0093	alex.postma@ey.com
Marlies de Ruiter	+31 88 407 7887	marlies.de.ruiter@nl.ey.com
Chris Sanger	+44 20 7951 0150	csanger@uk.ey.com
Rob Thomas	+44 20 7760 5538	RThomas5@uk.ey.com
Jano Bustos	+1 212 773 9584	joseantonio.bustos@ey.com

OECD c/o Mr. David Bradburry
2 Rue André Pascal
75775 Paris
France

Author
JT/Pe

Phone
+49 30 278 76 310

Telefax
+49 30 278 76 799

E-Mail
trommer@dstv.de

Date
18.10.2071

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REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITALISED ECONOMY

A. Digitalisation, Business Models and Value Creation

A.1 The process of digitalisation has become one of the main drivers of innovation and growth across the economy. Please describe the impact of this process on business models, and the nature of these changes (e.g. means and location of value creation, organisation, supply chains and cost structure).

Digitalisation has been a source for undertakings to maximize efficiency and reduce costs, i.e. through the development of fast computer systems or entire production places run by computers and machines. Moreover, digitalization and internet technology led to the development of entire new business models which run without the requirement of physical presence, i.e. online services or information platforms (AirBnB, Google, Facebook, Amazon). A further distinction is needed, however, for undertakings which in part rely on classical industrial characteristics, such as logistics or tangible goods. Amazon and Apple are good examples for this. While Amazon uses an online platform, the products sold via the platform are shipped from storages all over the world using logistics services. Apple on the other hand sells devices (tangible property) that come with special software (intangible property). In this view Apple and Amazon can be considered as hybrid business models which use both, classical industrial characteristics and digital characteristics.

This is in contrast to highly digitalized business models which predominantly rely on virtual or digital environments and lack physical presence or industrial characteristics.

Both business models have been influenced by digitalization significantly. However, the highly digitalized economy is capable of reducing costs, i.e. for supply chains, storage places and logistics or office spaces and employees, since the maintenance of digital services (algorithms, patents, IP) can be carried out by fewer employees or even by digital processes. This maximizes costs and benefits and triggers classical taxation schemes which relied on the principle of establishment.

A.2 Highly digitalised business models are generally heavily reliant on intangible property (IP) to conduct their activities. What role does IP play in highly digitalised businesses, and what are the types of IP that are important for different types of business models (e.g. patents, brands, algorithms, etc.)?

IP is the source of value in highly digitalized economy. For example, online platforms and networks are based on mass of personal data and user information. Personal data and user information are just two examples without which the business model of undertakings such as Google or Facebook would not work or generate value.

A.3 Digitalisation has created new opportunities in the way sales activities can be carried out at a distance from a market and its customers. How are sales operations organised across different highly digitalised business models? What are the relevant business considerations driving remote selling models, and in which circumstances are remote selling models (as opposed to local sales models) most prevalent?

In terms of logistics or sales activities a distinction can be made between hybrid business models and highly digitalized business models.

Hybrid business models still use classical sales activities and logistics and thereby are connected to or located within a market. The example of Amazon and Apple works here as well. For example, although Amazon provides an online platform (distance) the products are predominantly shipped from local storage places.

Highly digitalized business models do not need to be physically present since they contact customers in a purely virtual sphere. Sales operations take place directly with the customer “in its living room”. These kind of remote selling is preferred with online platforms, digital services or the supply of digital content. Netflix or Spotify are example of these distance or remote selling business models. The digital content and service is delivered directly to the consumer, i.e. can be streamed at home. For this the EU Commission Proposal for Directive on the supply of Digital Content can be considered (COM(2015) 634 final).

A.4 Digitalisation has permitted businesses to gather and use data across borders to an unprecedented degree. What is the role of data collection and analysis in different highly digitalised business models, and what types of data are being collected and analysed?

Digitalisation led to the development of new technologies and processes being capable of managing large numbers of information and data in real time. With this new services developed and emerged either for the evaluation of the mass data or for the use of the information and evaluation of this data.

