

# Tax Challenges of Digitalisation

## Comments Received on the Request for Input - Part II

25 October 2017

Write to us  
[ctp.contact@oecd.org](mailto:ctp.contact@oecd.org)

Visit our website  
[www.oecd.org/tax](http://www.oecd.org/tax)

Follow us  
[@OECDtax](https://twitter.com/OECDtax)



## TABLE OF CONTENTS

### PART 2

Ibec	3
ICAEW	11
ICC	20
IHG	25
Informa	30
Informa- Action 1	39
Informa- GF Response 20 December 2013	46
Institute for Austrian and International Tax Law (WU)	51
International Alliance for Principled Taxation	56
Irish Tax Institute	67
ITI	78
Japan Association of New Economy (JANE)	83
Jeffery M. Kadet – Submission 1	84
Jeffery M. Kadet – Submission 2	113
KPMG	116
Loyens Loeff	134
Ludovici Piccone & Partners	144
Maisto e Associati	151
MEDEF	166
National Foreign Trade Council	169
NERA	175
Orontes Mariani	181
Oxford University Centre for Business Taxation	183
Padam Khincha & Shivanand	185
Porus Kaka	189
PwC	194
Silicon Valley Tax Directors Group	207
SJD Candidates – Levin College of Law	216
Sony	224
Spotify	227
Tax Executives Institute Inc	237
Tax Justice Network Israel	243
Telefonica	251
United States Council for International Business (USCIB)	267
Universidad de Castilla-La Mancha	275
University of Lausanne, IBFD, KU Leuven	
International Observatory on the Taxation of the Digital Economy	279
University of Mannheim	305



# **Submission to the Task Force on the Digital Economy addressing the tax challenges of the digital economy**

**October 2017**

**By e-mail:** [TFDE@oecd.org](mailto:TFDE@oecd.org)

13 October 2017

Ref: Draft outline of the interim report to the G20 ministers addressing the tax challenges of the digital economy

Dear Sir/Madam,

I am pleased to communicate the views of Ibec and its members on the issues surrounding the draft outline of the interim report to the G20 Ministers on addressing the tax challenges of the digital economy. Ibec represents the interests of Irish business including indigenous and multinational enterprises and SMEs, spanning all sectors of the Irish economy. Ibec and its sector associations work with government and policy makers at national and international level to shape business conditions and drive economic growth.

### **General comments**

Ibec as evidenced through its interaction on the OECD BEPS initiative is actively supportive of international tax initiatives which seek to align profit with substance worldwide. In addition, Ibec and its members are in favour of initiatives which seek to provide business with the tax environment it needs to support growth and investment. The importance of the taxation of digital activity in this respect should not be underestimated.

The digital economy may be defined as the contribution to total economic output derived from many digital 'inputs'. These inputs include: digital infrastructure, digital applications, digital skills, policy and conditions that leverage the use of digital technologies to enable greater productivity and growth in the economy. Ibec welcomed the conclusion in the OECD report on BEPS action 1 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"*.

Ibec considers that the digital economy has become an intrinsic element of the broader global economy and of many businesses driven by business and consumer activity. Many of the previous boundaries that existed between digital and 'traditional' or 'bricks and mortar' service providers are rapidly dissolving as enterprises across all sectors increase their online presence/services to generate more business by reaching new customers and markets but also to reduce costs.

As outlined in the draft questions, the growth and adoption of new digital technologies is happening at a rapid pace. Most often this growth is now blurring the line not only between digital and services but increasingly between digital and goods trade. As recognised in the draft, the growth of the internet of things, 3D printing and other hybrid technologies will mean this will only grow in the future.

In ongoing discussions about the digital economy, it is important to look to the future and ensure that tax policy facilitates and supports continued future growth. Establishing a separate framework for taxation to be levied on the digital economy would not only run contrary to the principle of

neutrality (as set out in the Ottawa Taxation Framework) but would become increasingly unworkable as growing numbers of 'pre-digital' businesses diversify their activities to offer more choice and better services to consumers. Fundamentally our view is at one with the view set out in the Ottawa Taxation Framework that:

*"Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation."*

Where BEPS issues do emerge, it is our continued view that issues which are particularly relevant to digital intensive firms will need to be dealt with as a coherent part of the overall BEPS framework. Abandoning the hard-won multilateral agreement on definitions of 'substance' and applications of tax rules is in our view a poor approach to a complex issue. Unilateral moves by certain countries aimed at the 'digital economy' will only serve to undermine the great achievements of the BEPS project and in some cases run directly contrary to it.

The rapid digitisation of all sectors, the rise of cross-border online services and commerce and growth of the use of information technology within companies and the broader economy mean that carve-outs or separate regimes for certain digital intensive sectors would become obsolete and potentially economically damaging within a short timeframe. We urge the Task Force on the Digital Economy (TFDE) to give these issues greater and more nuanced consideration than has been achieved in the political debate thus far.

## **Specific Views**

### **1. Digitisation, Business Models and Value Creation**

Empirical studies indicate that there is a statistically significant relationship between the digital density of an economy and increasing its productivity and growth. The World Economic Forum (WEF) reports a correlation between a country's uptake of digital technology and its impact on the economy and society.

Due to its pervasive nature, digital must not be viewed as just technological innovation or as a sector, but rather as an enabler of the broader economy and society. Digitisation spurs innovation in business models, creates new business ecosystems, promotes the transfer of knowledge across the economy and facilitates access to new markets. Economically, digital technology can boost productivity and reduce transaction and information costs.

This is particularly true for small globalised economies such as Ireland. The ICT sector contributed to a 4% increase in total labour productivity growth in Ireland in the period 2001-2013, against an average 2% OECD increase in the same period. The Irish tech sector also provides many positive spill-over effects in other companies and sectors at home and in the broader European economy. Digital can be a tool for marketing, connecting people and supporting value chains, including an 'App economy' in the EU that supports 1.57 million jobs. Digital transformation can improve public

services and complement policy and investment decisions in transport, energy, education and health systems by making them smarter to improve efficiencies and benefit consumers.

It is also important to highlight several key points about the scope and reach of the digital economy;

- the digital economy delivers greater choice, competitiveness/price benefits and convenience to consumers, particularly in remote locations or to groups of customers who may face difficulty in physically accessing ‘traditional’ services;
- digital and e-commerce services provide more and more users across the world with easy and cost-effective access to information services and to key resources in areas including education and health which can make a real and positive difference;
- for many young people, the consumption of online and related services exceeds that of non-digital services (but usage of digital services across all population sectors is growing);
- the digital economy gives many young people an opportunity to start their own business or secure skilled employment in a dynamic and growing sector of the economy at a time when youth unemployment levels in many EU and OECD states remain stubbornly high;
- the digital economy promotes cross-border trade and contributes to more sustainable growth and competition in a globalised economy;
- the sector has enormous potential to grow further.

It is therefore of critical importance that tax rules do not discourage businesses to trade, grow and deliver services to customers and markets by complicating or amending regulation that would specifically target digital enterprises. As such we welcome the comment in the consultation document making it clear that *“implementation of the BEPS package, especially BEPS Actions 3, 6, 7 and 8-10, would substantially address the BEPS issues exacerbated by digitalisation”*.

## **2. Challenges and Opportunities for Tax Systems**

Many of the regularly cited implications of a highly digitised economy on existing tax bases, structures of tax systems and the distribution of taxing rights as alluded to in the questionnaire are in our view overstated. Features of the digital economy that might differentiate it from the ‘traditional’ economy for taxation purposes are often applicable to approaches taken by many other ‘non-digital’ business sectors.

The business models prevalent in today’s digital economy are neither radical nor new (even though products and services may be), but are, in many instances, traditional business practices that have been modified to support the growth and development of the digital economy, just as other core business practices have historically been adapted or evolved to take account of factors including new technologies, changing social and demographic trends etc. Many of the issues raised are a product of the considerable R&D and innovation investment necessary to survive and thrive in the digital economy, the high levels of financial investment and risk involved in starting many new e-commerce enterprises, and the level of volatility in the sector driven by new and constantly evolving technology advances.

When it comes to the taxation rights of individual countries our central view is that the digital economy should be treated no different to any other sector of the economy as the business models at play are fundamentally not wholly different. When it comes to base erosion and profit shifting these challenges where they emerge for digital companies should be dealt with through BEPS

actions 3,6,7,8,9 and 10 as with other sectors. Our view is that these actions not just ‘substantially’ but wholly deal with such issues.

### **3. Options to address the broader direct tax policy challenges**

#### **Tax nexus concept of “significant economic presence”:**

Those engaged in digital business, like all business managers, consider a broad range of factors to inform decisions on the location of bases including local tax regimes and incentives, ease of doing business, availability and costs of skilled personnel, quality of infrastructure, political stability and other issues.

Ibec considers that the issue of a business providing customers with goods/services (digital or otherwise) in a market/jurisdiction without a physical presence is not unusual (particularly for smaller destination markets) and should not be an issue that requires any major deviations from current international tax policy as currently being implemented through BEPS. This does not apply only to the digital economy but to all sectors. Fundamentally our view is that corporate income tax should not be based on the customer’s location (although the country where the customer is located may choose to impose a consumption tax) but where the value is created.

Any moves which would alter current taxation rights away from a country which, under existing tax principles, can levy tax based on the function, assets and risks of a business, to other jurisdictions based on where consumption occurs (however measured), would have serious implications. Economies such as Ireland’s and many other OECD states of similar size with strong export bases but small domestic markets would face major difficulties. For business, the danger of double taxation would increase.

Ibec considers that the suggested nexus function runs counter to the Ottawa principles by proposing rules that would delineate ‘traditional’ business from the digital economy, therefore violating the neutrality principle. If income tax on dematerialized digital activities were applied, it could potentially result in double taxation and also affect the provision of digital economy goods and services to smaller markets or more remote economies.

The application of VAT on a broader range of deliveries of digital goods and services would be a better option of taxation than the proposals outlined. Indeed, Europe has already pushed ahead in this regard with 2015 changes to the taxation of digital services focusing the determination of the tax based on the final market. Our view is that this approach negates the need for many of the options discussed in the document and could be applied more widely and consistently globally. The TFDE could play a useful role in setting out a route to more consistent global standards in this regard.

Finally, the outline should emphasize the strong and positive competitiveness and knowledge benefits that the digital economy delivers to business and consumers in smaller and remote markets. Tax rules should support and encourage such access; new tax and administrative burdens unrelated to local profit or activity could achieve the opposite effect.

#### **Withholding tax on certain types of digital transactions**

This proposal again raises the issue of singling out specific types of payments which is effectively ring-fencing the digital economy. The options outlined could also lead to double taxation and, given

the low values of transactions, could be incredibly administratively burdensome. VAT or a broad consumption tax which does not differentiate between digital and non-digital services or the origin (domestic/foreign) of providers would be preferable.

### **Digital equalisation levy**

As with previous proposals this proposal again raises the issue of singling out the digital economy in breach of the neutrality principle. In addition, and as noted in the BEPS action 1 report it would also raise 'substantial questions' both with respect to trade agreements and with respect to EU law particularly when it comes to state-aid.

### **Unilateral tax changes**

Ibec remains concerned about the contrast between the BEPS work and unilateral proposals from Europe which are ill-conceived and damaging to multilateral tax reform. Ibec and Irish business is wholly opposed to the notions of turnover taxes, diverted profit taxes and other poorly constructed levies across Europe.

In the first instance, this would result in lower revenue from corporate profits in smaller countries (even those with substantial substance related to these profits). It would effectively result in a transfer of resources from smaller countries to larger ones. This would inevitably lead to other taxes being increased to offset this loss of revenue or services being reduced considerably. Either would be extremely damaging to Europe as whole, through deterioration of the business environment, and to the majority of the EU's member states. The only net beneficiaries of this process would be Member States with larger populations who are also large net importers of European goods. In the case of Ireland, which exports the greater part of its output to the larger central economies of the EU, companies would see part of their profits, apportioned to other larger, less globalised and less dynamic economies.

The fact that many of these constructs run directly contrary to the notion of 'substance' agreed through the BEPS process is a particular worry in this regard. Given the complex issues already at hand we feel the timing of these interventions is less than helpful. Member States time would be better served ensuring the coherent implementation of the BEPS process across EU states rather than engaging in a round of unilateral moves which are ultimately poorly designed.

Taxation based on turnover is an idea which has long been avoided in international tax standards for good reason. The notion would undermine the growth of new and smaller business trading across borders (particularly those who are pre-profit or have minimal profit), it would reduce investment in new firms and would discriminate heavily against companies in low margin, slow growth and capital-intensive sectors such as food and manufacturing.

We believe it is essential that any proposals in this area are agreed internationally through the OECD. This will ensure European companies' competitiveness and guarantee global consistency in an international level playing field, whilst respecting Member States' competences to set their own tax policies

## **Concluding remarks**

Ibec sincerely thanks the TFDE for the opportunity provided to outline the views of its members on this draft paper and would be pleased to elaborate on the issues raised in this submission if required. Ibec looks forward to further future engagement with the TFDE on this and other issues.

Yours sincerely,

---

Gerard Brady  
Head of Tax and Fiscal Policy

**Ibec Head Office**

84/86 Lower Baggot Street  
Dublin 2  
T: + 353 1 605 1500  
E: [membership@ibec.ie](mailto:membership@ibec.ie)  
W: [www.ibec.ie/membership](http://www.ibec.ie/membership)

**Galway**

Ross House  
Victoria Place  
Galway  
T: + 353 91 561109  
E: [west@ibec.ie](mailto:west@ibec.ie)  
W: [www.ibec.ie/west](http://www.ibec.ie/west)

**Cork**

Knockrea House  
Douglas Road  
Cork  
T: + 353 21 4295511  
E: [cork@ibec.ie](mailto:cork@ibec.ie)  
W: [www.ibec.ie/cork](http://www.ibec.ie/cork)

**Ibec Europe**

Avenue de Cortenbergh  
89, Box 2  
B-1000 Brussels  
BELGIUM  
T: + 32 (0)2 512.33.33  
F: + 32 (0)2 512.13.53  
E: [europe@ibec.ie](mailto:europe@ibec.ie)  
W: [www.ibec.ie/europe](http://www.ibec.ie/europe)

**Limerick**

Gardner House Bank Place  
Charlotte Quay Limerick  
T: + 353 61 410411  
E: [midwest@ibec.ie](mailto:midwest@ibec.ie)  
W: [www.ibec.ie/midwest](http://www.ibec.ie/midwest)

**Donegal**

3rd Floor, Pier One Quay Street  
Donegal Town Donegal  
T: + 353 74 9722474  
E: [northwest@ibec.ie](mailto:northwest@ibec.ie)  
W: [www.ibec.ie/northwest](http://www.ibec.ie/northwest)

**Waterford**

Business Park Cork Road  
Waterford  
T: + 353 51 331260  
E: [southeast@ibec.ie](mailto:southeast@ibec.ie)  
W: [www.ibec.ie/southeast](http://www.ibec.ie/southeast)



# ICAEW REPRESENTATION 111/17

## TAX REPRESENTATION

### TAX CHALLENGES OF THE DIGITALIZED ECONOMY

ICAEW welcomes the opportunity to comment on the Request for Input on work regarding the Tax Challenges of the Digital Economy published OECD on 21 September 2017.

This response of 13 October 2017 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

### Contents

	Paragraphs
Introduction	1 - 3
Section A – Digitalisation, Business Models and Value Creation	4 – 6
Section B – Challenges and Opportunities for Tax Systems	7 – 14
Section C – Implementation of the BEPS package	15 – 18
Section D – Options to address the broader direct tax policy challenges	19 – 24
Annex – Unilateral country actions targeting the digital economy	25 - 33
Ten Tenets for a Better Tax System	Appendix 1

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 147,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

Copyright © ICAEW 2017  
All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is appropriately attributed, replicated accurately and is not used in a misleading context;
- the source of the extract or document is acknowledged and the title and ICAEW reference number are quoted.

Where third-party copyright material has been identified application for permission must be made to the copyright holder.

For more information, please contact ICAEW Tax Faculty: [taxfac@icaew.com](mailto:taxfac@icaew.com)

[icaew.com](http://icaew.com)

## INTRODUCTION

1. In the time available, three weeks, between the issue of the Request for Input on 21 September and the deadline for comment of 13 October it has not been possible to consult with ICAEW members to provide a response to the detailed policy design questions in section D nor to provide detailed comments on the broad range of questions in sections A to C of this Request for Input.
2. We have, however, set down some general remarks which we hope will be helpful.
3. As noted below the European Commission has also just published its own paper A Fair and Efficient Tax System in the European Union for the Digital Single Market and it will be absolutely essential for any measures agreed amongst the EU member countries to be consistent with any proposals from the OECD and vice versa.

## OUTLINE OF THE INTERIM REPORT FOR THE G20 FINANCE MINISTERS

4. We welcome the publication of the Outline of the Interim Report for the G20 Finance Ministers and in particular Chapter II which will contain an “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).”
5. 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.
6. It will also be helpful if the Interim Report identifies the pros and the cons of the different taxing options set out so that policy makers, business and tax advisers can be clear on the potential implications of the different policy options.

## SECTION A – DIGITALISATION, BUSINESS MODELS AND VALUE CREATION

### The success and failure of digital businesses

7. The internet came into being about 50 years ago and the World Wide Web (WWW) some 25 years ago and the digitalisation of the economy began with the WWW. During the three week period of this OECD “Request for Input” Google, of which the parent company is now called Alphabet, celebrated its 19th birthday: it was founded in 1998. Other major corporates of the more digital part of the economy include Amazon and Facebook which are 13, Netflix 12 and Twitter 11 years old.
8. Many of the early 1990s pioneers of the digital part of the economy failed to sustain their early success and a considerable number went out of business in the dotcom “bust” of 2000.
9. Current success is no guarantee that it will continue into the future and any major taxation moves need to consider the potential consequences of disruption certainly to the smaller and more fragile part of this market.
10. It is also worth considering whether imposing extra taxes on particular ways of doing business may discourage innovation and risk taking when there is a need for greater productivity in many economies in the world.

11. Nevertheless today's digital part of the market place is characterised by some hugely successful digital businesses which are dominant in their part of that market place eg : online advertising – Google; movies – Netflix; retail – Amazon & ebay; travel – Priceline, Expedia & Booking.com; consumer asset sharing – Airbnb, Uber & Lyft.
12. There is a public concern that some of these successful businesses are not making a sufficient contribution to the public finances by way of taxation on their profits. On the front page of the Financial Times, Thursday 12 October 2017, is the latest of a long line of articles about the tax position of internet businesses *Netflix and eBay spark renewed tax scrutiny after paying £1.9m*. This was followed on the next day by a lead editorial in the Financial Times *Netflix and eBay find the holes in the UK tax net* which concludes "the current system is manifestly unsatisfactory".

### Different business models

13. The recent European Commission Communication to the European Parliament and the Council on "A fair and efficient tax system in the EU for the Digital Single Market", published on 21 September 2017, puts forward four examples of the currently recognised new ways of doing business, accepting that its list is non-exhaustive (businesses in addition are increasingly operating multiple business models within the same legal entity):

**Online retailer model**, whereby online platforms sell goods or connect buyers and sellers in return for a transaction or placement fee or a commission. Examples of businesses include Amazon, Zalando, Alibaba.

**Social media model**, whereby network owners rely on advertising revenues by delivering targeted marketing messages to consumers. Examples of businesses include Facebook, Xing, Qzone.