Some business models, such as google or facebook built up their business model upon the evaluation of their user data.

Other business models use the evaluation of mass data to provide better customer support. For example Netflix and Spotify employ algorithms they propose “movies or music you may like” based on the previous selections a customer has made.

A.5 In a number of instances, businesses have developed an architecture around their online platforms that encourages the active participation of users and/or customers from different jurisdictions. Is the establishment and operation of such global (or at least cross-country) user networks new and specific to certain highly digitalised business models, and what are the potential implications for value creation?

No answer possible at this moment.

A.6 The digitalisation of the economy is a process of constant evolution. Please describe how you see business models evolving in the future due to advances in information and communications technology (e.g. Artificial Intelligence, 3D printing).

The development of algorithms and artificial intelligence opens the door towards robotics and automotive driving.

Also medicine and the treatment of patients will see further developments and digital services.

B. Challenges and Opportunities for Tax Systems

B.1 What issues are you experiencing with the current international taxation framework? (e.g. legal, administrative burden, certainty)

A major issue is the different positions and views between the EU, US, Japan and BRIC countries regarding the need and degree to which the digitalized economy must be subjected to taxation. For example, many highly digitalized companies have their seat in the US and pay taxes there although they generate a large portion of revenue in the EU or other States.

Furthermore, the international tax scheme is built upon a “classical” view of an industrial economy where physical presence is the link to the place where a company is taxed. With highly digitalized companies this tax base ceases to exist.

B.2 Digitalisation raises a number of challenges and opportunities for the current international tax system. In particular:

a) What are the implications of highly digitalised business models and their value chain on taxation policy? In particular:

(i) What impact are these business models having on existing tax bases, structures of tax systems and the distribution of taxing rights between countries?

The key problem is that the digital economy or at least the highly digitalized economy does not, by the very nature of their economic activity, come within the scope of the existing international tax framework.

The current international tax framework does not effectively grasp the specificities of the digital economy and in particular the development of highly digitalized business models which lack the classical tax base – physical presence. With the digitalization and new business models, physical presence is no longer required to generate profit in another Member State

The Digital Economy relies heavily on alternative and highly digitalized business models. Services are offered online and delivered directly to the consumer. The nature of these business models is to generate maximum welfare through the employment of new, innovative and digitalized processes and procedures. This is due to alternative means and location of value creation, alternative organization, supply chains and cost structure. Further, highly digitalized business models are heavily reliant on intangible property (IP) to conduct their activities, i.e. patents, brands or algorithms.

(ii) Are there any specific implications for the taxation of business profits?

See above.

b) What opportunities to improve tax administration services and compliance strategies are created by digital technologies?

Exchange of information and data through digital channels is one mechanism through which tax administration can be improved.

C. Implementation of the BEPS package

C.1 Although still early in the implementation of the BEPS package, how have the various BEPS measures (especially those identified as particularly relevant for the digital economy – i.e. BEPS Actions 3, 6, 7 and 8-10) addressed the BEPS risks and the broader tax challenges raised by digitalisation? Please feel free to support your answers with real life examples illustrating these impacts.

The proposal for a Common Corporate Tax Base, BEPS initiatives and the OECD action plan have been a starting point for a future reform targeting the digital economy. However, these initiatives only partly target the challenges regarding the taxation of the digital economy.

Regarding to BEPS a distinction should be made between the problem of tax aversion, which is in general addressed by the BEPS initiative and the lack of a taxation framework applicable to certain forms of business models in the digital economy, which is the case where the traditional tax base – the principle of establishment – ceases to exist.

For example, hybrid undertakings, which are undertakings that rely on digitalization and new technologies but still sell products or tangible goods, which use the international tax framework to avail taxation and maximize profit (i.e. Apple). This is a problem which is, in principle, dealt

with by BEPS initiatives. However, in the broad sense of digital economy, undertakings like Apple would also come within the scope of the digital economy.

This is different for highly digitalized business models where undertakings offer services from one country in another Member State without physical presence (Google, Facebook etc.). This new business models take away the tax base – the principle of establishment – which is used for the taxation of the “classical economy”.

C.2 A growing number of countries have implemented the new guidelines and implementation mechanisms relating to value-added tax (VAT)/ goods and services tax (GST) that were agreed in the BEPS package to level the playing field between domestic and foreign suppliers of intangibles and services. What has been your experience from the implementation of these collection models (e.g. compliance, impact on business operations)? What are some examples of best practice in this area?

No answer possible at this moment.

D. Options to address the broader direct tax policy challenges

D.1 The 2015 Report outlined a number of potential options to address the broader direct tax challenges driven by digitalisation. Please identify and describe the specific challenges associated with the application (e.g. implementation, compliance, neutrality) of these options. What are the advantages and disadvantages of these options, including from an administrative and economic perspective, and how might some of the disadvantages be addressed or mitigated through tax policy design? In particular, comments are welcome on the following specific issues:

a) Tax nexus concept of “significant economic presence”:

(i) What transactions should be included within its scope?

This depends on how digital economy is defined. Does it include hybrid business models and highly digitalized business models or only the highly digitalized business models. A final answer cannot be given at this stage.

(ii) How should the digital presence be measured and determined?

The definition of digital presence must give due account to the new business models relied on by the highly digitalized economy. Virtual presence, the location where the profit is generated or the place where the digital content is delivered are possibilities by which digital presence can be measured.

However, the definition of digital presence should be carefully defined weighing all pros and cons of alternative models of digital presence. Also due account should be given if a potential definition of digital presence gives rise to new loopholes for the digital economy.

(iii) How could meaningful income be attributed to the significant economic presence and how would such an approach interact with existing transfer pricing rules and profit attribution rules applicable to the traditional permanent establishment?

Financial thresholds can be an option. Only if an undertaking generates a certain profit margin in one Member State digital presence is established.

However, a final and conclusive statement can only be adopted at a later stage of the development of the EU initiative.

(iv) How could such a measure be efficiently and effectively implemented in practice?

No answer possible at this stage.

b) Withholding tax on certain types of digital transactions:

(i) What transactions should be included within its scope?

This depends on how digital economy is defined. Does it include hybrid business models and highly digitalized business models or only the highly digitalized business models. A final answer cannot be given at this stage.

(ii) How could the negative impacts of gross basis taxation be mitigated?

A key element to minimize potential distortions is to define clear and easily comprehensible definitions and a clear scope of application to which short-term solution applies.

For example, the equalization tax is an appealing short-term solution, yet it raises the risk of double taxation. Since the equalization tax is calculated on the basis of the turnover of an undertaking, the equalization tax is paid on top of tax that may be paid in the home or host state. Since the equalization tax is intended to compensate the State where the profit is gained the tax should be shared between the home and host state of the undertaking. This may require new rules on offsetting and transfer.

Thus, due account must be given to all impacts, positive and negative, of short term solutions.

Also, it would be welcomed that it is clarified to what extent Member States remain to adopt bilateral agreements on the basis of the OECD-MA to avoid double taxation.

(iii) How could the threat of double taxation be mitigated?

See above.

(iv) How could such a measure be efficiently and effectively implemented in practice?

See above.

c) Digital equalisation levy:

(i) What transactions should be included within its scope?

No final answer can be given at this stage. However, the initiative should target transactions and activities that operate cross-boarder.

(ii) How could the negative impacts of gross basis taxation be mitigated?

A key element to minimize potential distortions is to define clear and easily comprehensible definitions and a clear scope of application to which short-term solution applies.

For example, the equalization tax is an appealing short-term solution, yet it raises the risk of double taxation. Since the equalization tax is calculated on the basis of the turnover of an undertaking, the equalization tax is paid on top of tax that may be paid in the home or host state. Since the equalization tax is intended to compensate the State where the profit is gained the tax should be shared between the home and host state of the undertaking. This may require new rules on offsetting and transfer.

Thus, due account must be given to all impacts, positive and negative, of short term solutions.

Also, it would be welcomed that it is clarified to what extent Member States remain to adopt bilateral agreements on the basis of the OECD-MA to avoid double taxation.