**Subscription model**, whereby platforms charge subscription fee for continued access to a digital service (e.g. music or videos). Examples of businesses include Netflix, Spotify, iQiyi.

**Collaborative platform model**, whereby digital platforms connect spare capacity and demand, use reputational currency mechanisms to underpin consumption, and enable individuals to share "access" to assets rather than own them outright. Platforms charge a fixed or variable fee on each transaction. Examples of businesses include Airbnb, Blablacar, Didi Chuxing.

14. With many companies operating a number of distinct business models within their own businesses this demonstrates how difficult it is going to be to design any additional taxation mechanisms to do justice to the variety of digital business models: the attempt could prove as doomed to failure as Sisyphus pushing his boulder up a hill in Greek Mythology.

### SECTION B – CHALLENGES AND OPPORTUNITIES FOR TAX SYSTEMS

15. It is undoubtedly true that digital is likely to continue to be an increasing part of national economies, and of the global economy, and there are some legitimate concerns that the existing (and future) business models are sufficiently different from those of the past for the current national, and international, tax systems to have great difficulty in taxing them in a way which supports the public finances and addresses public concerns which are to ensure that all significant participants in the global economy are paying what might be considered to be their "fair share" of tax.
16. But policy makers also need to recognise that many countries have refashioned their tax systems in recent years, not least to recognise the difficulty of identifying and taxing profits and have increased the taxation of, for instance, labour, property and sales (VAT). In the UK the annual studies of PwC into the tax borne by the largest UK businesses have shown a decline in corporate income tax from 50% of taxes borne to less than 20% in the latest, 2016, report.

But this has not totally overturned the complaint that international businesses are in a better position to take advantage of faults in the existing tax regime to pay less tax than their purely domestically based competitors.

17. The digitalisation of the economy is also being mirrored by the work of tax administrations in digitalising their tax systems which is featured in the continuing work of the OECD Forum on Tax Administration.
18. The first chapter of the recently published Tax Administration 2017 is entitled “The changing face of tax administration” and the Executive Summary states “Simplifying tax requirements - without exception tax services or customer strategies are looking to incorporate design approaches that include mobile and digital solutions that best fit the taxpayers preferred means of engagement.”

## **SECTION C – IMPLEMENTATION OF THE BEPS PACKAGE**

19. At the time the main BEPS report on the Digital Economy (Action 1) was published in late 2015, along with all the other BEPS reports, it was felt that the other measures would go a considerable way to addressing the potential lack of taxation of the digital part of the economy.
20. The OECD Secretary General’s Report to the G20 Summit in July 2017 included, as Annex 1, a Progress Report on the Inclusive Framework on BEPS, July 2016 to June 2017. At page 24 it stated:

“There was clear agreement [in the final BEPS 2015 report on the Digital Economy] that the consistent and widespread implementation of the BEPS package would address many of the double non-taxation concerns raised by digitalisation.”

21. The UK has introduced, or is in the process of introducing, all the minimum standards outlined in the BEPS Action Plan 2015 report but it is too early to gauge the success of those measures in combating base erosion and profit shifting and addressing the particular challenges posed by the digitalisation of business.
22. When these BEPS measures have been introduced in more countries this will require increased judgement in the application of, for instance, the transfer pricing rules and there are likely to be more disputes so it will be extremely important to ensure that dispute resolution mechanisms are improved and are fit for purpose.
23. In relation to C.2 there is increasing agreement that the rules for determining where VAT is due should be based on the destination principle but the effective implementation of this rule will require a consensus on the practicalities: the who, where and when to ensure the VAT due is actually collected. We are aware that discussions are ongoing at OECD on these complex issues and we aim to participate in this continuing debate.
24. The UK also introduced a unilateral measure, the Diverted Profits Tax, more than two years ago and we comment on that in section D below.

## **SECTION D – OPTIONS TO ADDRESS THE BROADER DIRECT TAX POLICY CHALLENGES**

25. Although the potential taxing options included in the current Request for Input were considered in the 2015 Report none of them was recommended for incorporation in domestic tax regimes because, to quote from the July 2017 report:  
“...further calibration of the options would be needed”

and because, as noted above, other BEPS measures were likely to mitigate the problem.

26. In our view there needs to be more analysis of the nature of the most successful digitalised business models which are the subject of adverse public comments and which have the greatest impact on the public finances of individual countries. Only on the basis of a detailed analysis of current digital business models should new tax policies be recommended by OECD. We hope that such an analysis will be contained in the next report of the Task Force on the Digitalised Economy as set out in the Outline on which we have commented at the beginning of this response.
27. Until such analysis has been completed and communicated to the outside world we do not believe we can put forward meaningful answers to the questions posed in the current “Request for Input”.
28. It may, however, be helpful to make some general comments.
29. We think there should be a substantial threshold before any new measures come into operation, for instance in France for the youtube tax the threshold is €100k per year, so that only the largest highly digitalised businesses are potentially “caught” by such measures. Such provisions need to ensure they do not breach, for instance, EU non-discrimination rules.
30. There should be appropriate exemption mechanisms so that if tax is paid under such new measures there will be appropriate exemption to avoid the risk of double taxation.
31. If there is to be an extension of the existing treaty definition of permanent establishment to include activity carried out by digital means, referred to as “tax nexus concept of “significant economic presence”” then this may best be defined around a revenue based factor and there will need to be adjustments to the profit attribution rules to minimise incremental compliance costs

#### **Other tax measures that have already been introduced**

32. 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 scope of 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.
33. We are aware of a number of other countries that have introduced unilateral measures and it would be helpful for OECD to collate a comprehensive list and at the same time to discourage other countries from following suit as such unilateral action is likely to lead to double taxation, more cross border tax disputes and be detrimental to international trade.

## Annex – Unilateral country actions targeting the digital economy<sup>1</sup>

This is not intended as an exhaustive list but is intended to give some indication of some measures that have been taken, or considered, by other countries. It is reproduced with the permission of an ICAEW member who edits a publication for IBFD and the footnote indicated that use of the material requires IBFD prior permission.

### France

In 2012 the French government commissioned a report on the taxation of the digital economy from Pierre Colin & Nicolas Collin which was published in January 2013, see [http://www.hldataprotection.com/files/2013/06/Taxation\\_Digital\\_Economy.pdf](http://www.hldataprotection.com/files/2013/06/Taxation_Digital_Economy.pdf).

More recently the Economic and Finance Ministry has issued a Press Release supporting the idea of a taxable digital presence.

### Indonesia

There is a plan to subject e-commerce transactions to a withholding tax.

### India

A 27 May 2016 notification by the Indian government provides for a 6% equalization levy to be withheld by Indian residents and PEs from business-to-business payments to a non-resident service provider for specified digital services. These include online advertisements, digital advertising space and any other service which may be notified later. The scope of the tax could therefore be quite wide. On the basis that the levy is not an income tax, the government considers it outside the ambit of India's tax treaties and it may not qualify as a foreign tax credit in the recipient's jurisdiction. There is an exemption for payments of less than INR 100,000 per year.

### Israel

On 11 April 2016, the Israel tax authorities issued final Circular 04/2016 on Internet activity that will deem a foreign company to have an Israeli PE if it has premises or representation in Israel and a "significant digital presence" involving Israeli users. This involves online activities that include, for example, the following:

- substantial advertising, marketing and customer relations management;
- Service contracts signed online by Israeli consumers;
- the use of online services by Israeli consumers; and
- websites operated in Hebrew or that offer Israeli currency payment options.

In the absence of any physical presence, a tax treaty should still provide exemption as lacking a PE. Preparatory and auxiliary activities such as mere advertising should also be treaty protected. However, it is thought that the Israeli tax authorities will take an aggressive attitude towards the treaty exemption claims.

Non-treaty residents are much more vulnerable to attack because Israeli domestic legislation does not require the existence of a PE but merely the conduct of business in Israel.

Finally, Israel imposes a 25% withholding tax on all payments made to non-residents, failing an exemption or reduction certificate issued by the tax authorities. Companies providing online services to Israeli consumers are likely to face the possibility of customers wishing to withhold tax from payments should the tax authorities refuse to issue an exemption certificate. In this regard, it is thought that the tax authorities will take an aggressive attitude towards any treaty claim regarding the application of the PE exemption.

---

<sup>1</sup> The information provided in this Annex is under IBFD copyright, derived from the International Tax Structuring publication on <https://www.ibfd.org/IBFD-Tax-Portal>, reproduced with permission. It should not be used without permission from IBFD.

### **Italy**

Italy is considering a 25% withholding tax on the basis of a virtual PE based on Significant Digital Presence. On 24 April 2017, Italy released a new bill for public consultation (DL 24 April 2017, No.50) aimed at establishing a mechanism to tax internet based activities.

### **Taiwan**

Taiwan is considering a withholding tax.

### **Thailand**

A draft bill for banks as agents to withhold 5% from online purchases is being reviewed by the Finance Minister. It is also understood that proposals for draft legislation have been released that would directly tax foreign companies operating business digitally.

### **Turkey**

On 7 September 2016 Turkey proposed a law imposing tax on payments made through an electronic place of business and other online activities.

### **United States**

The US 2017 Budget included proposals to create a new category of Subpart F (CFC) foreign base company digital income from a controlled foreign company's lease or sale of a digital copyrighted article or from the provision of digital services where the relevant intangible property was developed by a related party and the CFC's employees do not make a substantial contribution to the development of the intangible property that gives rise to the income.

### **A "Virtual Service" or Significant Digital Presence" Permanent Establishment**

Kuwait's and Saudi Arabia's tax authorities have introduced the concept of a "Virtual Services PE" deemed to exist with no physical presence but the rendering of services for more than the tax treaty threshold period (usually 183 days). There remains the question of whether a tax treaty exemption will be respected or whether these measures amount to a treaty override. In fact, Saudi Arabia has confirmed that a tax treaty will continue to take precedence.

## APPENDIX 1

### ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see <http://www.icaew.com/-/media/corporate/files/technical/tax/tax-news/taxguides/taxguide-0499.ashx>).



## **Draft ICC Comments on OECD request for input on work regarding the tax challenges of the digitalised economy**

ICC appreciates the opportunity to provide input on the OECD consultation regarding the tax challenges of the digitalised economy. ICC fully supports a harmonised approach to ensure that international tax rules remain relevant and applicable in an increasingly digitalised global economy. ICC therefore welcomes the OECD initiative to explore the tax challenges raised by digitalisation in preparation for the interim report to the G20 in April 2018 setting out possible solutions to taxing the digital economy at international level.

### **General comments**

The digital economy is not only revolutionising the way businesses operate but also creates new opportunities for global growth and prosperity. 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. As digitalisation continues to be an important driver for global economic growth, ICC strongly believes that any discussions around the taxation of the digital economy should promote, and not hinder, growth and cross-border trade and investment. Furthermore, a collaborative approach together with business would be highly recommended, in order to fully grasp the challenges, implications, opportunities and solutions that the digital economy presents. For the ICC business community, the integrity of the international tax system is of critical importance - coherent and coordinated implementation of international guidelines are essential in establishing a consistent global tax system that better facilitates cross-border trade and economic growth.

ICC supports the OECD Base Erosion and Profit Shifting (BEPS) Action 1 Report conclusions 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 digital economy and its business models present however some key features which are potentially relevant from a tax perspective."* It is our view that a separate taxing system for digital companies could be fraught with challenges that would create uncertainty and negative consequences for economic growth and cross-border trade and investment. The underlying issue that digitalisation presents with respect to the concept of economic presence and the interaction with the notion of permanent establishment will need to be broached at international level with a view to achieving global consensus, as opposed to counter-productive unilateral measures. As the digital economy is increasingly becoming the economy itself, any special measures for the digital economy will effectively change the international tax rules for the entire economy; therefore careful consideration, involving the entire business community, must be given to any changes.

\* \* \*

### **Responses to specific questions raised**

#### **A. Digitalisation, Business Models and Value Creation**

##### **A.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)**

ICC believes that it is important to stay true to the basic principles of taxation as significant changes to an existing system could lead to greater disruption, which would be counter-productive for all stakeholders including businesses, governments or consumers. The rapid evolution of digitalisation has permeated many spectrums of life, including the way that businesses operate today. However, to a large degree, these changes provide alternative means to completing commercial transactions which were traditionally undertaken physically. These activities do not simply create a presence that could lead to taxation in a country where the user or buyer would be located, but rather a significant presence in the location of product and service development and cloud computing infrastructure.



Therefore, a different means of achieving the same result should neither alter the conclusion on taxable presence, nor the characterisation of income.

This aspect is an important consideration, given that the basic principle of taxation rests on the fact that activities give rise to incomes and such incomes should be taxable in the jurisdiction in which the activities are undertaken. While digitalisation results in automating activities and functions through the use of software and systems, there are identifiable locations from where the software and systems operate. This could either be the location of the hardware or the people who develop, operate, and manage the software and systems. Traditional taxation mechanics are applicable for the digitalised economy insofar as these require appropriate value to be allocated to these functions, which can be achieved through an improved and simplified application of the transfer pricing provisions. As global reporting becomes more transparent, the functional distribution should result in each country where activities are undertaken receiving an appropriate return which may be subjected to income taxation. ICC reiterates the need to ensure that national governments reach acceptable consensus such that businesses are not burdened with overbearing, complex compliance requirements or uncertainty.

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

With respect to retail business, the prevalent issue relates to the absence of an effective international framework to ensure VAT collection in the market jurisdiction. Cross-border trade in goods, services and intangibles creates challenges for VAT particularly where products are acquired by private consumers from suppliers abroad. The digital economy raises policy challenges regarding the collection of VAT. For example, the proliferation of online sellers provides challenges to the collection and payment of VAT. In order to implement an effective and efficient collection process of VAT, ICC believes that administrative co-operation between countries should be strengthened. Over the past few decades *International VAT/GST guidelines* have adequately served as a preliminary response to the growth of cross-border trade and the corresponding risk of inconsistencies between different VAT systems applying different tax treatments, however, it is ICC's view that further guidance to address the evolution of the digital economy would be needed.

### **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:*
- 2
  - 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?*

As the focus on the digital economy tax debate is on taxing remote sales by the country of consumption, if a business is reporting local sales on its local income tax return, none of the suggested options should apply. A 'significant economic presence' (SEP) concept is a fundamental change to the existing permanent establishment framework and, as the digital economy is increasingly becoming the economy itself, would represent a significant change in taxation for all businesses. It should only be considered in connection with a consideration of the rules that would attribute profit to a SEP PE. If a SEP PE is based solely on local revenue, it would seem to attract profit no higher than an entity performing limited distribution functions would earn. If the SEP taxation is truly based on net income, it seems to better align with the existing principles of taxation.

This option may have the least amount of disruption, compared to the other two options of a withholding tax or an equalization levy. A significant economic presence could make the case for a 'permanent establishment' (PE), of which the taxation principles, including attribution of profit are sufficiently defined and implemented. It would be important to note, however, that there is still concern regarding countries seeking to tax a digital presence in the absence of any other activities. Such wide extension of the PE concept would also lead to uncontrolled double taxation.

For smooth implementation, ICC suggests that a detailed commentary on the principles under which such significant economic presence could result in a PE, together with the proposed rules to attribute profit to the SEP PE, could be provided and updated intermittently as business models evolve. This would help reduce business uncertainty and the incremental cost of doing business in a cross-border framework.

#### **D.1 c) Digital equalisation levy:**

- v. *What transactions should be included within its scope?*
- vi. *How could the negative impacts of gross basis taxation be mitigated?*
- vii. *How could the threat of double taxation be mitigated?*
- viii. *How could such a measure be efficiently and effectively implemented in practice?*

Countries where an equalisation levy has been adopted (e.g. India) have experienced greater uncertainty and cost to businesses. The levy is introduced outside of the existing income tax law, which raises questions on treaty coverage of it. A unilateral levy would therefore be a cost to business, require separate administrative intervention/compliance and make the taxation system more onerous. In India, whilst the current scope of the levy is restricted to online advertising related services, an increase in the scope would undoubtedly create greater uncertainty and disruption.

It is important to bear in mind that achieving an outcome that promotes growth and appropriately divides the tax base among countries requires a consensus based approach and any unilateral actions at a national or regional level would only create complexities for businesses with little or no effective resolutions. In addition, there is a risk of double taxation if one country imposes a tax, such as an equalisation levy, which is outside the framework of double tax agreements.

The digitalisation of the economy raises challenging issues. A rush to address those issues could result in a large part of the economy being subject to unilateral actions. There is also a likelihood that imposing an equalisation levy could increase costs to local consumers, depending on the economics. In such cases, this is clearly not the best solution, as it simply increases the tax burden on local consumers. ICC holds that there is an urgent need for countries to collectively discuss and



resolve this issue through mutual consensus, as opposed to unilateral actions. ICC reiterates that any solutions should have broader adoption by countries to allow for a seamless application for businesses.

\* \* \*

As was discussed during the work on BEPS Action 1, there is insufficient understanding of the incidence of direct and indirect taxes and ICC believes that this would be worth researching further as work on the taxation of the digital economy progresses. Annex E of the Action 1 Final Report addresses the economic incidence of the options to address the broader direct tax challenges of the digital economy. That analysis, however, proceeds from the assumption that changes are adopted in a global coordinated step such that relative tax rates are unchanged. In the absence of global coordinated adoption, the incidence of taxation might be very different. ICC offers its knowledge and experience to assist in presenting business views on further issues and discussion drafts in this area.



## **The International Chamber of Commerce (ICC) Commission on Taxation**

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy.

Founded in 1919, and with interests spanning every sector of private enterprise, ICC's global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.

OECD Tax Challenges of the Digitalised Economy workstream  
(sent via email to TFDE@oecd.org)

2 October 2017

Dear Sir or Madam,

# REQUEST FOR INPUT ON WORK REGARDING THE TAX CHALLENGES OF THE DIGITAL ECONOMY

IHG welcomes the opportunity to provide input for work regarding the tax challenges of the digitalized economy pursuant to the release issued on 22<sup>nd</sup> September 2017.

## About IHG

IHG® (InterContinental Hotels Group) [LON:IHG, NYSE:IHG (ADRs)] is a global organisation with a broad portfolio of hotel brands, including InterContinental® Hotels & Resorts, Kimpton® Hotels & Restaurants, HUALUXE™ Hotels and Resorts, Crowne Plaza® Hotels & Resorts, Hotel Indigo®, EVEN® Hotels, Holiday Inn® Hotels & Resorts, Holiday Inn Express®, Staybridge Suites® and Candlewood Suites®.

InterContinental Hotels Group PLC is the Group's holding company and is incorporated in Great Britain and registered in England and Wales. More than 350,000 people work across IHG's hotels and corporate offices globally.

## Overview and background comments

1. Given the exceptional complexity of the issues under review, and the short timescale available to provide considered input, it would not be practical or constructive for us to attempt to provide a response concerning all areas. Our comments therefore focus narrowly on commercial and tax issues associated with the fragmentation of sales and fulfilment functions which has been facilitated by digital functionality, and on issues associated with the use of a withholding tax on certain types of digital transactions (ie. Input area D.1 b).
2. In any consideration of issues associated with the digitalised economy it is appropriate to start with a recognition and appreciation of the functional benefits which digital developments have



\*IHG® Rewards Club not applicable to Kimpton® Hotels & Restaurants; to be included at a future date

brought, and of the commercial developments which that has lead to. At the core of that is an almost instantaneous communication speed which makes it possible to perform functions at a distance.