(iii) How could the threat of double taxation be mitigated?

Equalisation levy must be attached to the national tax scheme in which the levy must be paid. Where the equalization levy is paid on top in one Member State only, the risk of double taxation remains significantly high.

(iv) How could such a measure be efficiently and effectively implemented in practice?

The allocation of supervision and monitoring to a single supervisory authority, which is responsible for the assessment of the consolidated accounts and which determines the equalization levy to be paid in a specific state.

D.2 A number of other tax measures have been proposed, announced or introduced by various countries that seek to address the direct tax challenges of highly digitalised business models (e.g. diverted profit taxes, new withholding taxes, turnover taxes).

a) What are the advantages and disadvantages of these approaches? Where possible, please share any direct experience from the implementation (e.g. compliance, impact on business operations) of these approaches.

Disadvantage: Regulatory competition, double taxation, closing off of the market and fragmentation of taxation rules at a European and global sphere. This leads to higher compliance costs for undertakings which has an even bigger impact for small and medium enterprises.

b) How might some of disadvantages of these approaches be addressed or mitigated through tax policy design?

See answers to D1 above.

c) What are the specific impacts of these unilateral and uncoordinated approaches on the level of certainty and complexity of international taxation?

See answer to point a).

E. Other Comments

E.1 Are there any other issues not mentioned above that you would like to see considered by the TFDE as part of its work on taxation and digitalisation?

Two issues that emerge is the personal scope, i.e. what entities and undertakings are bound. Will there be a categorization of undertakings for which the framework is mandatory? (similar to the current EU proposal on the CCTB)

Growth is important for a stable economy. Since the digitalization has been a valuable factor for the

Grant Thornton International

BEPS Action 1

Input on the Work regarding the Tax Challenges of the
Digitalised Economy



Grant Thornton International Ltd welcomes the opportunity to provide input on the work regarding the tax challenges of the digitalised economy. We appreciate the work that the OECD has undertaken on the wider BEPS project and would like to make the following comments on this further guidance.

Tax Policy and Statistics Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France

By e-mail to: TFDE@oecd.org

13 October 2017

Subject: Input on the Work regarding the Tax Challenges of the Digitalised Economy

Following the Action 1 report on *Addressing the Tax Challenges of the Digital Economy* (2015)¹, we appreciate being granted this opportunity in this Request for Input to provide comments on the tax challenges of the Digitalised Economy. The Action 1 report pointed out that the digital economy plays a growing influential role alongside the rest of the economy. We have limited our comments at this stage to A) Digitalisation, Business Models and Value Creation and B) Challenges and Opportunities for Tax Systems, with a focus on data and its role within business models. Furthermore, we comment upon whether the application of the arm's length principle is possible.

We believe it is too early to make definitive comments on whether certain options (withholding taxes, equalisation taxes, digital turnover taxes) are required. This is because the other BEPS actions which could have an impact in this area are either not yet in place (eg changes to Permanent Establishments under Action 7²) or only recently included in the OECD 2017 Transfer Pricing Guidelines (e.g. intangibles under Actions 8-10) and may not (yet) be in local law. For this reason, we do not comment at this stage on the questions in parts C and D of the Request for Input and we consider that these measures should be given time to take effect before any final decisions are made as to whether additional measures are needed or are desirable.

Also we endorse the statement made in Action 1 Final Report 2015 (§ 253) according to which, Digital Technology has not changed the fundamental nature of the core activities that businesses carry out as part of a business model to generate profits, but it has had significant impact on how these activities are carried out and on how the value is created or added.

As a result and by way of principle, we are of the view that the arm's length principle, in light of other BEPS actions – especially 7 and 8-10, should prevail when defining income taxation in the Digital Economy. Any alternative regime that materially deviates from it should be restricted to very limited circumstances and should be accompanied by strong elimination of double taxation mechanisms.

A. Digitalisation, business models and value creation

Business models and the other means of how to conduct business have changed dramatically over the last 20 years. The collection of data has become an important factor, not only for digitally focused companies but also for those operating in more traditional industries. At the time of presenting the initial BEPS action plans in 2013, an American start-up delivered the first affordable fully electric-power cars to retail customers in Europe. Now almost five years

¹ OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Action 1 - 2015 Final Report.

² OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status*, Action 7 - 2015 Final Report.

later, this company has only sold a quarter of a million cars but already has a higher market capitalization than other well-known established global car brands. Despite the fact that the competition has been around for decades and produces and sells significantly greater amounts of cars on an annual basis, shareholders anticipate higher potential future profits and growth for the green-field newcomer. One of the reasons for these high shareholder expectations is the company's unrivalled ability to gather unique data from their electric cars, which can further be put to use for new innovations.

The collection, aggregation and analysis of data may significantly contribute to the creation of intellectual property. Today, companies rely on the use of (consumer) data to formulate policies, create new business, devise marketing and sales strategies or even sell it as a commodity to third parties. Companies use artificial intelligence to extract more value from raw user data, such as applying algorithms to predict when (or where) customers are ready to buy products or services, or to calculate risks. The gathering of information can also be a side-product of doing business. Multinational enterprises started, for instance, with online webshops to improve their sales revenues; a process in which they discovered that the data relating to human online behaviour can be more valuable than the product itself.

The global economy has been increasingly impacted by the network effect, under which a business may use its data, derived from a critical mass of users, allowing it to develop a unique competitive advantage. By having a presence in a large market/country, software companies are now able to collect large quantities of raw data, which further enhances the opportunities for that business to further consolidate its market advantage and to be in a position to create even more valuable IP.

Many software groups provide free services (e.g. email, navigation, agenda, translation, search engine) to consumers and are 'remunerated' in the form of data. Consumers are being presented this option of 'payment' when using online 'free' services. The transfer of valuable consumer data to the central hub, may be considered to balance the outstanding investments, in the form of free services, made by the software providers.

B. Challenges and opportunities for tax systems

Governments and tax authorities are realizing the importance and value of data for businesses and have started setting up initiatives on how to ensure their entitlement to tax their 'fair share'. Apart from identifying a taxable presence, the next key question is whether profit could be allocated to such a presence and if so, how to calculate this profit. In this process the principles as set out in the respective (OECD based) Model Tax Convention on Income and on Capital and the OECD 2017 Transfer Pricing Guidelines should be the starting point. Looking at the level of profits involved with selling data, tax authorities are seeking ways to attribute a (significant) part of this profit to their country. In this regard, some tax authorities take the position that the consumers within their markets are adding value to foreign enterprises, without receiving a local benefit. This has already resulted in uncoordinated proposals which are based on fictive taxations and are not compatible with current accepted international principles.

When taking into account the benefit theory, historically used to support the taxation of non-resident enterprises, jurisdictions would like to receive some form of compensation for the fact that there is access to a market where commerce is possible within its jurisdiction. This would imply that countries with large populations and open markets could be considered a key to success for enterprises, due to their large potential data pool. Despite the fact that some of the largest companies have a significant digital footprint in various jurisdictions, enabling them to collect valuable data, local tax authorities are limited at present by current

tax legislations and international accepted tax principles. As a consequence, it is very challenging to identify who and what should be taxed.

Who to tax

Currently the international tax treaty models do not provide guidance for the taxation of activities that are not legally or physically present in a jurisdiction.

For instance, a mobile platform that operates in a specific jurisdiction but is maintained and supported by a centralized team in another jurisdiction, would not have a local taxable presence in the specific jurisdiction. In the absence of local legislation, the current Article 5 of the Model Tax Convention on Income and on Capital does not allow the source country to share in the benefits derived from these types of activities in within its market.

By way of another example, it could be the case that a taxable presence conducts physical sales activities and also sells through a website. As a consequence of these activities, data may be collected and aggregated by a non-resident entity, to be used for further development or sold to third-parties. Currently, data collection as a by-product does not fall under the activities of the taxable presence as it cannot be attributed to the activities that triggered the tax presence in the first place.