3. One commercial benefit of that instantaneous communication, particularly when combined with increased analytical and processing capacity and speed, is that it enables commercial consolidations and efficiencies to be secured via regional or global business service centres, or similar specialist centres or centres of excellence. Whereas there are issues and challenges which are posed for international tax systems by such cost related developments, we suggest that those are, in general, challenges which current international tax approaches, with appropriate tweaks and updates, can cope with.
4. Our understanding is that the current tax (and non-tax) challenges and difficulties principally arise because digital functionality has given rise to a much more significant degree of commercial separation between the sales and fulfilment functions. That reflects both what is functionally possible (ie. performing sales functions at a distance) but also that, for most B to C businesses, customers will increasingly look to online comparison and review sites, and to online sales and marketing channels, as their primary sources and channels for purchases.
5. At a first order level that separation of sales and fulfilment functions, combined with the consolidation and efficiency benefits of using regional or global centres, may increasingly result in sales functions which-as a practical matter- would previously have had to be locally based functions, no longer being so- and hence in activities and taxable profits arising elsewhere. It has also resulted increasingly in what would have been in house sales functions being conducted by third parties who act as intermediaries across entire business sectors. At a second order level, where barriers to entry or other factors (including tax factors) result in either limited competitive pressures or other advantages for those conducting these third-party sales functions, that may result in the proportion of profits for those engaged in the fulfilment functions being put under pressure. That can have both a direct impact on local taxation (i.e. lower taxable profits of the fulfilment function) and an indirect impact (e.g. that level of fulfilment profit then representing the comparable in a commissionaire or similar structure).
6. Within our own industry one of the ways in which the competitive tension between that fulfilment function (i.e. hotel stays) and third party sales functions is maintained is by hotel participation in collectively funded marketing and sales programmes and activities (eg. Loyalty programmes, funding of reservation centres and online reservation facilities) for hotels operating under the same brand or umbrella groupings. Those marketing activities will typically be operated and administered by IHG, or other relevant hotel franchise and management groups, but as support services which are collectively funded by third party participating hotels, rather than as profit centres. The core 'for profit' fees are in contrast franchise or equivalent fees, and management fees.
7. The point that this is intended to illustrate is that what may appear to be formally similar services (e.g. online booking services) may play a very different role in different business contexts e.g. as a 'for profit' commission to an online travel agent or as effectively a cost sharing assessment or reimbursement paid by a participating hotel. For any digital tax measures to be able to operate as a tax on profit -and not as a toll charge on cost centres of local fulfilment or other businesses which are already taxed locally- those measures must be capable of distinguishing between such different profiles.
8. We understand that this is the type of aspect recognised in the 2015 report, where it was acknowledged that it would be difficult, if not impossible, to 'ring-fence' the digital economy for tax purposes because of the increasingly pervasive nature of digitalisation. We recognise however that the OECD has been tasked with trying to identify appropriately targeted options which try and surmount this difficulty and facilitate a co-ordinated international approach rather than uncoordinated unilateral action. We support the objective of achieving a coordinated

consensus and provide comments below on the specific option of using a withholding tax based approach. We do not intend by that to express support for this particular option over others-or indeed to pre-empt discussion as to whether existing measures are already sufficient. We do however consider that we are well placed to provide constructive comment concerning a withholding tax option, as there are a number of jurisdictions in which we are already subject to withholding taxes (or similar 'deemed profit taxes') on some categories of our third party fee streams.

**QUESTION D.1. b) -Option of withholding tax on certain types of digital transactions**

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

(a) As commented we would not wish to express support for either a withholding tax or an alternative option as opposed to commenting concerning possible issues if a withholding tax approach were to be adopted.

(b) As a general practical matter we are familiar with the use of withholding tax mechanisms in B to B transactions where, for the local authority, they have the benefit of simplicity but, for the recipient, they have the disadvantage noted of being a gross withholding rather than a profit based tax. As a result withholding taxes often translate to high effective tax rates on profits, particularly when applied -as is increasingly the case- to revenues from active businesses rather than to pure income profit streams. For example, a 10% withholding on fees where the underlying profit margin is 25% translates to a 40% local tax rate. In such cases there can be a misallocation of excessive taxing rights to the local jurisdiction or even a de facto barrier to competition from non-local providers.

(c) These adverse features are exacerbated in the context of modern businesses because, whereas the taxable profits of the recipient group will effectively be allocated amongst various entities in accordance with transfer pricing principles, the associated foreign tax credit 'sticks' in the individual recipient entity. Thus if 15% of the above 25% profit margin remains in the recipient after paying appropriate intra-group charges made to it, then the withholding tax will represent a 66% tax charge from the perspective of that recipient- whereas the other 10 of group profit margin will still be taxed elsewhere without credit.

(d) In the above example -which is far from extreme- a 10% withholding tax is likely to translate to a circa 70% effective tax rate. If, in addition to a 10% withholding tax on 'for profit' fees, a 10% withholding tax were applied to an equivalent amount of sales and marketing programme assessments/reimbursements, then the combined effective tax rate on profit would approach 100%.

(e) These adverse features may become yet further exacerbated by interest restrictions introduced pursuant to BEPS Action 4. For example, the UK's implementation of Action 4 excludes from profits an amount equivalent to the grossed-up amount of third party income subject to withholding taxes when computing the Action 4 interest limitation. This is on the grounds that withholding taxes allocate the associated taxing rights to the overseas jurisdiction. As the recipient group's interest expense cannot reduce third party withholding taxes this operates as a principle that a proportion of interest expense should be denied tax relief anywhere for any group which conducts third party business on which withholding taxes are suffered.

(f) We assume that the intention of a digital withholding tax option would be to subject 'for profit' payments for digital services to withholding taxes at a rate which was intended to allocate an appropriate share of taxing rights to the local jurisdiction. What may be the appropriate rate to achieve that objective would of course depend on the function and profit margin/profile of the fees concerned, as well as the specific factors discussed above. As we note there may however be material variations in the underlying functional and profit profiles concerned. Indeed, even in the case of pure 'for profit' digital businesses, a decision would be needed as to whether to take a snapshot view or assume a particular profit profile over time e.g. if business models involve incurring losses as an investment to secure a market position which can then be profitably exploited at a later date. And

(g) We assume that a registration and self-assessment or other mechanism would be required to deal with direct B to C business, but are not fully clear as to what is envisaged under the option outlined in the release.

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

(a) We believe that a significant number of modifications and reliefs would be required, both with respect to current international norms for tax credit relief, and with respect to the detailed drafting of the withholding tax provisions and rate setting, in order to mitigate the issues and problems identified above.

(b) As a general matter, when setting withholding tax rates in this and other contexts, rates need to reflect a recognition of whether and where the items subjected to withholding represent active income with significant levels of associated expenditure rather than pure income profit. In the digital and other areas (e.g. our franchise business) the businesses concerned are active businesses with significant year on year overhead and other costs of conducting the business and earning the fee streams. Rates need to be set at rates which can reasonably be expected to achieve any intended allocation of taxing rights based on reasonable profit margin assumptions -and no higher. That may well involve rates lower than 5%. As part of such an assessment a decision is needed concerning how to view financing costs (i.e. item (i)(e)) -and whether margin assumptions used for considering a reasonable withholding rate should be based on a margin after some financing cost assumption. The current approach of high withholding tax rates and additional interest limitations results in various forms and layers of economic double taxation.

(c) Relieving provisions would be required so that withholding tax only applied to 'for profit' fees and not to collective funding arrangements such as those described. Particularly for businesses which are not pure digital businesses, there is an integral link here with transfer pricing considerations (e.g. for the fund type circumstance we describe we will consider whether and where intra-group service charges may be needed for an activity of managing funded services if those represent support functions for earning core 'for profit' fees). Where - as we believe is the case with our core fee streams- current international norms already adequately allocate taxing rights for such fee streams, additional digital taxes would disrupt that existing balance. Consideration might therefore be given to whether a self-assessment form of withholding tax process could give more flexibility to claim and apply reliefs for functions which are cost centres more appropriately dealt with under transfer pricing provisions.

(d) Separate changes in international norms for foreign tax credit relief are required to address item (i) (c) e.g. to enable some flow through of credit availability into entities making material intra-group charges into the primary counter-party which suffers withholding tax.

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

We believe that our comments re (ii) above also address these issues of double taxation mitigation. And

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

We refer to our comments above. It is not clear to us -whether in the context of B to C charges, or in the context of appropriately targeting the appropriate quantum of 'for profit' fees- that a standard withholding tax mechanism could function appropriately. A system of registration and self-assessment on appropriately designed withholding tax principles which aim to dovetail with existing taxation regimes does perhaps have more prospect of doing so than such a standard withholding tax approach. Clearly substantial development and due diligence work would be needed in order to determine whether or not that is indeed the case.

We hope that these comments are helpful. We would be pleased to expand on them further as necessary.

Yours faithfully,



**C.P. Garwood**  
Head of Tax

12th October 2017

OECD BEPS Project

Via email: [TFDE@OECD.org](mailto:TFDE@OECD.org)

Dear Sirs

## Digital Economy – OECD Request for Input

Informa PLC welcomes the OECD's Request for Input on the tax challenges of the digital economy, which was issued in September 2017.

Informa previously responded to the November 2013 discussion document and the OECD's request for input on BEPS Action 1, "Addressing the Tax Challenges of the Digital Economy", issued in March 2014.

Our previous responses remain relevant and current, and as such, we have repeated some of our previous comments in the responses below, as well as appending our previous letters in Appendix 1 & 2 attached. We have also provided an update on the Informa business model in Appendix 3

We are pleased to provide input as follows:

### Background Remarks

Whilst we have responded to the OECD's specific requests for input below, we take the view that it is important to analyse 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.

Furthermore, it would seem premature to judge the BEPS measures as inadequate; many jurisdictions are still in the process of introducing the required implementing legislation, and tax authorities have not yet even received their first country by country reports. The measures have thus not been tested yet, and so it cannot be correct to start on a second tier of "anti-BEPS" measures. Moreover, even if in due course the BEPS measures are seen as "failing" the question of why they failed would need to be considered; was it due to MNE's finding "new" BEPS techniques or was it due to ineffectual or non- implementation by certain jurisdictions? Whilst the former would require measures aimed at changing corporate behaviour, the latter would demand measures targeted at states who were (presumably) trying to obtain an unfair advantage.

However, we can see merit in work at this point which considers how profits are allocated between jurisdictions. In particular, whether the existing application of the 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.

**Informa Group plc**  
5 Howick Place, London SW1P 1WG  
United Kingdom

**T** +44 (0)20 7017 5000

**F** +44 (0)20 7017 4519

**E** [info@informa.com](mailto:info@informa.com)

**W** [www.informa.com](http://www.informa.com)



## 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).**

The digitalisation of elements of the Informa supply chain has not fundamentally changed the business model or the means or location of value creation. For the Informa publishing businesses, the main driver of value continues to be the creation of highly valuable and relevant content for business and academics. The location of this value creation remains largely unchanged; although, at the margins, the easier nature of remote and home working has meant that some value creation may now take place in places where it would not have done so previously.

The main change to the Informa supply chain, derived from digitalisation, is the delivery of the product with the supply chain shortening; as Informa now provide platforms whereby the customer can access digitally the content to which they subscribe. This has reduced the need for paper printing and physical distribution of product and the logistics surrounding that. However, it is worth noting that distribution and logistics were not considered to be a high value element of the pre-digital supply chain.

Digitalisation of products has allowed Informa to develop and grow its business as it can now reach more customers, in more locations, where historically it would not have had an established distribution network. It has also reduced the reliance on third party distributors. The sales function remains largely unchanged, as “on the ground” sales and business development functions are still required to meet customers and develop relationships.

**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.)?**

We are not entirely clear what is a “highly digitalised business model”. Nearly all modern media business models will have both physical elements in the creation of product / content as well as digital communication and delivery platforms. Are online only retailers highly digitalised if they only provide physical products? Are traditional retailers highly digitalised if they have a comprehensive website and offer a “click and collect” facility? Are manufacturers of consumer goods highly digitalised if their advertising campaigns are mainly driven by digital data?

For the Informa Publishing Businesses, the IP within the content of the products is the highest value intangible. The digital platforms (IP) which enable the delivery of or access to the digital product are becoming of increasing importance as users expect seamless digital interaction and accessibility. These digital platforms are also important for growth as they enable more regular and more consistent interactions with customers. Informa have created these digital platforms from the bases in the UK and the US.

It is worth noting, that the Events businesses, which do not primarily provide digital content, and continue to derive most of their value from face to face interactions, are increasingly reliant on highly sophisticated marketing tools (which we would certainly consider a form of IP) to reach their diverse customer base. Also, each event requires a separate and distinct digital presence to go to market with.

It may therefore be misleading to assume that only highly digitalised businesses are heavily reliant on IP in conducting their activities; it is more likely that nearly every business of any size is dependent on IP to a large degree.

**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?**

For the Informa businesses, sales operations are generally not organised differently across the different business models, whether highly digitalised or not as they face the market.

Each of the divisions have developed e-commerce and digital platforms, as would be expected of any modern business wishing to maintain contact and build relationships with its customer base. Informa has developed such platforms and, without them, we would have fallen behind what is now the standard operating model in our markets.

**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?**

Informa is primarily involved in “business to business” activity. Our operations will always have collected some data on customers. E-commerce and digitalisation has made the collection and organisation of such data easier, but we suspect the developments in consumer businesses are more significant than in the “b2b” sector.

**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?**

Each of the Informa businesses, whether highly digitalised or not, have online platforms which encourage the active participation of customers, located anywhere in the world. Therefore, we do not believe that such user networks are specific to highly digitalised business models and we consider these are simply part of the modern economy.

In our events businesses, online platforms encourage regular engagement with communities surrounding the events and encourage sharing of knowledge. These platforms are now considered necessary to maintain customer engagement and are “value protecting” as well as “value creating”.

**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).**

We have not yet a fixed view on how AI could affect the business. In the near term, the greater integration of marketing, production and sales tools – the “360 degree view” of the customer – is likely to be the direction in which our businesses move.

## **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)**

Informa, as a Group are not experiencing material issues with the current international taxation framework. We consider that the work already done by the OECD, has brought about the necessary clarifications and improvements required, and the main task is now one of implementation by national governments on a consistent basis. This will include the implementation and support of the BEPS dispute resolution procedures.

The BEPS documentation requirements, around CBCR and the Masterfile has significantly increased the administrative burden on the business, although we appreciate that this burden is largely restricted to the introductory year. We hope that the extra administrative burden on the business gives taxing authorities the clarity and information they have sought.

Changes to the indirect taxation of digital revenues at the point of consumption by a consumer has created anomalies within our business. Informa sell identical content in both digital and printed format and consider that most of the value in the product lies where the content was created. However, the indirect taxation of the product is different. This can create further cost to the business as consumers are unlikely to be willing to bear any extra cost for purchasing digital products.

Informa also suffers revenue based withholding taxes on Event activities in a number of countries. This creates double taxation and conflicts with the OECD and BEPS premise that tax should be levied against profits. Withholding taxes may be levied on activities where there is no actual profit in the value chain.

**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?

In response to this question, we would reiterate that highly digital business models are simply a product of advancing technologies and a shift in interactions with customers, and, although they may create concerns around taxing rights between different countries, these concerns are not related to base erosion and profit shifting. BEPS has been a feature of mismatches and missing elements in the international tax systems. It appears that some highly-digitalised businesses have been well placed to take advantage of such mismatches and missing elements; however we consider that the BEPS project has gone a long way to mitigating this.

In the b2b sector, as elsewhere, digitalisation has reduced the need for a presence in a country to deliver products. Nevertheless, in general, we continue to need a presence in countries where we have previously been located, to maintain relationships with customers and understand the market. Digitalisation may shorten the supply chain but other costs and location of value creation remain unchanged.

E-commerce platforms can broaden the reach of our products, and expand our customer base in territories where we have not had a significant presence before. However, this generally represents growth in a market, and additional economic activity, and, overall an increase in the tax base worldwide. We would continue to take the view that the profit attributable to a country where we make sales but have no physical presence is zero, as the value of an item is not changed by its mere sale.

Taxing **profits** according to the value chain of a product or service should still be fair in a modern market, as the countries in the value chain where the value is created should continue to have taxing rights on the generation of profits. We remain of the view that direct taxation should only be levied on profit.

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

We have no comments on this matter.

**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.**

As noted above, we believe that the BEPS measures have gone a long way to mitigating the risks created through BEPS.

For Informa, the digitalisation of certain elements within the supply chain, has not created significant tax challenges. We consider that the other BEPS actions have provided sufficient clarity around the taxation of the business' profits; in that profits should be taxed in the jurisdiction where the value has been created and that profits are created through the operations of specific people functions. All of the Informa digital products and platforms continue to be created by specific people functions in identifiable locations.

**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?**

As noted, Informa faces additional compliance costs from such changes, as well as having to deal with differences between the indirect taxation of digital and printed product.

**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:**

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.

We provided comments on each of these options in our April 2014 letter, attached. Our view has not fundamentally changed. We can see that 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 should only be used as a last resort to tax profits that for whatever reason are not being taxed at all, or at artificially low rates, and should only be contemplated if a time comes when it can be demonstrated that the BEPS project has “failed”.

**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?

Further extension of the PE concept so that it encompasses a digital rather than a physical presence relies on determining a factor attributable to a territory 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, as we have pointed out before, 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; although we would expect a significant increase in tax disputes to arise if such an extension was made to the PE concept. It should also be noted that a significant increase in the number of PE's with little profit attribution will increase compliance costs for both taxpayers and revenue authorities, which may be disproportionate in many cases to the tax actually collected.

**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?

Both b) and c) are in our view blunt instruments likely to lead to double taxation and a stifling of innovation. However structured, taxes which are directly calculated from revenues will only reflect profit attributable to the territory where sales are made in a minority of cases. This 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. Revenue based taxes are also likely to load additional costs onto businesses in a start-up phase and slow down development. In our view, revenue based taxation should only be used as a last resort and targeted against situations where states are seeking to obtain a competitive advantage by under-taxing or not taxing profits generated in their jurisdiction.

**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.**

Diverted profits taxes seem to us to be essentially a reaction to questions of proper tax allocation, and it would have been better for states to agree a common approach. So far the implementation of DPT's in various states has not affected our actual tax payments, but has increased our compliance costs. The other models essentially seem to boil down to variants on revenue based taxes.

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

**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, any unilateral or uncoordinated approach creates a further administrative burden on businesses, which can only lead to further cost. It also goes against the objective of creating certainty and fairness over international taxation, which was the principal objective of the BEPS project and a key objective of the OECD itself.

#### **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?**

We have no comments to make.

## Appendix 1

Informa response of December 2013 to the OECD's request for input on the tax challenges of the Digital Economy, issued November 2013

## Appendix 2

Informa response, dated [April 2014], to the OECD's request for input on BEPS Action 1, "Addressing the Tax Challenges of the Digital Economy" following Public Discussion Draft issued, March 2014.

## APPENDIX 3

### Information on Informa PLC

Informa PLC is a broad based, resilient business to business media group. We operate in the knowledge and information economy, delivering products and services to commercial and academic customers through various platforms, from digital to print to face to face. Through this engagement, the Group share knowledge, insight and intelligence in specialist topics, and provide connectivity to expert communities.