What to tax

Assuming a local taxable presence in a specific jurisdiction *can* be identified as a result of digitalised services, a second questions arises: what is the taxable base? From a business perspective, online sales services can be seen as a sales activity. In this regard, this activity should be remunerated according to the arm's length principle as described in article 9 of the Model Tax Convention on Income and on Capital. However, as described above, as a possible consequence of the online sales activity, data will most likely be passed through to a central hub without local involvement, for further product development or alternatively be sold as raw data to third parties. This would imply that a local entity should not be entitled to future profits that is derived from this data transfer.

Even if a transfer of data can be identified, it must be priced at market value. It is challenging to price a specific data transfer destined to become part of a larger centralized set, on which companies can perform data analysis or sell as raw data. In this regard, most of the value could be in the fact that groups are able to gather specific data from multiple countries to identify contrasts and/or correlations between different markets. Through this reasoning, one could argue that raw data derived from a single jurisdictional market by itself has no or limited market value. On the other hand, it could be argued that the jurisdiction contributing the most data to an aggregated set, adds the most proportional value.

In our opinion a global approach is needed in order to avoid double taxation due to uncoordinated local approaches.

Preliminary comments on application of the arm's length principle

According to the revised OECD 2017 Transfer Pricing Guidelines, it is important to identify the relevant risk and control functions and where these functions are performed. As it pertains to IP, special focus has been placed on the exercised DEMPE³-control functions. Within a group a central hub can be responsible for all activities relating to global data gathering from the different markets where the group is active. From this gathered data the

³ Development, enhancement, maintenance, protection and exploitation.

group could develop future applications, services and potentially IP. Furthermore, the data can be used to assist with strategic management decisions or can be sold to third parties.

These functions are often accompanied by significant business risks and investments. Assuming that this hub performs most of these functions, it should be entitled to profit or losses as a result thereof. While it is clear that the raw data has latent value, this only comes to fruition at a later stage.

Based on the above, we acknowledge the fact that data (gathering) is important for (future) business models and profits. The mere fact of data gathering in a specific jurisdiction is not an active function, thus does not have any controllable risk linked to it. Therefore, this function cannot be entitled to a remuneration related to that data in the specific jurisdiction.

Another matter to consider is whether having access to a market so that the collection of data is possible, is a reason to attribute profits to a particular jurisdiction. According to the OECD 2017 Transfer Pricing Guidelines, market access is a comparability factor and not a key value driver⁴, as it cannot be owned or controlled as an intangible. In this respect, based on economic principles, there are no functions or risks relating to the mere access to a market in a specific jurisdiction that would lead to any form of remuneration.

If it is accepted that solutions need to be found to arrive at a more 'equitable' outcome, the effect may be that the arm's length principle is not the most suitable instrument to address this challenge. This would be a serious departure from the principles behind the OECD 2017 Transfer Pricing Guidelines, and for that reason should be carefully evaluated and only adopted provided there is a consensus, and only if and when the other BEPS measures are, in due course, found to be ineffective to deal with the issues addressed here.

Closing remarks

On behalf of the global network of Grant Thornton International Member Firms, with the contribution of our colleagues, Wendy Nicholls, Charles Marais, Michiel van den Berg, Chaïd Dali-Ali and Adriaan Bijleveld, we respectfully submit our input regarding the tax challenges of the digitalised economy.

We are grateful for the opportunity to provide our input and would be pleased to discuss or clarify our response. Please contact the undersigned or any of the contacts below.

Yours Faithfully,



Francesca Lagerberg
Global leader - Tax Services
Grant Thornton International Limited

Grant Thornton Contacts	E-mail
Wendy Nicholls	Wendy.nicholls@uk.gt.com
Charles Marais	Charles.marais@nl.gt.com
Michel van den Berg	Michiel.vanden.berg@nl.gt.com
Chaïd Dali-Ali	CDali-Ali@avocats-gt.com
Adriaan Bijleveld	Adriaan.bijleveld@nl.gt.com

⁴ OECD 2017 Transfer Pricing Guidelines, Chapter 1 under section D.6.