The Group strive to be a leader in the speciality topics it covers, providing intelligence not readily available elsewhere. The markets in which the Group operate are increasingly global, with the Group proactively developing, from its core business in the UK and the US, into China, the Middle East and other developed and developing markets.

Informa have four commercial divisions, supported by a fifth, global supports division:

*Academic Publishing* – Publishes high quality specialist content and knowledge for upper level academic communities.

*Business Intelligence* – Provides specialist data driven intelligence and insight, with 100+ digital subscription products.

*Global Exhibitions* – Organises transaction oriented events and creates digital platforms that connects groups for business and trade.

*Knowledge and Networking* – Creates and connects communities based on sharing insights and learning, at events and online.

*Global Support* – Supports Operating divisions with business services and provides leadership and governance to the Group.

The Group has over 7,500 employees in over 100 offices in 27 countries and also runs events and sells digital products in many more countries.

The Group prides itself on its transition to “digital”; with the vast majority of BI products and AP journals having now transitioned to digital platforms generating approximately 75% of publishing revenues. Book publishing has had a steady migration to digital delivery although high level academics continue to choose the printed format.

In the Events business, social media has developed into a powerful marketing tool, “within events” technology continues to grow, and the online platforms created for each of the events allows further engagement with the customer base as well as potential new revenue streams.

11<sup>th</sup> April 2014

OECD  
BEPS Project  
via e-mail: [CTP.BEPS@oecd.org](mailto:CTP.BEPS@oecd.org)

Dear Sirs,

## **Base Erosion and Profit Shifting (BEPS) Action 1**

### **Address the Tax Challenges of the Digital Economy**

Informa plc welcomes the OECD's request for input on BEPS Action 1, "Address the Tax Challenges of the Digital Economy" following the Public Discussion Draft issued on 24 March 2014.

Informa previously responded to the 22 November 2013 discussion document. Background information on the company is included as an appendix to this document.

We are pleased to provide input as follows:

1. The document specifically asks for comments on the following three areas:
  - *Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules;*
  - *The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account;*
  - *The examples of new business models in the digital economy and whether (and if so which) other business models should be considered.*
2. In our view, Parts II and III of the document provide good background information on the development and influence of information and communication technology, and how the "digital economy" has increasingly become the economy itself. The key features of the digital economy and its business models are identified and analysed well. These parts of the document illustrate that the "digital economy" has increasingly become simply "the economy".

3. The document also asks for comment on

- *The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy;*
- *Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones .*

4. Parts IV & V of the document illustrate that BEPS is a feature of mismatches and missing elements in the international tax system. Some multi-national enterprises that work in areas of the economy which have seen the greatest impact of digital technology may be well placed to take advantage of such mismatches and missing elements; however, none of the BEPS issues are exclusive to such companies. We are not aware of BEPS concerns that are specific to companies creating digital products.

5. Accordingly, the other actions contemplated by the BEPS project will thus address BEPS for digital and non-digital companies alike. We do not see any value in other measures beyond those identified for direct taxation. The current work on VAT/GST should also address BEPS concerns.

6. The document finally asks for comments around broader taxation challenges of the digital economy as follows:

- *The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation;*
- *The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft;*
- *The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives;*

- *Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.*
7. Addressing the final bullet first, we agree the Ottawa taxation framework principles are the appropriate framework for analysing these tax challenges.
  8. The broader challenges of the Digital Economy raised in Part VI of the paper would exist if the mismatches and missing elements of the current system were all eliminated. These challenges do not involve base erosion or profit shifting – they are a consequence of advances in technology.
  9. We do not under-estimate these challenges, nor suggest they should not be tackled. However, in our view they open up profound questions of how taxation should operate in a world of largely digital commerce. These questions need to be discussed and debated outside the framework of the BEPS project.
  10. What is not addressed in the 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 document does not, in our view, sufficiently question whether the tax challenges of the digital economy could be more a matter of timing due to different rates of digital development rather than permanent changes to tax bases, and as digital exports become more evenly spread, the challenges may recede.
  11. 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.
  12. Part VII of the document sets out potential options to address the tax challenges 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 profits of base erosion or profit shifting.

13. In relation to the specific proposals in Part VII we would make the following comments:

- An over-arching point we would make is that in our field in particular the move from traditional print based business to digital based business has not affected our core “mission” – we are still delivering information into the same markets, just in a more technologically advanced manner. From our perspective, the supply chain may have shortened, but the value in our product is still created prior to the point of delivery.
- We would thus find it surprising that moving from printed to digital delivery of the same product, used by the same customers in the same markets would lead to profoundly different tax results for us.
- The “New Nexus based on significant digital presence” represents a tax on an attributed profit based on revenue in a place of sale. This goes against the principle that value is created in where a product is created, not simply by a market for that product; it would represent a fundamental shift in the international tax system to adopt such an approach.
- Such a system would also be very complex to administer. It would substantially increase compliance costs for business through increasing the number of returns required and the complexity of attributing profit to various jurisdictions.
- 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.
- This is particularly relevant if a digital presence is considered to be created from collecting data – data collection itself, however massive, does not create any value. Data only has value when analysed. Such analysis is done by people or by algorithms designed by people. The value is thus created where people analyse the data or where people created the analysis tools.

- Three “virtual PE” models are described. The first is surely now rendered impractical 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 shares the same problems; and the third would seem to be a logical extension of current rules, but would be of limited application.
- Another approach put forward is applying a withholding tax to digital transactions. This raises similar concerns to the “New Nexus” approach mentioned above. It marks a shift in taxation to where sales are made from where product is created.
- Any withholding tax above a low single digit number is likely to result in double taxation. Under current principles a state where a product is created is unlikely to give enough double tax relief on profits on that product for a withholding tax on revenue from that product to be fully compensated. If greater credit for such withholding tax is given in future, producer states, where value has traditionally been considered to be created, will lose out.
- If withholding tax results in double taxation, producers are likely to increase prices to compensate for this effect, with detrimental impact on the consumer economy.
- A withholding tax also transfers the burden of compliance/payment from producer to consumer, with the difficulties noted in the document.
- 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, and we would suggest the focus should be on increasing digital trade, and encouraging digital product to be developed in economies which have been slower to adapt.

14. We would broadly agree that the principal effective consumption tax option is to require non-resident suppliers to register and account for VAT in states of consumption. This process should be made as simple as possible.

15. There is one specific challenge of the digital economy which the document does not address. This is differential consumption tax rates on physical and digital versions of the same product.
16. In general, this is an area where governments potentially benefit from significantly increased tax revenues on the same product; effectively the reverse of base erosion.
17. We face specific challenges in our businesses when dealing with non-VAT registered consumers.
18. Consumers regard printed and digital versions of the same information as essentially the same product. Some digital products may contain features that cannot be present in print, and these may be valued by the consumer; but the premium they are prepared to pay is small (and may be non-existent).
19. The non – VAT registered consumer is focused on the price they pay – the pre VAT price is irrelevant to them.
20. We have therefore experienced the need to discount digital certain products where the consumers are non - VAT registered against the printed product price, so that the consumers pay broadly the same price.
21. The beneficiary of such discounts is the taxing authority, not the consumer. In the Digital Economy, the challenges are not confined to loss of tax revenues – governments are often gaining revenues from a shift from print to digital delivery.

We trust the OECD will find these comments helpful as it continues its work on BEPS Action Point 1.

Yours faithfully,

**GLYN FULLELOVE**

Group Tax Director, Informa plc

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

## APPENDIX

### Information on Informa plc

Informa plc is a broad based, resilient business to business media group. We operate in three main areas; Global Events, which incorporates a range of face to face media businesses, including exhibitions, conferences and awards; Business Intelligence, which delivers high value proprietary content to a number of industries including healthcare, pharmaceuticals, financial services, maritime, commodities, telecoms and insurance and the legal profession; and Academic Publishing, which produces books and journals for the academic market, including university libraries.

We have over 6,000 employees in over 100 offices in 25 countries; we also run events and sell digital products in many more countries.

We pride ourselves on our digital expertise, which runs across all our businesses. The vast majority of our publishing products have now transitioned to digital platforms and approximately three-quarters of our publishing revenues are from digital product. In the Events business, we have seen social media becoming a powerful marketing tool, and have invested in technology used “within events”.

**We see our mission as Bringing Knowledge to Life:** Businesses, professionals and academics worldwide turn to Informa for unparalleled knowledge, up-to-the minute information and highly specialist skills and services. Our ability to deliver high quality knowledge and services through multiple media channels, in dynamic and rapidly changing environments, makes our offer unique and extremely valuable to individuals and organisations.

20 December 2013

OECD  
BEPS Project  
via e-mail: [CTP.BEPS@oecd.org](mailto:CTP.BEPS@oecd.org)

Dear Sirs,

## **Tax Challenges of the Digital Economy**

Informa plc welcomes the OECD's request for input on the tax challenges of the Digital Economy which was issued on 22 November 2013.

We are pleased to provide input as follows:

### ***A. Nature of work/activities undertaken by your organisation***

#### **A.1. Please describe the background of your organisation, including the nature of the work or activities performed.**

Informa plc is a broad based, resilient business to business media group. We operate in three main areas; Events, which incorporates a range of face to face media businesses, including exhibitions, conferences and awards; Professional and Commercial Information (PCI), which delivers high value proprietary content to a number of industries including healthcare, pharmaceuticals, financial services, maritime, commodities, telecoms and insurance and the legal profession; and Academic information, which produces books and journals for the academic market, including university libraries.

We have over 6,000 employees in over 100 offices in 25 countries; we also run events and sell digital products in many more countries.

We pride ourselves on our digital expertise, which runs across all our businesses. The vast majority of our publishing products have now transitioned to digital platforms and, in 2012, 74% of publishing revenues were from digital product. In the Events business, we have seen social media becoming a powerful marketing tool, and have invested in technology used "within events".

**We see our mission as Bringing Knowledge to Life:** Businesses, professionals and academics worldwide turn to Informa for unparalleled knowledge, up-to-the minute information and highly specialist skills and services. Our ability to deliver high quality knowledge and services through multiple media channels, in dynamic and rapidly changing environments, makes our offer unique and extremely valuable to individuals and organisations.

Our 2012 revenues were £1.23bn of which over £500m were attributable to electronic product and a significant amount more was attributable in part to digital marketing, or supported by digital technology.

***B. Impact of information and communication technology on the activities of the organisation***

**B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.**

In our business, the fundamental business relationship between the provider of valuable information and the purchaser of such information is unchanged.

We still produce valuable content for our customers; what has principally changed is how it is delivered. Instead of a printed journal, book or bespoke report, all can be delivered electronically. In addition, customers can access more specific and more tailored content through sophisticated database interfaces. Access to such databases can be linked to a digital journal subscription or an e-book purchase, or can be obtained independently. However, the fundamental relationship is still between a content provider and a customer purchasing that content.

The customer will access the content through a variety of electronic devices; personal computers, tablets and smart-phones. Customers for our content product will typically not interact with each other.

Within PCI, the transition to digital is virtually complete, whilst within Academic Information print still sits alongside digital as an important medium.

We have identified a change in the relationship with customers within our Academic Information division in particular. When text books and academic journals were purely a printed medium, our relationship with customers essentially ended at the point of sale. However, when customers purchase a digital text book or journal, they expect to be able to download a replacement copy, should their version become corrupted or lost when they change their computer and “update” services are also often expected or required. So the relationship is not broken at point of sale, and the supplier has to continue to incur cost after sale; e-books and journals are effectively sold “in perpetuity”. This has required the creation of systems to meet the on-going requirements and “dark archives” in which digital copies of books and journals can be stored for the long term, and retrieved for customers even if the original publisher has gone out of business.

Within the events business in particular we have seen the application of digital technology in the marketing of events through more sophisticated customer relationship systems being able to identify potential event attendees and sponsors, and we have been able to extend this to parts of our publishing business. We have also seen the development of interactive

and “networking” events where communications technology is used by delegates to interact both with speakers and each other.

## **B.2. How do these models leverage new technology to change organisational structures and supply chains?**

In our publishing businesses we have shortened and simplified the supply chain by cutting out the “physical” delivery of product. To take one of our oldest products, Lloyds List, this is now delivered to a laptop or tablet and no longer delivered by mail or purchased from a news vendor. Digital delivery also allows the inter-linkage of journals with database type product.

As noted above, whilst the shortening of the supply chain can eliminate some costs, the move to digital delivery can also add costs in the development of digital platforms, including meeting expectations of additional on-line functionality and the creation of “dark archives”. Digital delivery is not necessarily cheaper than print, and may be more expensive in some cases

The structure of our organisation is little changed, although technology allows more home and remote working in the assemblage of content. We have increased our recruitment of eMedia experts and technologists to support the development of digital delivery and marketing.

## **B.3. In each of the business models identified, what assets and activities contribute to the generation of value?**

The prime generators of value in publishing are the creation of content, and the improvement of delivery systems. Our customers will simply not purchase sub-standard content. The more relevant the content to their work, the more likely they are to purchase, and the more they will be prepared to pay. The development of easier and quicker delivery mechanisms, such as reliable and user-friendly “apps” for tablet devices will also encourage a purchase decision.

In events the improved analysis of data through more sophisticated customer relationship management can be a driver of value – the system of managing data rather than the data itself being critical. “In-event” networking and inter-active software can enhance the experience of event attendees, and in some cases can be the prime attraction of the event.

In summary, the assets and activities contributing to value are content and innovation in delivery.

Once the product is at the point of delivery, in our view value creation is largely complete, although the customer may place value on “after-sales service” provided by us, such as the ability to update a publication.

**B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?**

There has been little fundamental change; as noted above, it is easier for content to be created in several places. Equally, the development of technology to improve delivery can be more widely dispersed.

Historically, there could be some (low) value attributable to the physical delivery of product. However, as physical delivery disappears from the supply chain, this element disappears.

**B.5. How have changes in underlying business models impacted the way in which business is organized as a legal or tax matter?**

There has been little change, as the fundamental relationships have not changed. However, as noted there is a reduced requirement for organisation and entities at the delivery stage. A greater variety of sources for content and innovation will require greater focus on organisation and legal structure at that earlier point of the supply chain.

**B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?**

From a corporate tax point of view, challenges will arise in determining profit allocation to potential dispersed sources of content and innovation. From a VAT perspective, whilst there are split VAT rates and differing treatments for digital and non-digital versions of the same product, challenges in getting invoicing correct will continue.

**B.7. How do you see business models and supply chains evolving in the future due to advances in information technology?**

That is very difficult to answer, as both developments in hardware and software and our customer industries have to be considered. It is possible more and more data will be collected, but data itself is of little value – it is the processing and interpretation of such data which is important. Much data may be irrelevant, some data can simply be wrong. Internal and “closed” networks may become important drivers of innovation as companies seek to manage dispersed workforces and suppliers. Data flow is also likely to become more two way; for example, our business and academic customers can now request download/usage data on products from us, and are thus able to make more informed purchase decisions. This trend is likely to continue.

In the business to business market it makes sense to have a single point of delivery between content producer and content user. We can envisage selling a variety of content to a business in a single package and that business then dispersing the data within its organisation. However, such central procurement is not a new activity specific to the digital world, and certain industries such as pharmaceuticals are fragmenting into more specialised units which results in customers who are only interested in a narrow range of products.

### ***C. Other comments***

**C.1. Please provide any other comment you may have regarding Action 1, including any additional information that you would consider useful in identifying the challenges that the digital economy poses for the application of existing international tax rules.**

We have addressed the questions from our specific point of view, and recognise that there are other parts of the “digital economy”, including, for example, on-line shopping for physical products and on-line services. However, in most cases it would appear that the digital economy is shortening or modifying a supply chain rather than fundamentally changing the value creation process; the customer ultimately values the product or service, not the supply chain process involved.

A particular issue for digital publishers supplying to consumers who cannot recover VAT is that there is a perception that “the internet is free”. Hence digital consumers expect lower prices, not higher, for digital products when compared to printed matter. As noted, it is not a given that digital production is cheaper than print; given the development of ever more complex delivery platforms, and the requirements for “dark archives”, digital costs may even be higher. Where the supplier has to absorb the VAT cost on digital product, profit margins will be squeezed, and investment in digital technology will suffer.

We trust you find our input to be helpful

Yours faithfully,

**GLYN FULLELOVE**

Group Tax Director, Informa plc

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

Mr. Pascal Saint-Amans  
Director, Centre for Tax Policy and Administration  
OECD

By email to: [TFDE@oecd.org](mailto:TFDE@oecd.org)

Vienna, October 11, 2017

**Subject: Comments on the tax challenges raised by the digitalization of the economy**

Dear Mr. Saint-Amans,

The WU Global Tax Policy Center and the WU Transfer Pricing Center at the Institute for Austrian and International Tax Law at WU (Vienna University of Economics and Business) would like to thank the OECD for the opportunity to provide comments on the tax challenges raised by the digitalization of the economy and BEPS Action 1 Report on "Addressing the Tax Challenges of the Digital Economy", released in October 2015.

We are pleased to elaborate on our comments on the raised issues.

**A. Digitalisation, Business Models and Value Creation**

On these topics, we agree and support the analysis and conclusions drawn by the BEPS Action 1 Report issued in October 2015.

**B. Challenges and Opportunities for Tax Systems**

**B.1 What issues are you experiencing with the current international taxation framework?**

The current biggest challenges for businesses is the accommodation of all the different international initiatives. Also, if rules are fragmented with different grouping of countries adopting different standards, double taxation is more likely to result. A global standard should be rather adopted.

The line between the direct and indirect taxation is being blurred. The unilateral measures introduced by India and the UK, for instance, are declared to be either not conventional income tax and/or beyond the scope of tax treaties. Clarity needs to be restored before the MLI and other treaty changes/BEPS measures can function in a proper and coordinated manner.

## **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?*

These business models are jurisdiction and industry agnostic. For instance, an e-commerce platform will cut across different countries and industries whereas the taxing rights and tax systems are still be organized around distinct jurisdictions and product/industry lines.

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

Digitalization offers the opportunity to transform the way tax administrations function and we commend the work of the FTA in this area. We feel that these transformation aspects should be clearly separated from the debate on how digitalisation impacts on international tax norms. Tax administrations need a better understanding of the potential of AI, Robotics, Blockchain and ITOT and tax policy makers need to explore the new policy options opened up by these new technologies (e.g. beneficial ownership registers based upon the distributed ledger technology). WU has launched a multi-stakeholder initiative on these issues and would be happy to contribute to the ongoing dialogue.

## **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 impact**

*i) Action 13 and digitalisation challenges:*

It is still early but the most significant immediate impact will be the transparency brought by BEPS Action 13 which has also introduced the most extensively adopted measures. The other actions still await adoption by a fair number of countries into their local rules.

*ii) Actions 7-10 and digitalisation challenges:*

When analysing Actions 7-10 of the BEPS project, it is evident how the OECD has aimed at aligning transfer pricing outcomes with value creation. To this end, on the one hand, the threshold defining the taxable nexus of business profits to a country has been lowered and, on the other hand, the guidance on how to tax business profits has been considerably developed (both in the context of Article 7 and of Article 9 of the OECD Model), with significant amendments still under development.

In order to understand whether these amendments will be able to reach their goals (i.e. the abovementioned alignment of transfer pricing outcomes with value creation) in the specific context of the digitalized economy, the starting point should be a clear understanding of how such economy creates its value. To this end, the conclusions reached by BEPS Action 1 in its Chapter 4 "The digital economy, new business models and key features" are of outmost importance. In this context, the OECD has rightly concluded that the key features of the digital economy are the following:

- *Mobility, with respect to (i) the intangibles on which the digital economy relies heavily, (ii) users, and (iii) business functions as a consequence of the decreased need for local personnel to perform certain functions as well as the flexibility in many cases to choose the location of servers and other resources.*
- *Reliance on data, including in particular the use of so-called "big data".*
- *Network effects, understood with reference to user participation, integration and synergies.*
- *Use of multi-sided business models in which the two sides of the market may be in different jurisdictions.*
- *Tendency toward monopoly or oligopoly in certain business models relying heavily on network effects.*
- *Volatility due to low barriers to entry and rapidly evolving technology.*

Therefore, the further work by the TFDE should ideally focus in parallel on the following two topics, keeping in mind the abovementioned key features of the digital economy:

- a) Further clarify or extend the taxable *nexus* of business profits to the countries where their value is generated (i.e. by means of further defining the meaning of "permanent establishment");
- b) Further develop guidance on *how* to tax those business profits, both (and consistently) in the context of article 7 and article 9.

As for the clarification or extension of the taxable *nexus*, the amendments suggested by BEPS Action 7 have rightly addressed some crucial aspects relevant for the digital economy. However, further developments might aim to explore how topics like "intangibles", "users", "business functions", "big data", "network effects", and "market" could be relevant in global value chains and, therefore, in a revised definition of "permanent establishments" (or in its interpretation). To this end, some considerations could be placed on the possible introduction of a "digital" permanent establishment (both at the national level and in the OECD Model).

Once this clarification or extension of the taxable *nexus* has been carefully analysed, the next crucial question would be *how* to tax those profits. In this context, the work developed under BEPS Actions 8-10 has already clarified some relevant notions (that, to some extent, should be further developed in the context of attribution of profits to permanent establishments). Indeed, the OECD has clarified that an analysis of how value is created should fundamentally start from the assessment of the accurately delineation of the actual transactions undertaken. To this end, the following economically relevant characteristics should be considered as key factors:

- *The contractual terms of the transaction.*
- *The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices.*
- *The characteristics of property transferred or services provided.*
- *The economic circumstances of the parties and of the market in which the parties operate.*
- *The business strategies pursued by the parties.*

The analysis of these economically relevant characteristics is already potentially able to define *how* to tax business profits in line with value creation in the specific context of the digital economy.

However, further developments might aim to explore how the abovementioned topics (i.e. "intangibles", "users", "business functions", "big data", "network effects", and "market") fit into the analysis of the accurately delineation of the actual transactions. Indeed, on the one hand, numerous practical difficulties might be encountered in practice when matching value creation in the digitalized economy with functions performed, assets used, and risks assumed (especially in the context of the analysis of the relevant DEMPE functions). On the other hand, the more fundamental question of how much value is created in the digitalized economy by the relevance of the economic circumstances of the parties and of the market should be properly addressed. In this regard, further considerations should be developed on the relevance of location specific advantages and location savings in the context of the digitalized economy. Indeed, in numerous cases, a

considerable amount of value created by the digitalized economy derives from the customers, who unconsciously contribute (or even voluntarily “work”) to the value of the business, in exchange of cheaper products or services (for example, see Facebook’s free platform or Uber’s cheap taxi services).

The above considerations should be based on a careful analysis of the global value chains of the business models operating in the digitalized economy that could be developed in a series of toolkits addressing these issues for defined business models both from a legal and economic perspective.

## **D. Options to address the broader direct tax policy challenges**

### **D.1.a) Tax nexus concept of “significant economic presence”:**

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

As BEPS Action 1 suggests, it is difficult to draw the line between the digitalized and the non-digitalized parts of the economy. Therefore, the transactions need to be carefully delineated to minimise confusion. For instance, if conventional offshore operations start having an online ordering option alongside other sales channel or having certain lines of products delivered remotely, will the nexus concept apply to the operations in its entirety or only to the segment that is sold online or that involves digital delivery?

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

There could be a balance of residence and source/market state factors. In addition, it is best to avoid subjective test such as which entity the retail customer think they are dealing with. The latter would add uncertainty for businesses. Perhaps safe-harbours should be considered, e.g., simple website with no extra functionality should not constitute a sufficient presence.

*(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?*

The current DEMPE concept is perhaps more suited for conventional R&D, rather than light footprint activities. The DEMPE guidance could be supplemented with other factors or key significant people functions that balance residence and source factors, for instance, who has editorial rights to the website, who makes the pricing decisions or decision whether to offer or deliver a particular service online.

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

Industry associations could be engaged to draw up and suggest voluntary compliance standards for consideration for acceptance by governments. It will be more practicable if it is something that the industry already thinks they can enforce or has the means to implement.

### **D.1.b) Digital equalisation levy:**

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

There should be clearly defined categories - for instance relying on standard industry classifications that is commonly accepted rather than vague definitions.

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

The tax rate should be modest with a high threshold of exemption based on efficiency of collecting the tax. For instance, it is not efficient for a small business or person doing some part-time online business to collect the tax.

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

Have such levies be brought into the treaty network so that corresponding and competent authority reliefs can be had. Creditability should be checked on the counterparty side.

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

Through the use of technology. This may be offered through payment intermediaries such as payment gateways, credit card companies or banks, which can provide the interface or software for merchants to comply in a standardized manner to a large number of potential taxpayers.

**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.**

*a) What are the advantages and disadvantages of these approaches?*

Diverted profit taxes potentially distort the PE concepts and are generally technically difficult to implement for tax administrators and taxpayers in developing countries.

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

Tax policy design should be tailored to be appropriate to the stage of development, resources and economic needs of that country. If base erosion is less of a concern than attracting investments and jobs, there may be less economically harmful ways of raising revenues than levying a DPT or withholding tax on digital transactions.

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

Unilateralism distorts the international tax system not just with double taxation but also makes the harmonization of BEPS measures that much more challenging.

**E. Other Comments**

How the extra measures (if any) on digitalisation can be sequenced after or how it may be better coordinated with the preexisting BEPS measures.

We trust that you will find these comments useful. We look forward to continue our participation in this very important project.

Sincerely yours,

**Prof. Dr. Jeffrey P Owens**

Director of the WU Global Tax Policy Center  
Institute for Austrian and International Tax Law  
Vienna University of Economics and Business (WU)

**Dr. Raffaele Petruzzi**

Managing Director of the WU Transfer Pricing Center  
Institute for Austrian and International Tax Law  
Vienna University of Economics and Business (WU)

## INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COUNSEL AND SECRETARIAT TO THE ALLIANCE:  
BAKER & MCKENZIE LLP  
ATT: MARY C. BENNETT  
815 CONNECTICUT AVENUE, N.W.  
WASHINGTON, D.C. 20006  
USA  
TEL: +1 202 452 7045  
FAX: +1 202 416 6910  
[mary.bennett@bakermckenzie.com](mailto:mary.bennett@bakermckenzie.com)

October 13, 2017

### VIA E-MAIL

Mr. Pascal Saint-Amans  
Director  
OECD Centre for Tax Policy & Administration  
2 rue André-Pascal  
75116 Paris  
France  
[TFDE@oecd.org](mailto:TFDE@oecd.org)

**Re: Comment on 22 September 2017 Request for Input on Work Regarding the Tax Challenges of the Digitalized Economy**

Dear Pascal,

This letter is submitted on behalf of the International Alliance for Principled Taxation (IAPT or Alliance) to provide you with the IAPT's comments on the 22 September 2017 Request for Input on Work Regarding the Tax Challenges of the Digitalized Economy. We appreciate the opportunity to provide these comments on this important topic.

The IAPT is a group of major multinational corporations representing a variety of business sectors.<sup>1</sup> The group's purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally. The group participated actively as a stakeholder in the discussions leading to the October 2015 final reports from the OECD/G20 BEPS Project.

As we indicated in comments we submitted previously to the OECD (in October 2013 and April 2014), the IAPT fully supports a number of the conclusions reached by the Task Force on the Digital Economy (TFDE) in the course of the BEPS Project. These include the continuing relevance of the Ottawa

---


<sup>1</sup> The current membership of the IAPT is made up of the following companies: AB InBev S.A.; Accenture plc; Facebook, Inc.; Microsoft Corporation; Procter & Gamble Co.; Repsol S.A.; and Tupperware Brands Corporation.

Taxation Framework Principles, the inappropriateness of any effort to ring-fence the digital economy, the fact that many of the digital economy business models have parallels in the more traditional economy, that the tax structures used by digital businesses are similar to those used by more traditional businesses, that no unique BEPS issues are presented by the digital economy, and that the implementation of the measures recommended under Actions 1 through 15 of the BEPS Action Plan could be expected to substantially address the BEPS issues presented by the digital economy.

That being said, we have taken note of recent indications by a number of participants in the BEPS process that additional options, specifically targeted at the digital economy, must be pursued immediately in order to address lingering concerns. As a group of companies from a variety of business sectors, the IAPT's focus is on evaluating the implications of such actions on the broader international tax system and the broader economy. Our comments will therefore focus on those aspects of the request for input, particularly sections 3.C (Implementation of the BEPS Package) and 3.D (Options to address the broader direct tax policy challenges) of that document.

The group's comments are set forth in the Annex to this letter. We very much appreciate the willingness of the delegates to consider them as they continue their deliberations on the taxation of the digital economy. We look forward to discussing these comments with the delegates at the consultation to be held in November.

Sincerely yours on behalf of the Alliance,

A handwritten signature in black ink, reading "Mary C. Bennett". The signature is fluid and cursive, with a long horizontal stroke extending from the end.

Mary C. Bennett  
Baker & McKenzie LLP  
Counsel to the Alliance

## **ANNEX**

### **IAPT Comments on the 22 September 2017 Request for Input on Work Regarding the Tax Challenges of the Digitalized Economy**

#### **I. Executive Summary**

1. The entire range of Action items under the BEPS Action Plan is having an effect on the taxation of companies operating in the digital economy.
2. The objective of the TFDE's 2018 interim report should be to monitor the effects to date of the implementation of the BEPS recommendations, including the responses by both governments and businesses, in order to be able to make a responsible, evidence-based assessment as to whether any supplemental measures are actually needed to address the taxation challenges of the digital economy. Any attempt to reach decisions on such further actions in the TFDE's 2018 interim report would be dangerously premature and would undermine the OECD's credibility as an organization that bases its policy recommendations on facts and careful analysis.
3. In order to lessen administrative burdens on taxpayers and tax administrations alike, the IAPT reiterates its plea for consideration of a mechanism that would allow foreign enterprises that would otherwise have a PE in a Contracting State because of the fact that a related party in that State causes them to have a dependent agent PE or fixed place of business PE to elect out of PE status if the related person elects to be taxable in that State on the sum of: (i) the profits that would otherwise be taxable to that related person and (ii) the profits that would otherwise be taxable to the PE. We also reiterate our offer to work with delegates to consider modified or alternative versions to address their concerns.
4. Any BEPS concerns that may exist in the case of remote sellers into a market are effectively eliminated in situations where the business adopts a reseller model. In the reseller case, the sales to local customers are fully booked on the tax books of a local taxpayer (i.e., company or branch), which should eliminate the need to introduce special measures to extend the market jurisdiction's taxing rights over those sales profits.
5. Inasmuch as each of the options referenced in the request for input (i.e., the significant economic presence PE, the equalization levy, and the withholding tax) is designed to tax the business income (or gross business revenues) of nonresident sellers who do not have a PE in the customer jurisdiction concerned, we believe each raises serious issues of potential conflict with existing treaty obligations and could not be lawfully implemented without appropriate amendments to applicable treaties.
6. Also, each of these proposals appears to reflect a desire on the part of market jurisdictions to obtain more tax revenues from foreign sellers than would be called for under existing international tax principles, and the proposals seek to satisfy that desire without reference to whether any change is needed to address any BEPS concerns identified to date. In other words, the proposals represent a pure shift of

taxing jurisdiction away from countries of development and production towards countries of consumption, without reference to BEPS concerns.

7. Profit could only be attributed to a “significant economic presence” PE by abandoning existing principles and embracing some radical new approach designed to attribute some arbitrary amount of profit to the market jurisdiction. The Action 1 Final Report suggests that such a new approach would likely have to be based on something like a formulary apportionment or an arbitrary deemed profit percentage.

8. It is extremely difficult to imagine that a radical new approach could be adopted for PE profit attribution purposes without the risk that any such approach would end up being applied for normal transfer pricing purposes as well. It is equally difficult to imagine that such an approach could be applied to a specific sector without the risk that it would be extended (at least by some jurisdictions) to other sectors as well. Thus, the significance of endorsing such a deviation would be enormous, and the decision should therefore be approached very cautiously.

9. The distortions that would be produced by introducing such a concept of “value creation” at the market location also should not be underestimated.

10. As for the withholding tax and equalization levy options: (i) they, too, represent a dramatic shifting of taxing jurisdiction away from the location where functions are performed, assets are used, and risks are undertaken to the consumer jurisdiction; (ii) they raise serious treaty conflict issues; (iii) they abandon notions of fairness and neutrality by imposing a gross basis tax which may exceed profit margins or even apply in loss cases; (iv) they operate as a kind of tariff, acting as a barrier to cross-border trade; (v) they can fall particularly hard on small or start-up enterprises and on consumers themselves; and (vi) they are ill-targeted to “leveling the playing field” between resident and nonresident sellers.

## **II. Implementation of the BEPS Package**

11. As the request for input notes, we are “still early in the implementation of the BEPS package”. In its prior submissions (in October 2013 and April 2014) and its comments during public consultations, the IAPT stressed the extent to which the various measures recommended under Actions 1 through 15 of the BEPS Action Plan would, once implemented, substantially address the BEPS concerns identified in the course of the BEPS project as existing in the digital economy. This was consistent with the view expressed in the Action 1 Final Report itself.

12. It is worth reiterating and updating our previous comments in that regard. For example, we previously noted that:

- Action 1’s VAT work will reduce the risk of double non-taxation of supplies by digital / internet companies.
- Action 2 will prevent digital / internet companies from using hybrid instruments to obtain deductions without corresponding income inclusions.

- Action 3 will prevent digital / internet companies from sheltering income from intangible assets from tax through the use of no-taxed or low-taxed passive CFCs.
- Actions 4 and 9 will limit the ability of digital / internet companies to reduce taxable income through the use of certain deductible payments.
- Action 5 will prevent digital / internet companies from enjoying the benefits of preferential regimes without engaging in substantial business activities, or obtaining rulings the benefit of which effectively relies on nondisclosure to affected jurisdictions.
- Action 6 will prevent digital / internet companies from using treaties to achieve double non-taxation.
- Action 7 will prevent digital / internet companies from avoiding PEs by fragmenting activities to take advantage of Article 5(4), treating core activities as excepted activities under Article 5(4), or disregarding activities of local salespeople which lead to the conclusion of contracts.
- Actions 8 - 10 will ensure that digital / internet companies align intangible-related returns with the creation of value, make arm's length intangible-related payments, and value intangibles appropriately.
- Action 11 will allow for the collection and analysis of BEPS behaviors by digital / internet companies and the effectiveness of actions to address them.
- Action 12 will ensure disclosure of aggressive tax planning arrangements by digital / internet companies.
- Action 13 will ensure robust transfer pricing documentation and country-by-country reporting by digital / internet companies.
- Action 15 will ensure efficient implementation of solutions developed to address the taxation of digital / internet companies.

13. Activities already underway on the part of both taxpayers and governments are starting to bear out the predictions of dramatic effects on the international tax landscape as a result of this combination of recommended measures. For example, in the VAT area, the Action 1 recommendations for the extraterritorial application of VAT obligations on nonresident sellers based on the destination principle have received quick and widespread adoption across the globe. This is leading to substantial new revenue collections for the implementing jurisdictions.

14. In the direct tax area, the adoption of a new Anti-Tax Avoidance Directive in the EU will have the effect in the near term of implementing a significant number of the BEPS Action item recommendations. Other jurisdictions are moving in the same direction. The United States, for example, appears to be on the verge of major tax reform legislation which appears likely to require current U.S. taxation of all non-U.S. earnings of U.S. MNEs, as well as important limitations on base-eroding

payments out of the United States by non-U.S. MNEs. The signature of the Action 15 Multilateral Instrument by more than 70 jurisdictions since early June will lead to widespread implementation of the treaty-related BEPS recommendations across the global treaty network with unprecedented speed.

15. For their part, taxpayers are also adjusting their operations in reaction to the BEPS recommendations. Anecdotal evidence to date suggests that a large number of taxpayers, both within and beyond the digital economy, are taking steps to align their structures with the requirements of the BEPS recommendations. Many companies that have previously relied heavily on centralized distributor models which make remote sales into market jurisdictions are converting to a model that involves use of a local reseller (e.g., a branch or subsidiary), which will create a taxable presence through which sales revenue is booked in the market jurisdictions. A large number of companies that may previously have held their valuable IP in low-tax, low-function jurisdictions are taking steps to “onshore” that IP ownership into jurisdictions where the relevant activities take place, in line with the recommendations of Actions 8-10.

16. These types of changes can take some time (and considerable expense) to implement on the part of large organizations, but their effect will ultimately become visible to tax administrations in a variety of ways, including through CbC reporting, normal tax return disclosures, and audit results. The important point is that the TFDE, if it intends to act responsibly, must take seriously its mandate to monitor the results of the BEPS project before making any decisions on whether supplemental measures are needed to address the challenges of the digital economy. Timing considerations dictate that this monitoring will not be possible to complete by the first quarter of 2018, given that the very first CbC reports and tax returns reflecting the changes underway will likely not become available to individual jurisdictions, at the very earliest, until the latter part of 2017, and the analysis of those will undoubtedly extend well into 2018 and beyond.

17. ***Suggestion:* Accordingly, in order for the TFDE to be able to make a responsible, evidence-based assessment of whether any supplemental measures to address the tax challenges of the digital economy may be needed, we strongly urge that the TFDE’s 2018 interim report focus primarily on the effects of BEPS implementation on the part of not only countries but also taxpayers, with a view to gaining a full understanding of whether the newly implemented measures and structures leave any substantial BEPS concerns that would warrant extraordinary, sector-specific further actions to be taken. Any attempt to reach decisions on such further actions in the TFDE’s 2018 interim report would be dangerously premature and would undermine the OECD’s credibility as an organization that bases its policy recommendations on facts and careful analysis.**

18. One further point regarding implementation of the BEPS package relates to the complexity and administrative burdens faced by taxpayers, both within and beyond the digital sector, that are adopting new distribution models that involve the existence of PEs in a large number of jurisdictions. These structures can entail very substantial compliance obligations and create significant additional operating and administrative costs, often with small amounts of attributable profits.

19. In our September 5, 2016 comments on the discussion draft on the attribution of profits to PEs, the IAPT stressed the need for an administratively convenient way to deal with such cases. Specifically, we commented as follows:

106. Paragraph 246 of the 2010 Attribution of Profits Report cited as one such mechanism an approach whereby the host jurisdiction could “actually collect tax only from the dependent agent enterprise even though the amount of tax is calculated by reference to the activities of both the dependent agent enterprise and the dependent agent PE. In practice what this means is taxing the dependent agent enterprise not only on the profits attributable to the people functions it performs on behalf of the non-resident enterprise (and its own assets and risks assumed), but also on the reward for the free capital which is properly attributable to the PE of the non-resident enterprise.” This type of approach has been successfully implemented in practice by some countries.<sup>2</sup>

107. We would recommend consideration of a mechanism that would allow foreign enterprises that would otherwise have a PE in a Contracting State because of the fact that a related party in that State causes them to have a dependent agent PE or fixed place of business PE to elect out of PE status if the related person elects to be taxable in that State on the sum of: (i) the profits that would otherwise be taxable to that related person and (ii) the profits that would otherwise be taxable to the PE. We believe such a mechanism could be introduced through an appropriate treaty provision or competent authority agreement between the parties to a bilateral tax treaty, which could include a concept along the following lines:

*Notwithstanding the provisions of Article 5, activities conducted in a Contracting State by a person that is closely related to an enterprise or through a fixed place of business of any such person shall be deemed not to cause such enterprise to have a permanent establishment in that State if the enterprise and the person jointly make a binding election pursuant to which the profits of such person which may be taxed in that State shall be equal to the sum of the profits such person would have and the profits that would be attributable to any such permanent establishment of the enterprise in the absence of such election. It is understood that the enterprise and person that make the binding election provided under this paragraph shall ensure that the conditions established between them produce a result that is consistent with the effect of the election, and it is further understood that such conditions shall be considered to be consistent with conditions that are made or imposed between independent enterprises for purposes of the provisions of the domestic law of each Contracting State and Article 9 of this Convention.*

108. A mechanism of this sort would allow a nonresident enterprise that would otherwise be treated as having a PE in a host State to avoid being treated as having such a PE (and thus avoid the need to comply with host State tax and reporting obligations) in certain circumstances and provided that certain conditions are met. It would similarly allow the local tax administration to deal exclusively with its resident enterprise in obtaining all the tax to which it is entitled based on the combined features of the local enterprise and PE in its jurisdiction.

---

<sup>2</sup> See, e.g., IRS press release IR-INT-1999-13, regarding the competent authority agreement between the United States and Mexico to ignore the existence of a Mexican PE in certain cases in the maquila industry, where the taxpayers agreed that the Mexican maquila enterprise would pay tax to Mexico not only on its own arm's length profit but also on an amount determined by reference to what the profits of the U.S. enterprise's Mexican PE would have been.

109. For this result to apply, the provision would require the resident enterprise and the nonresident enterprise to enter into:

- A binding election that provides the resident enterprise agrees to recognize profits, if any, equal to the sum of the profits that would be attributable to the PE of the nonresident enterprise that would exist in the absence of the binding election, based upon the functions undertaken on that nonresident enterprise's account (taking into account assets and risks attributed to the PE, and the necessary "free" capital to support them), plus the arm's length profits, if any, the resident enterprise would have in the absence of the binding election, based upon the functions undertaken by that resident enterprise on its own account (taking into account its own assets and risks).
- Intercompany arrangements that provide that where the binding election is made, the resident enterprise shall charge the nonresident enterprise, and the nonresident enterprise shall pay, an amount such that the total profits recognized by the resident enterprise are equal to the arm's length profits, if any, the resident enterprise would recognize in the absence of the election plus the profits, if any, that would be attributable to the PE the nonresident enterprise would have in the absence of the election. While the latter amount depends under the AOA on assets, risks, and capital deemed owned, assumed, or contributed respectively to the PE, such intercompany arrangement would not need to delineate such deemed assets, risk, or capital.

110. This mechanism would result in the nonresident enterprise having no PE, no filing obligation, and no corporate income tax liability in the host State arising from the activities conducted on the nonresident enterprise's account by the resident enterprise or at its premises. The nonresident would be entitled to deduct the amounts accrued under the intercompany arrangement with the resident discussed above. The mechanism would *not* eliminate a PE, filing obligation, or corporate income tax liability in a host State arising from a nonresident enterprise's *own* activities or operations in that State unrelated to a PE arising from a resident enterprise's activities or premises.

111. This is just one suggestion of a possible mechanism that could be used to achieve administrative simplification, while at the same time guaranteeing the host State its ability to collect the full amount of corporate tax due to it on the profits of its resident enterprise and the PE. We would be glad to work with delegates to consider modified or alternative versions to address their concerns.

20. ***Suggestion:*** In order to lessen administrative burdens and costs on taxpayers and tax administrations alike, the IAPT reiterates its plea for consideration of a mechanism that would allow foreign enterprises that would otherwise have a PE in a Contracting State because of the fact that a related party in that State causes them to have a dependent agent PE or fixed place of business PE to elect out of PE status if the related person elects to be taxable in that State on the sum of: (i) the profits that would otherwise be taxable to that related person and (ii) the profits that

**would otherwise be taxable to the PE. We also reiterate our offer to work with delegates to consider modified or alternative versions to address their concerns.**

### **III. Options to address the broader direct tax policy challenges**

21. The request for input seeks comments on three options drawn from the 2015 Action 1 Final Report: (i) the tax nexus concept of “significant economic presence”; (ii) a withholding tax on certain types of digital transactions; and (iii) a digital equalization levy. We have a number of general comments about these options.

22. First, as indicated above, we believe it would be dangerously premature for the TFDE to consider making a recommendation on any of these options in its 2018 interim report, as there will have been insufficient time by then to evaluate the BEPS implementation data to determine whether any such additional measure is actually needed. In particular, we believe that any BEPS concerns that may exist in the case of remote sellers into a market are effectively eliminated in situations where the business adopts a reseller model. In the reseller case, the sales to local customers are fully booked on the tax books of a local taxpayer (i.e., company or branch), which should eliminate the need to introduce special measures to extend the market jurisdiction’s taxing rights over those sales profits.

23. Second, we note that the Action 1 Final Report had stated that countries could implement any of these options, “provided they respect existing treaty obligations, or in their bilateral tax treaties”. Inasmuch as each of these options is designed to tax the business income (or gross business revenues) of nonresident sellers who do not have a PE in the customer jurisdiction concerned, we believe each raises serious issues of potential conflict with existing treaty obligations and could not be lawfully implemented without appropriate amendments to applicable treaties. We have seen some commentary to the effect that an “equalization levy” may not be an “income tax” of the type covered by treaties and therefore may not be subject to treaty constraints in its implementation. The IAPT seriously questions the legitimacy of that characterization, given that such levies in practice appear to be essentially indistinguishable from a gross basis withholding tax on a category of business profits. The fact that a country may use nomenclature that differs from that found in its income tax provisions or may enact such a levy in legislation separate from its income tax law should be acknowledged to be mere formalities; a country should not be able to evade its treaty obligations by such superficial differences.

24. Third, we note that each of these proposals appears to reflect a desire on the part of market jurisdictions to obtain more tax revenues from foreign sellers than would be called for under existing international tax principles, and that the proposals seek to satisfy that desire without reference to whether any change is needed to address any BEPS concerns identified to date. In other words, the proposals represent a pure shift of taxing jurisdiction away from countries of development and production towards countries of consumption, without reference to BEPS concerns.

25. For example, the Action 1 Final Report clearly and correctly indicated that no material income would be attributable to a PE based on a “significant economic presence” standard without substantial modification to the existing principles for the attribution of profits to PEs. That is because the existing principles attribute profits based on the “functions, assets, and risks” of a PE, and a PE consisting only of

a “significant economic presence” would not have any functions, assets, or risks to which profit might be attributed. This means that profit could only be attributed to such a PE by abandoning existing principles and embracing some radical new approach designed to attribute some arbitrary amount of profit to the market jurisdiction. The Action 1 Final Report suggests that such a new approach would likely have to be based on something like a formulary apportionment or an arbitrary deemed profit percentage.

26. The existing principles for PE profit attribution are based on the “functions, assets, and risks” analysis common to standard transfer pricing analysis called for by the OECD’s *Transfer Pricing Guidelines*. It is extremely difficult to imagine that a radical new approach could be adopted for PE profit attribution purposes without the risk that any such approach would end up being applied for normal transfer pricing purposes as well. It is equally difficult to imagine that such an approach could be applied to a specific sector without the risk that it would be extended (at least by some jurisdictions) to other sectors as well. In other words, the significance of endorsing such a change for purposes of attributing profits to a digital business enterprise’s PE under a significant economic presence standard is enormous. It would remove any principled basis for opposing similar departures aimed at shifting revenues away from the jurisdiction(s) where functions, assets, and risks are located (i.e., the traditional place to which “value creation” has been attributed) and toward the market jurisdiction, based on no more than an arbitrary determination that the market deserved some specific amount of allocable profit. This would amount to a complete reversal of the principle so heavily emphasized during the BEPS project, namely that profits should be aligned with the place where functions are performed, assets are used, and risks are undertaken.

27. The distortions that would be produced by introducing such a concept also should not be underestimated. The arm’s length principle as developed by the OECD is intended to operate in neutral fashion, in the sense that an entity’s profits from transacting with a related party are intended to be the same as if the entity had transacted with an unrelated party under the same or similar conditions. Introducing a separate standard for determining the profit of a “significant economic presence” PE would introduce distortions into the decision of whether to transact with a related or unrelated party. As indicated above, that distortion would likely spread beyond PE profit attribution to regular transfer pricing analyses, and beyond the initially targeted sector to the rest of the economy. It would also remove a long-established standard for determining the market jurisdiction’s profit or loss (i.e., by reference to objective data relating to unrelated party transactions) and replace that with the arbitrary profit standard the market jurisdiction chooses to use to satisfy its revenue desires.

28. The distortions could also arise between sectors (if the new arbitrary approach is limited to some taxpayers viewed as falling within the “digital” sector), or even within a sector (depending on whether the taxpayer is considered to have a traditional PE or only a “significant electronic presence” PE). It is also the case that even if an international consensus could be reached on what the new arbitrary approach should be for attributing profits to a significant economic presence PE within the digital sector (and on how to define the digital sector), some countries would find it hard to resist the temptation to substitute their own arbitrary approach (or to extend the scope of the digital sector), and other countries would have little principled basis on which to argue against such deviations. This scope extension will be inevitable as the traditional economy becomes the digital economy.

29. We will not comment on the withholding tax and equalization levy options, other than to note that: (i) they, too, represent a dramatic shifting of taxing jurisdiction away from the location where functions are performed, assets are used, and risks are undertaken to the consumer jurisdiction; (ii) as indicated above, they raise serious treaty conflict issues; (iii) they abandon notions of fairness and neutrality by imposing a gross basis tax which may exceed profit margins or even apply in loss cases; (iv) they operate as a kind of tariff, acting as a barrier to cross-border trade; (v) they can fall particularly hard on small or start-up enterprises, on small-market economies, and on consumers themselves; and (vi) they are ill-targeted to “leveling the playing field” between resident and nonresident sellers.

\* \* \* \* \*



**Irish Tax Institute**

**Response to OECD Request for Input Regarding the Tax Challenges of  
the Digitalised Economy**

**13 October 2017**

## About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax.

The Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice. With over 5,000 members in Ireland, along with the Chartered Institute of Taxation UK and The Tax Institute of Australia, we are part of the 28,000-strong international CTA network and a member of the Confédération Fiscale Européenne, (CFE) the European umbrella body for tax professionals.

Our members provide tax education and expertise to thousands of businesses, multinationals, and individuals in Ireland and internationally. In addition, many hold senior roles within professional service firms, global companies, Government, Revenue, state bodies and the European Commission.

After 50 years, the Institute remains deeply committed to the role it can play in education, tax administration and tax policy in Ireland and in building an efficient and innovative tax system that contributes to a successful economy and society. We are also committed to the future of the tax profession, our members and our role in serving Ireland's taxpayers and best interests in a new international world order. Our *Irish Tax Series* publications and online database *TaxFind* are respected and recognised as Ireland's most extensive tax information sources.

Irish Tax Institute - Leading through tax education.

The Irish Tax Institute welcomes the opportunity to contribute to this consultation on the tax challenges of the digitalised economy.

### **The importance of the “Digital Economy” to global economic growth**

Businesses make enormous capital and human investment every year in digitising their operations. Such advances in technology and developments in the digitalisation of the overall economy provide tremendous opportunities for development and growth for OECD countries.

Business to business and business to consumer e-commerce, has opened up a global market place that did not exist twenty years ago. Consumers now have access to a vast array of products and services sold online that they could never have previously enjoyed, ranging from goods such as books and computer equipment to the increasing range of digitised services in the form of entertainment, financial services and education, to name but a few. Consumers in OECD countries across the world now have a much wider breadth of choice at lower cost than they would have paid in the digital economy because digitisation has enabled businesses to sell across greater geographical distances and has removed many of the barriers to cross border trade.

The contribution that the digital economy is making to global growth has been recognised widely by the OECD, World Economic Forum, the EU and many others.

#### **OECD, Ministerial Declaration on the Digital Economy: Innovation, Growth and Social Prosperity (Cancun Declaration), 22-23 June 2016**

*“Recognise that the digital economy is a powerful catalyst for innovation, growth and social prosperity.”<sup>1</sup>*

#### **OECD, Key Issues for Digital Transformation in the G20 - Report prepared for a joint G20 German Presidency/ OECD conference, Berlin, Germany, 12 January 2017**

*“The ongoing digitalisation of the economy and society holds many promises to spur innovation, generate efficiencies, and improve services throughout the economy. Moreover, the successful transition to a digital economy is a necessary condition for boosting more inclusive and sustainable growth and enhancing overall well-being.”<sup>2</sup>*

#### **World Economic Forum - Shaping the Future of Digital Economy and Society**

*“The exponential growth in digitization and internet connectivity is the backbone of the Fourth Industrial Revolution. It has the potential to propel societies forward, enable innovative business models and help governments address legitimate policy concerns. Digitization is transforming business models, the policy landscape and social norms.”<sup>3</sup>*

<sup>1</sup>OECD, Ministerial Declaration on the Digital Economy: Innovation, Growth and Social Prosperity (Cancun Declaration), 22-23 June 2016 <https://www.oecd.org/internet/Digital-Economy-Ministerial-Declaration-2016.pdf>

<sup>2</sup>OECD, Key Issues for Digital Transformation in the G20 - Report prepared for a joint G20 German Presidency/ OECD conference, Berlin, Germany, 12 January 2017 <http://www.oecd.org/g20/key-issues-for-digital-transformation-in-the-g20.pdf>

<sup>3</sup> World Economic Forum - Shaping the Future of Digital Economy and Society <https://www.weforum.org/system-initiatives/shaping-the-future-of-digital-economy-and-society>

**European Commission Mid-term Review on the implementation of the Digital Market Strategy, May 2017**

*"It is essential that EU businesses grasp the opportunities of digital technology to remain competitive at global level, that EU start-ups are able to scale up quickly, with full use of cloud computing, big data solutions, robotics and high speed broadband, thereby creating new jobs, increased productivity, resource efficiency and sustainability."*<sup>4</sup>

**European Commission President Jean-Claude Juncker, Political Guidelines, 15 July 2014**

*"I believe that we must make much better use of the great opportunities offered by digital technologies, which know no borders."*<sup>5</sup>

**European Commission Expert Group on the Digital Economy Report, 28 May 2014**

*"First: there should not be a special tax regime for digital companies. Rather the general rules should be applied or adapted so that "digital" companies are treated in the same way as others."*<sup>6</sup>

**The importance of the Digital Economy for Ireland**

Like many small economies in the OECD, Ireland has to trade openly with other countries in order to generate sustainable tax revenues and meet the needs of its citizens.

Ireland has a population of less than five million people but digitisation provides our small and medium sized businesses with the opportunity to participate in the global marketplace. This global access is critical to the development of Ireland's tax base as we currently have narrow product and market diversification in our indigenous sector:

- 20% of Irish small firms export just one product and close to half, export fewer than five.<sup>7</sup>
- 23% of all exported products by Irish companies in 2015 were "Meat of bovine animals, fresh or chilled."<sup>8</sup>
- 27% of Irish firms export to just one market.<sup>9</sup>
- 11% of Irish owned firms account for close to 50% of total export value.<sup>10</sup>

<sup>4</sup> European Commission, Mid-term review on the implementation of the Digital Single Market Strategy – A Connected Digital Single Market for All, 10 May 2017 <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1496330315823&uri=CELEX:52017DC0228>

<sup>5</sup> Political Guidelines for the next European Commission – A New Start for Europe: My Agenda for Jobs, Growth, Fairness and Democratic Change, 15 July 2014 [https://ec.europa.eu/commission/sites/beta-political/files/juncker-political-guidelines-speech\\_en.pdf](https://ec.europa.eu/commission/sites/beta-political/files/juncker-political-guidelines-speech_en.pdf)

<sup>6</sup> European Commission Expert Group on the Digital Economy Report, 28 May 2014 [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/resources/documents/taxation/gen\\_info/good\\_governance\\_matters/digital/report\\_digital\\_economy.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf)

<sup>7</sup> ESRI, Expanding and Diversifying the Manufactured Exports of Irish-owned Enterprises (April 2017) <https://www.esri.ie/pubs/BKMNEXT335.pdf>

<sup>8</sup> ESRI, Expanding and Diversifying the Manufactured Exports of Irish-owned Enterprises (April 2017) <https://www.esri.ie/pubs/BKMNEXT335.pdf>

<sup>9</sup> ESRI, Expanding and Diversifying the Manufactured Exports of Irish-owned Enterprises (April 2017) <https://www.esri.ie/pubs/BKMNEXT335.pdf>

Supporting more Irish businesses to scale up is essential if we are to achieve the necessary diversification in our tax base that will help to insulate it against future economic shocks.

### IMF comments on Ireland

The IMF has been instructive in terms of what Ireland must set out to do. It “must create a resilient, dynamic, innovative economy that is broader based in its structure and less vulnerable.”<sup>11</sup>

Digitisation is a key enabler to achieving this growth and diversification in the domestic sector because it offers our businesses the opportunity to trade beyond Irish and UK shores.

### Digitizing Europe, May 2016

*Digitizing Europe*<sup>12</sup> has named Ireland as one of nine European frontrunner countries that could see the largest benefits from a more digitised European economy.

The report says that: “*Europe is at a digital crossroads, with a unique chance to either capture an immense opportunity, or see the region fall behind other nations. And the frontrunner countries are even more sensitive than the EU as a whole to a lost digital opportunity, since a larger share of their economies is digitized, and the majority of their future growth is digitally enabled.*”

*“A European digital single market (DSM) would encompass more than 500 million consumers and is expected to add €415 billion in annual GDP to EU.”*

### The digital economy is part of the broader global economy

In October 2015, the OECD Task Force on the Digital Economy concluded that it is “neither appropriate nor feasible” to ring fence the digital economy, recognising that the overall global economy is becoming increasingly digitised.

The digital economy has penetrated the overall economy and one cannot be ringfenced from the other. For this reason, care should be taken to avoid creating a separate set of tax rules for so called “digital” businesses. To do so would require policy makers, tax administrations and taxpayers to make arbitrary distinctions every day about which businesses are “digital” businesses and which are not. And the complexity of such characterisations will inevitably deepen over time when you consider that this generation of children is likely to carry out work in the digital economy that has not even been imagined today.

---

<sup>10</sup> ESRI, Expanding and Diversifying the Manufactured Exports of Irish-owned Enterprises (April 2017) <https://www.esri.ie/pubs/BKMNEXT335.pdf>

<sup>11</sup> IMF, “Staff Concluding Statement of the 2017 Article IV Consultation” (May 2017), <http://www.imf.org/en/News/Articles/2017/05/12/ms051217-ireland-staff-concluding-statement-of-the-2017-article-iv-consultation>

<sup>12</sup> Digitizing Europe, May 2016 [http://image-src.bcg.com/BCG\\_COM/BCG-Digitizing-Europe-May-2016\\_tcm22-36552.pdf](http://image-src.bcg.com/BCG_COM/BCG-Digitizing-Europe-May-2016_tcm22-36552.pdf)

For all the opportunity that the digital economy offers, it remains part of the overall global economy and whatever rules are developed to deal with the tax challenges it brings must apply equally to all businesses operating in the global economy.

## **An overview of the tax challenges**

The rapid expansion of the digital economy has undoubtedly created challenges for the global tax regime. However, many of these challenges are in the process of being addressed through the OECD's Base Erosion and Profit Shifting (BEPS) project. The OECD's report on Action 1<sup>13</sup> acknowledges that the digital economy does not generate unique BEPS issues, rather some of its key features exacerbate other BEPS risks. The mobility of customers, business functions and intangibles that characterise the digital economy are recognised across the 15 BEPS Actions and the overall approach of more closely aligning profits with value will resolve much of the misalignment between the business models and the tax rules. Furthermore, countries such as Ireland which are in the European Union are also in the process of implementing the EU Anti-Tax Avoidance Directives, ATAD<sup>14</sup> and ATAD 2.<sup>15</sup>

Most OECD countries are still only part way through the implementation of these BEPS and ATAD actions. In addition to this, guidance on hard to value intangibles and profit splits is still evolving and the impact of choices by policymakers and tax authorities in the application of emerging guidance has yet to be fully understood.

Until the details of the overall BEPS package have been agreed and BEPS and ATAD have been implemented, it is very difficult to assess the impact that these far reaching changes will have on the digital economy.

Indirect taxes also have an important role to play in the taxation of the digital economy and cannot be dealt with in isolation to corporation tax. Just as the global corporation tax rules have not kept pace with the modern digital economy, VAT systems globally have struggled to define the place of supply of a digital service. The EU has played a leading role in attempting to reform their VAT regime but despite the fact they have been working on this project since 1993 and have invested significant resources that work is still ongoing.

### **Federation of German Industries Submission to BEPS Action 1, 14 April 2014**

*"We acknowledge that consumption taxes might be the better option to tackle the issue that market jurisdictions do not obtain their desired share of revenue from digital providers. For instance, the new rules concerning the supply of electronic services entering into force in 2015 in the EU will extend the destination based principle to telecommunications, broadcasting and electronically provided services. This will ensure a fair and reliable procedure within the EU and will be combined with a Mini One Stop Shop (MOSS) to facilitate administration for businesses."*<sup>16</sup>

In addition, many countries and regions face VAT compliance challenges and are experiencing very significant VAT gaps. In its EU VAT Gap Report published recently, it was

<sup>13</sup> 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. <http://dx.doi.org/10.1787/9789264241046-en>

<sup>14</sup> Council Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market

<sup>15</sup> Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries

<sup>16</sup> Federation of German Industries Submission to OECD BEPS Action 1, 14 April 2014

estimated that EU countries lost a total of €152 billion in Value-Added Tax (VAT) revenues in 2015. This represents a loss of 12% of the total expected VAT revenue.<sup>17</sup>

Steps to advance the VAT rules for the digital economy and improve VAT administration and collection could result in significantly increased revenues for many countries, as work progresses on the corporation tax agenda.

### **The alternative OECD approaches**

This consultation outlines three options to address the broader direct tax policy challenges of the digital economy:

- a) Tax nexus concept of “significant economic presence”
- b) Withholding tax on certain types of digital transactions
- c) Digital equalisation levy

Each approach brings challenges and any decisions on whether and how to act on these options should be guided by the Ottawa taxation framework principles<sup>18</sup> of:

- Neutrality.
- Efficiency.
- Certainty and simplicity.
- Effectiveness and fairness; and
- Flexibility.

### **Tax nexus concept of “significant economic presence”**

The concept of “significant economic presence” creates a new form of nexus for certain businesses in the digital economy that may not be regarded as having a permanent establishment by virtue of their physical presence under the existing Article 7 of the OECD Model Convention.<sup>19</sup>

At present, OECD countries are dealing with proposed amendments to this Article under BEPS Action 7 and the Multilateral Instrument (MLI). A number of countries have concerns about reducing the threshold for permanent establishment (PE) until such time as further clarity is available on the attribution of profits to such PEs. Even before considering any new nexus test for digital businesses, it is proving difficult to achieve certainty and consensus on the matter.

Particular challenges arise in trying to attribute a PE to a business that has no presence in a country other than perhaps gathering raw data there. Is this sufficient to create a nexus in that country and even if it is, what value can be attributed to that raw data, when all the people functions in extracting the value from it are located elsewhere?

---

<sup>17</sup> VAT Gap Report, 28 September 2017 [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/vat\\_gap\\_factsheet\\_2017.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/vat_gap_factsheet_2017.pdf)

<sup>18</sup> Electronic Commerce: Taxation Framework Conditions - A Report by the Committee on Fiscal Affairs, 8 October 1998 <https://www.oecd.org/ctp/consumption/1923256.pdf>

<sup>19</sup> OECD Model Tax Convention on Income and on Capital 2014

Valid concerns also arise about the level of uncertainty that would result from undoubtedly very different interpretations of such a nexus by tax authorities even in the event that global consensus could be reached on the definition of a “significant economic presence.”

Businesses are already experiencing the predicted rise in tax disputes in a post BEPS era and it is likely that a widely drawn nexus test with related profit attribution rules could open digital businesses to a never-ending plethora of international tax disputes.

### **Withholding tax on certain types of digital transactions**

Withholding taxes that operate at present in the international tax regime, generally apply to passive income from capital investment such as dividends, interest and royalties. They apply to gross payments, often at a low rate. In these cases, the gross payment is generally a reasonable approximation to the profit arising from the asset, as the costs that are directly involved in generating that income would be low.

However, applying a withholding tax to gross payments for goods and services is an entirely different matter as the expenses involved in generating this type of income will be much higher. In fact, a lot of digital businesses operate on very low profit margins or indeed are actually in a loss-making position. This is particularly true in the case of start-up and small businesses, investing in their ambition to operate as global firms and trying to break into new markets.

Imposing a withholding tax on digital businesses would be a very “blunt instrument” to collect tax from them and could push many new entrants and small businesses into a loss-making situation. Although the context is different, Appendix 1 highlights the impact of a turnover tax (betting tax) on a business’ profitability, for illustrative purposes.

Ironically, larger digital companies may have the scale to trade through the imposition of such taxes - it is the smaller companies that could be impacted most by them.

The principle of neutrality is also important in the context of withholding taxes.

#### **Federation of German Industries Submission to BEPS Action 1, 14 April 2014**

*“There are various aspects which do not support imposing WHT. First of all, it would raise neutrality issues when treating transactions in digital services different from other transactions, e.g. is music or software a digital product if downloaded but not if provided on physical instrument like a CD. Most importantly, however, levying WHT could lead to a double taxation of the digital activities as the withholding tax will easily exceed the tax due on the net profits.”<sup>20</sup>*

A withholding tax which is based on gross payments alone is more akin to a consumption tax and it is the role of VAT to ensure that adequate taxes on consumption are collected in the relevant countries.

---

<sup>20</sup>Federation of German Industries Submission to OECD BEPS Action 1, 14 April 2014

Finally, the administration difficulties of a withholding tax must be considered. Individuals in business to consumer transactions will not collect and pay over a withholding tax to the tax authorities. This then raises the question of efficiency - who will collect the tax and how will it be administered? Will some type of collection agent be required to act as a withholding agent for the taxpayer and what costs will this add for them, in terms of complexity and uncertainty?

### **Digital equalisation levy**

Similarly, a digital equalisation levy represents a payment based on gross revenue. The concerns raised above will equally apply in terms of proportionality, ability to pay and the potential for widescale disruption and cost for businesses small and large.

A digital equalisation levy based purely on customer numbers in the market country is completely at variance with the principle of taxing profits where value is created. It would result in a different tax model for so called “digital businesses” as compared with businesses in the traditional sector, which would be neither neutral nor fair. It would also create huge uncertainty as to who fell within the definition of a digital business for the purposes of the levy.

It is very unlikely that a levy such as this would be creditable under existing OECD double tax agreements and would thus lead to multiple taxation of business profits globally.

It would also act in an arbitrary manner to favour economies purely on the basis of large populations, without cognisance of the fact that the value created in supplying these customers is likely to have been generated elsewhere.

### **Conclusions**

The Irish Tax Institute agrees with the OECD approach that any further measures taken to address the specific tax challenges of the digital economy should only be determined after;

1. Full consideration of the wide-ranging business models and value chains involved,
2. An in-depth understanding of the specific tax challenges posed by particular features of the digital economy; and
3. A cost benefit analysis of introducing further changes for these businesses.

Many companies that operate globally have designed their business models precisely to take advantage of the economies and efficiencies available from digitisation. It is these economies that enable them to offer their goods and services to businesses and consumers at reduced cost.

If careful thought is not given to the imposition of new tax rules on these businesses, they could be forced to fundamentally reform their business models, forcing them to set up establishments in countries worldwide that are completely unnecessary from a business point of view, purely to satisfy tax rules. This would clearly be a retrograde step in the development of the digital economy and would run contrary to the stated digital strategy of numerous national and international bodies. It would inevitably result in additional cost for individuals, businesses and investors (including pension funds) globally.

Whatever solutions are chosen have to work effectively for the digital economy and the wider global economy. They have to be fair and effective, not giving rise to multiple tax charges, and they should be reached by international consensus as was the case with the broader

BEPS actions. While this framework for agreement may require an investment of time, we believe it offers the best likelihood of sustainable progress in a very complex and ever evolving area of international taxation.

## Appendix 1

### Example of how punitive a turnover tax can be – in the context of betting tax

Extract from the Irish Independent Betting Offices Association submission to the Department of Finance's Betting Tax Review 2017<sup>21</sup>

*“Because of its nature a turnover tax will have a disproportionate effect on those businesses with a lower net margin. The figures in Appendix II highlights the problem, as a flat 1% turnover tax equates to a crippling 100% of net profit for a smaller shop compared to 59% for the average Paddy Power shop. There can be no doubt that this unfair proportion of taxation to net profit borne by the smaller operator has been a major factor in the demise of many of our members.”*

## Appendix II

### Retail Sector – Betting Tax as a % of Profit

	<b>IIBOA Average LBO</b>	<b>Paddy Power Average LBO</b>
Turnover	€1,600,000	€4,688,000
<b>Betting Tax</b>	<b>€16,000</b>	<b>€46,880</b>
Operating Profit	*€16,000	€78,750
<b>Betting Tax as a proportion of profitability</b>	<b>100%</b>	<b>59.53%</b>

\* Based on a net margin of 1%.

<sup>21</sup> <http://www.finance.gov.ie/wp-content/uploads/2017/07/IIBOA-Submission-2017.pdf>



October 13, 2017

Mr. Pascal Saint-Amans  
Director, Center for Tax Policy and Administration  
OECD, 2, rue Andre Pascal  
74775 Oaruss/ Cedex 16  
France

Dear Mr. Saint-Amans,

The Information Technology Industry Council (ITI) hereby submits feedback on your ongoing work examining the tax challenges raised by digitalisation. ITI represents 62 of the leading information and communications technology (ICT) companies from around the world.<sup>1</sup> ITI is the voice of the high-tech community, advocating for policies that advance technology, promote innovation, open access to new and emerging markets, protect and enhance consumer choice, and foster increased global competition. ITI's member companies include wireless and wireline network equipment providers, computer hardware and software companies, Internet and digital service providers, mobile computing and communications device manufacturers, consumer electronics, and network security providers.

The global economy is digitised and data-driven. Digital commerce is exceptionally broad as it encompasses any economic activity involving the movement of digital information, services and products across borders. Indeed, digital commerce often yields the greatest impact in business-to-business contexts outside of the technology industry and is fundamental to the success and competitiveness of the private sector, including SMEs and startups in developing countries. Whether it is in the automotive, construction, energy, financial services, healthcare, manufacturing, or other sectors, business owners rely on cross-border data flows for their daily operations. As ITI members build hardware, develop software, and provide services that enable the business operations across all sectors, resolving ICT-related tax challenges in the global economy is a critical concern.

Increasingly tax policy is one such area where jurisdictions attempt to influence the technology sector and the use of ICT more broadly. We recognize the OECD has been heavily engaged in these policy debates and we appreciate your leadership on these issues. Further, we understand the modern digitalised economy has created a desire to revisit international tax norms. Overall, we feel strongly that such complex cross-border tax issues are best confronted through continuing multilateral engagement, especially given the OECD's recognition that these issues will impact all cross-border trade and

---

<sup>1</sup> For more information on ITI, including a list of its member companies, please visit: <http://www.itic.org/about/member-companies>.



investment. As interest in this area increases, it is important to recognize the OECD's role in not only providing policy insight into the taxation of technology firms or ICT-related business activities, but appropriate application of its policies and guidance in jurisdictions around the globe.

***Ring-fencing digital from the rest of the economy is impossible:*** In terms of taxation of technology firms or ICT-related business activities specifically, we agree with your conclusion in your BEPS Action 1 report on the impossibility of “ring-fenc(ing) the digital economy from the rest of the economy for tax purposes”. The European Commission Expert Group on Taxation of the Digital Economy similarly found in its 2014 report that relegating the digital economy to a subset of the broader global marketplace has been problematic due to the “widespread diffusion of the digital economy within the whole economy.” Acknowledging both the impossibility of isolating the digital economy and the need for a simple, stable international tax regime, the report concludes that rather than create a separate tax system for “digital” businesses, general tax rules should be applied or adapted to treat these businesses as any other in the mainstream economy.

As your Action 1 report elaborates, the convergence of the growing global economy and evolution of business models through digitalisation has resulted in companies navigating foreign markets in a fundamentally different way. The rapid development of digital technologies enables companies to conduct business across borders and deliver their products and services to consumers more efficiently and effectively across the world, increasing quality and reducing costs. By allowing for the central management of myriad operations that previously required a physical presence, the traditional framework of doing business has evolved. Companies are able to compete in the global marketplace at a much earlier stage in their development. Furthermore, as innovative technologies are embedded in, and integral to, operations of firms across the global marketplace, attempts to isolate business models with a predominant digital component as a separate sector of the economy would “require arbitrary lines to be drawn between what is digital and what is not”.

***Address the concerns, don't target the business model:*** Broadly speaking, we agree that the best way to address tax challenges in an increasingly digital global economy involves honing in on specific features of the relevant business models that raise tax concerns, and developing approaches to address those concerns. Policymakers should be mindful that the evolution of all digitalised business models will continue to accelerate, so approaches should be developed at a sufficiently high level to be sustainable for the future.

A good example of such an approach is the European Union's Electronically Supplied Services (ESS) rule. As you know, in 2008, the European Commission amended its VAT regulation and changed the place-of-supply rule for digital services to the place-of-consumption. Following the change in rules, the Commission did a number of things we would consider best practices. Critically, it allowed for a long and thoughtful transition—the effective date was set for January 2015. Commission officials used this time to form a working group to clarify the scope, administrative procedures and implementation guidelines. Several positive aspects of the rule resulted from this process. First, the ESS rule followed and adopted



OECD guidelines to limit the scope of business-to-business supplies and recommended the use of reverse charge for B2B transactions. Next, the rule simplified the administrative procedures to allow offshore companies to register with a single Member State to remit taxes due to all Member States. The tax agencies also invested in their systems to enable online registration, submission of tax returns and remittance of tax collected. These provisions have eased compliance for business and collection for EU countries.

However, such an approach is not always deployed, resulting in mixed policy outcomes. Overall, a significant challenge ITI members face in the tax space is the rush by countries to develop their own policy approaches, especially concerning digital goods and services. Continuing with the VAT example, seeing the success of the ESS approach, South Africa rushed to enact a similar provision. The quickness of its process led to issues that resulted in two rounds of additional clarifications and amendments. We have seen a similar dynamic as India has migrated to a Goods and Services Tax (GST) system. It announced the change in April 2017 and set the implementation for July 1, just three months later. Numerous problems have resulted.

***Continue favouring multilateral engagement rather than unilateral approaches on cross-border tax issues:*** Efforts to enact changes to direct tax rules focused on the “digital” economy have also resulted in complicating the international tax landscape. Though countries are free to establish their own tax laws, such laws have historically been accompanied by treaties to reduce double-taxation and streamline cross-border transaction. When economies take unilateral action, it not only puts these agreements into question; this individual movement across markets also impedes progress on a consistent, organized global tax conversation. As stated above, we agree with your preliminary conclusions and appreciate the attention and engagement with which you continue to analyze these issues; however, we also recognize that the process has created a short-term vacuum that jurisdictions seem eager to fill. Since the BEPS reports were issued in 2015, we have seen a number of countries move forward with various policies such as the Argentinian turnover tax (2015), Indian equalization levy (2016), Australian updated diverted profits tax (2017), and the United Kingdom diverted profits tax (2015) and updated withholding tax (2017), to name but a few.

One of the clear goals of the BEPS process, and the reason to pull it under the G20 banner, was to develop multilateral solutions to complex problems with the backing of the largest economies in the world. We recognize that the BEPS process was exhaustive and its conclusions hard fought. In the digital space the consensus was to continue the work and issue recommendations in 2020. We appreciate that this work continues but we must also recognize many economies have moved forward above and beyond the OECD’s work and conclusions. Perhaps the most significant example comes out of the European Union. As you know, recently, a block of EU Member States proposed a number of policies explicitly targeting technology firms and ICT-related business activities. These developments are precisely what the BEPS process tried to prevent.



***Equalisation levies and gross withholding taxes present numerous policy and legal issues:*** While our members are opposed to any special measures targeting the digital economy, they have immediate concerns about the notion of adopting such interim policies prior to the completion of the Action 1 Report mandated review. First, broadly speaking, we dispute the underlying notion that such taxes are levied on value where it is created. Tax law has long reinforced the idea that consumption of goods and services does not create value—development and production of goods and services does. Second, a tax imposed on gross revenue has no relationship to net income, which is the only appropriate base for a corporate income tax. Third, we believe these proposals inherently take tax revenue from one country (the country of production) and transfer that tax revenue to the market country. If such an approach is pursued it will require economies to agree between themselves to give up taxation on production.

An equalisation levy could have a number of unintended consequences for businesses and consumers. First, assuming the levy does not include an input credit, long supply chains could create a cascading tax which would multiply the base and amount of tax due. Further, we have heard concerns about the impact of such a tax on small- and medium-sized businesses, especially startups that have not achieved profitability—the very companies many policymakers that are focused on developing countries hope to assist. We also have concerns about the effect on the pricing of services and the impact that could have on consumers. A tax focused on digital services would likely raise the cost of services available in the cloud, for example, which we believe will be a major engine of growth for small and large businesses and developed and emerging economies across the world. Lastly, it is reasonable to believe that, ultimately, the tax would be borne by consumers, which raises questions about the fairness of such a policy.

We also have administrative and legal concerns about such a levy. Any such tax needs to be simple for tax authorities to administer, audit and enforce- and for enterprises to comply with (as noted in our above discussion of the EU’s ESS VAT rules.) We would flag particular concerns of non-resident entities that may not have a local infrastructure, versatility with the native language, local bank accounts, etc. Then we have pressing legal questions. First, any new taxes would need to be fully compliant with European Union laws and international trade obligations. Most critically, any corporate income tax must be fully compliant with tax treaty commitments. As this tax is intended to be a tax on corporate profits, it would be precluded by all existing intra-EU tax treaties. We believe any attempt to override tax treaties to impose taxes on a single industry or sector of the economy would be highly damaging to the integrity of the international tax treaty network.

***Efforts to create a special “digital” permanent establishment (PE) rule depart from reaffirmed long-standing international tax standards:*** Some have proposed creating a new PE nexus to target digital presence within jurisdictions. The notion of a digital PE runs counter to the fundamental agreements reached between countries on residence versus source taxation that underpin the international tax system. Even if such a concept could be delineated in any rational and administrable manner, how could profit be attributed to a digital presence under PE attribution rules (AOA or non-AOA)? In many ways, such profit attribution would operate as formulary apportionment, and therefore be a radical departure from the arm’s length standard that you reconfirmed through the BEPS reports.



\* \* \*

As you continue your work on digital taxation, we ask you to keep the following points in mind:

- There is no such thing as a “digital economy.” The global economy is digital – data flows and other digital activities permeate virtually every aspect of modern international commerce – and should be treated as such for tax purposes.
- The best way to address tax challenges in relation to technology firms and ICT-related business activities is to hone in on specific concerns raised by such firms and business activities and develop targeted approaches to address those concerns, recognizing the need for solutions to be sustainable for evolving business models.
- These proposals inherently take tax revenue from one country (the country of production) and transfer that tax revenue to the market country. There needs to be agreement between countries that they are willing to give up taxation on production.
- Unilateral approaches are counterproductive for everyone. Complex cross-border tax issues are best addressed through multilateral engagement.
- Targeted levies could have unintended consequences adverse to economic growth and present legal challenges.

Thank you for your consideration of these points. We look forward to your continued focus on these critical issues.

Sincerely,

A handwritten signature in black ink, appearing to read "Jennifer McCloskey", is written over a circular stamp. The stamp contains the text "Jennifer McCloskey", "Director", and "ITI" below it.

Jennifer McCloskey  
Director  
ITI



**Japan Association of New Economy (JANE)**

ARK Hills Executive Tower 8F N811

1-14-5 Akasaka, Minato-ku, Tokyo, JAPAN 107-0052

TEL: +81-(0)50-5835-0770 E-mail: [info@jane.or.jp](mailto:info@jane.or.jp)

Oct 13, 2017

**Input to the OECD on the Tax Challenges of Digitalisation**

We regard that the discussion on Base Erosion and Profit Shifting (BEPS) project of the OECD is based on the principle that the place of taxation should be determined by where the economic value is generated. However, the USA did not sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in June 2017, and fair international competition on the level playing field is not yet well secured, especially between American multinational companies and others.

Therefore, we would like the OECD to keep making efforts to involve countries around the globe, especially the USA, and address the issue under international cooperation.

The Japan Association of New Economy (JANE) presented its opinion at the OECD Conference Centre before ( [https://jane.or.jp/upload/topic249/topic\\_1.pdf](https://jane.or.jp/upload/topic249/topic_1.pdf) ). We would like you to refer to this opinion again.

Jeffery M Kadet  
511 West Prospect Street  
Seattle WA 98119

206 395-9849  
[kadetj@u.washington.edu](mailto:kadetj@u.washington.edu)  
[jeffkadet@gmail.com](mailto:jeffkadet@gmail.com)

October 11, 2017

Task Force on the Digital Economy  
OECD  
Paris

Via email to: [TFDE@OECD.org](mailto:TFDE@OECD.org)

Re: Submission Concerning Tax Challenges of  
Digitalization

This submission is in response to the OECD's 22 September 2017 invitation for public input on the tax challenges of digitization. I am submitting this personally and am not representing any group or speaking on behalf of any other person.

I would be pleased to respond to any questions.

Cordially,

:

A handwritten signature in black ink, appearing to read "Jeff Kadet", with a stylized flourish at the end.

Jeffery M. Kadet

c.c. Sol Picciotto

# SUBMISSION CONCERNING TAX CHALLENGES OF DIGITALIZATION

Summary	2
Detailed Responses	3
A. Digitalisation, Business Models and Value Creation	3
Introductory Comment	3
Conditions Before Digitalization and After	4
Concrete Approaches to Dealing with New Business Models	7
B. Challenges and Opportunities for Tax Systems	13
C. Implementation of the BEPS package	13
D. Options to address the broader direct tax policy challenges	14
Appendix A - Expansion of the Profit Shift Method: The Wave of the Future	16
Appendix B – Letter of 23 January 2013 to OECD re Worldwide Full-Inclusion	25

## SUMMARY

Profit shifting has been on steroids. Despite this, at the initiation of the BEPS project in 2013, a decision was made to limit the project's scope by accepting the separate entity concept and the arm's length principle. It is now time to think more broadly.

Considering this, in this submission I suggest four concrete approaches to dealing with BEPS behavior within the context of the digital economy. Certain of these approaches are new and presumably have not been previously considered by the Task Force. The first three may be initiated immediately. The fourth is a long-term approach. These four approaches are:

- **Identification of PEs in BEPS Structures and Applying Taxation to Them**—Many BEPS structures involve the recording of profits in a principal company where the management and conduct of the business takes place in the MNEs home country or a third country. Such cases will involve undeclared PEs that would be appropriately taxable in the countries where the business is managed and actually conducted. I suggest in this submission various steps that would lead to taxation of such BEPS structures. This in turn would lead to the unwinding of some existing structures and discouraging new structures. (Note that this is a focus on the country where the principal company's business is run and is not a focus on the BEPS project's expansion of Article 5, which expands the PE definition for countries from which a non-resident is earning revenue.)
- **Expanded Use of the Profit Split Method and Development of Concrete Allocation Keys and Weightings**—Broader use of the profits split method along with the creation of concrete allocation keys and weightings for common business models would ease compliance for taxpayers and significantly facilitate reviews by tax authorities. It would also greatly increase certainty for both taxpayers and tax authorities alike. See Appendix A.
- **Abandonment of Territorial Tax Systems in Favor of Something Better**—Territorial tax systems have significantly contributed to the BEPS contagion by strongly motivating MNEs to shift profits out of home countries, source/host countries, and the countries into which they sell products or provide services. Transfer pricing and CFC rules have been insufficient to protect home country tax bases. A typical goal of MNEs is to be taxable

nowhere. The Task Force on the Digital Economy could recommend that the relatively few countries that are home countries to MNEs should abandon their territorial systems and adopt residency-based full-inclusion systems. Under full-inclusion systems, the home countries of MNEs would tax currently at home country tax rates the worldwide income of their MNEs irrespective of which group member recorded the income. This is a very practical approach that could be instituted in the short term since its adoption only requires participation by the relatively few countries that are home countries to MNEs. In addition, there is no need for uniformity with each country being able to define its own tax base, tax rates, sourcing rules, etc. This full-inclusion approach stands on its own as an approach that would provide an environment with much less motivation for BEPS behavior. If the longer term formulary apportionment dialogue recommended below is successful, this full-inclusion approach could be an effective interim approach. See Appendix B.

- **Formulary Apportionment**—Initiation of a dialogue amongst all nations with a long-term goal of developing agreement for the implementation of a formulary apportionment taxation system.

## DETAILED RESPONSES

The invitation for public input provided a long list of specific issues. To keep within the parameters of those issues, I have provided my detailed responses within that framework. I have, though, only included those issues for which I have a response.

### 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).

#### Introductory Comment

It will be no surprise to any person involved in the entire BEPS project and in Action 1 in particular that digitalization has brought significant changes. What might not be appreciated, though, is the extent of certain changes and the differences that has made in the business models used decades ago versus those commonly used today. The tax laws in those decades leading up to the technology developments that occurred in the latter part of the 20<sup>th</sup> Century had been stable, relatively speaking. They worked reasonably well. Yes, over time, many countries enacted transfer pricing rules and some also added controlled foreign corporation (CFC) rules to help curb the excesses of some aggressive game-playing corporate taxpayers, but for the most part, things worked.

The changes in our environment occurred very gradually at first, then speeding up late in the last Century. Today, most government officials and practicing professionals grew up in a world that already exhibited many of these technological advances in communications and information technology. They have also grown up within an environment that included many countries already having adopted territorial tax systems in contrast to the worldwide systems that had earlier predominated. As a result, when many such officials and professionals think of the changes that have occurred from digitalization in the last twenty or thirty years, they are most typically thinking of the

conditions that existed at the start of their careers and not those that existed in the immediate post-World War II period when MNE reach and worldwide activities really expanded.

Another aspect that is probably less appreciated is the consolidation in many industries and markets that has occurred gradually over past decades. The increasing size and scale of the fewer players in increasingly larger markets has normally increased centralization of business management and many functions. This has made the integration and implementation of new technologies into operations more natural and affordable. Again, most government officials and practicing professionals have grown up in an environment that already exhibited a limited number of Goliath MNEs that dominate their respective products, services, and markets.

### Conditions Before Digitalization and After

Before the transformation over the past half century to new communication and computer technologies, MNEs typically operated around the world by setting up manufacturing plants close to their customers and other offices, many of which were involved in selling products. These manufacturing facilities and other offices performed significant business functions that generally had to be done locally. Guidance and direction, of course, came from the home office of the MNE, but real business activities and real management personnel directing those activities were in the plant or offices locally.

The communication links available a half century ago included letters delivered by postal services—a week or longer—and, where something was urgent, by courier—maybe 1 to 3 days depending on location. For transmitting information, there was the telex—this was before the fax machine came along—and the telephone. Back then, long-distance calls were expensive and only used for critical or urgent matters. As will be appreciated, this state of communications meant that an MNE's business operations in various countries around the world had to have their own management personnel. Day to day local business operations could not be done long distance from the MNE's home office. Thus, any such local operation would have its own CEO, operations director, sales director, plant manager, finance director, HR director, etc. Such local plants and other offices were stand-alone businesses truly operating independently of the MNE's home office, although of course under its guidance.

Although having their own local managements and conducting business independently, as a part of an MNE, such operations used group IP (e.g. product formulations, patents, trademarks, copyrights, manufacturing processes, etc.) and conducted business under the MNE's general group policies and procedures. A local operation might also use machinery and equipment provided by other MNE group members.

IP required for the local operations might be transferred in exchange for cash or shares, contributed in some other manner, or licensed in exchange for a royalty. Where MNE group members provided services (aside from stewardship activities, now being referred to as “shareholder activities”), appropriate charges might be made under service agreements. And for group member-provided machinery and equipment, they could be purchased or leased from the transferring group member or perhaps transferred in exchange for newly issued shares. Financing for the local group member purchasing

machinery and equipment might be through intercompany debt or through shareholder guaranteed local third-party debt.

To summarize, typical MNE foreign operations a half century ago prior to the process of digitalization and today's instantaneous communications involved independently run operations.

Were games being played back then to reduce taxation? Of course. A typical thing was to run sales through related tax haven companies (e.g. re-invoicing), lodging in those companies some amount of profit that wouldn't be taxed in any country. Or, another thing was to have a related company in a zero or low tax country perform certain services for related companies located in high tax countries, thereby allowing a deduction for the service fees in the high tax country with low or zero taxation in the country of the related service provider. There was also the ability to retain earnings overseas and then put it in a bank account to earn interest or use it to make other passive investments that would earn dividends, interest, rents, royalties, etc.

As a result of these types of tax motivated structuring, the U.S. in 1962 enacted CFC rules in an attempt to discourage such tax avoidance. Over the following decades, many other countries followed suit, implementing their own versions of these CFC rules as well as transfer pricing rules. Such rules did help to cool down some game playing in the 1960s through the mid-1990s, but later developments motivated MNEs to work hard to develop approaches that allowed low or zero taxation<sup>1</sup> while avoiding otherwise applicable CFC and transfer pricing rules.

While some undoubtedly still exist, today, the previously ubiquitous independently-run and locally-managed MNE foreign operations described above are rare, relatively speaking. Modern business models, which proliferated especially in the late 1990s and thereafter, are now used extensively. These new business models reflect both changes in technology and the adoption, often for competitive reasons, of contract manufacturing models most typically in countries having lower wage rates and available infrastructure developed to attract inbound investment. Most importantly, though, because of the powers unleashed by the internet, computers, and instantaneous communications, we have business models that involve worldwide operations that are centrally managed and directed, with many critical functions formerly performed within local country operations being performed centrally.

Consider a manufacturing MNE. R&D, raw material and component purchasing, management of production quantities and inventory levels, quality control, and sales operations are often conducted within the MNE's home office. The actual manufacturing

---

<sup>1</sup> 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>. These developments that so motivated tax-avoidance behavior included the proliferation of territorial tax systems along with reductions in corporate tax rates that affected foreign tax credit planning and increased the benefits of achieving zero and low-taxed foreign earnings, the elimination of exchange controls and other restrictions on cash movement, the development of supply chain and other new business models that reflected advances in technology, and the selling of tax structures by outside advisors.

may be carried out in an Asian location, but all the decisions on what to produce, raw material and component selections, production sizes, etc. are made in the MNE's home country. Local personnel are often focused on physical production and little more. In countries that are important markets for the MNE's products, there may of course be marketing and sales personnel, but many such MNEs make a material portion of their sales to global customers and major resellers. In such cases, the negotiation of sales terms and the conclusion of sales contracts will often involve sales personnel in the MNE's home office, many times with little or no involvement of sales and marketing people in the countries of customers. Further, for such manufacturers that sell significant quantities of their products (whether tangible products or intangible products) through their own online stores, these stores are often created, maintained, and managed within the MNE's home country. Home country personnel design, operate, and maintain the online stores, decide what products to offer and on what terms, set pricing, etc. Typically, no local country personnel in the country of the online store customers will be involved in such sales. Local functions, if any, will typically be limited to warehousing, delivery, and perhaps some customer support.

Now consider an MNE that conducts an internet-based business. It will normally have hundreds or thousands of employees in its home country developing, running, and maintaining the internet platforms that are the basis for the company's business and profitability. Such personnel also decide upon the services and products to offer and the pricing to be set for each country. Even where important platform programming (for example localization of the platforms for specific countries, languages, and markets) is conducted outside the home country, specific decision making and directions will come from home country personnel.

Say that an MNE is earning advertising revenues from its internet platforms that provide various free services to users, thereby being able to direct advertising to those users. Although revenues may come from customers needing advertising services in various countries around the world, the efforts that earn those revenues and the preponderances of the management of that business are primarily in the MNE's home country. There may, of course, be marketing, sales, and customer support personnel as well as programmers and others responsible for localization, etc. in local countries. However, a significant portion, if not the bulk of the revenues will be generated from direct advertiser interaction with the internet platforms and without any relevant involvement of locally-based MNE personnel. Viewed globally, there's one management that is running one worldwide business that is seamless to advertisers and users.

Today, these new business models are being used by the preponderance of MNEs.<sup>2</sup> 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

---

<sup>2</sup> To some extent, some heavily service based MNEs will represent an exception. Large professional MNEs (e.g. law and accounting) and consulting MNEs often develop within each market location independent standalone operations that use a standard MNE-developed base of knowledge and procedures.

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 minimization of taxation.

Consider an internet-based MNE business that earns advertising revenues or conducts sales agent or cloud services. An advertiser, user, or other customer will normally not be aware of which MNE group member is providing the services. There will typically be no indication of this on the web pages used. Normally, only if that advertiser, user, or customer makes a concerted effort to find the applicable user agreement and read through the fine print will the MNE group member be identified. Often, it will be a group member in a tax haven or a country such as Ireland or Singapore that allows the creation of tax efficient structures. Generally, very few persons read user agreements or other available documents. As such, advertisers, users, and other customers see themselves using the services of the MNE and its brand and not the services of any one specific legal entity.

The above description of today's commonly used business models has noted that one worldwide business is being conducted with the preponderance of management and functions occurring in the MNE's home country. Little has been said about the limited activities that are conducted in the countries where functions such as manufacturing, marketing, sales, and customer support occur.

While the functions being conducted outside the home country are often limited and do not constitute standalone businesses, they are typically only placed in such locations and not in the home country if they are critical functions integral to the business; they're normally not mere low-value services. On the production side, competition issues force physical manufacturing into certain countries with attractive wage rates and the necessary infrastructure. On the revenue side, the need to adequately serve local customers of the worldwide business's products and services forces the location of certain functions. For example, local warehousing and timely distribution along with customer support will typically be integral to an internet-based business that sells tangible products.

Because an MNE's locally-placed functions within today's business models are normally integral to its worldwide business, the contribution to the MNE's creation of value is real and must be recognized. Further, under many new business models, there is real value created by the community of users and customers located in each country who participate and add content. They, as a critical part of many of today's business models, must be recognized for the value they add.

#### Concrete Approaches to Dealing with New Business Models

The new business models have put profit shifting on steroids. A decision was made back at the initiation of the BEPS project in 2013 to limit its scope by accepting the separate entity concept and the arm's length principle.<sup>3</sup> In addition, the project declared at the start

---

<sup>3</sup> See pages 14 and 20 of the Action Plan on Base Erosion and Profit Shifting, issued by the OECD 19 July 2013, which included:

“... At the same time, there is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioural changes companies might adopt in response to the use of a formula would lead to

that “these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.”

It is now over four years later and the process of considering new business models and the implications of digitalisation is being pursued in a careful and thoughtful manner. It is now time to dispense with these artificial and self-imposed scope limitations and consider alternatives that will truly deal with the issues and not merely place plasters that might, at best, only curb a few of the worst excesses of aggressive taxpayers. We have a real chance to align profits with value creation.

I believe that the following four concrete approaches would significantly move us more toward the mandate of aligning profits with value creation and discouraging BEPS behavior. Certain of these approaches are new and presumably have not been previously considered by the Task Force. The first three may be initiated immediately. The fourth is a long-term approach.

- **Identification of PEs in BEPS Structures and Applying Taxation to Them**

A high percentage of profit shifting structures are artificial in that the real operations that create value occur in the home country or in third countries other than the zero or low-tax country in which the group member recording the profits is resident. Many of these structures were implemented with primarily paper changes and few, if any, real operational changes.<sup>4</sup>

---

investment decisions that are more efficient and tax-neutral than under a separate entity approach.”

**“Alternative income allocation systems, including formula based systems, are sometimes suggested.** However, the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalisation. Nevertheless, special measures, either within or beyond the arm’s length principle, may be required with respect to intangible assets, risk and over-capitalisation to address these flaws.”

It seems fair to say that the effort to put in place effective “special measures” was less than successful.

<sup>4</sup> Maybe the best documented example of this is the Swiss Tax Strategy implemented in 1999 by Caterpillar Inc. See the various reports and exhibits prepared for the 1 April 2014 hearings held by the Permanent Subcommittee on Investigations (part of the U.S. Senate committee on Homeland Security and Governmental Affairs). These documents are available at: <https://www.hsgac.senate.gov/subcommittees/investigations/hearings/caterpillars-offshore-tax-strategy>. See also some of the State aid investigation decisions that describe factual backgrounds in which entities earn their income primarily from the activities conducted by other group members. For example, see:

[http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=3\\_SA\\_38373](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38373) and [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=3\\_SA\\_38374](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38374).

In many such artificial structures, the actual operations of the zero or low-taxed principal company are conducted by personnel in the home country or some third country. Often, such activities are conducted under intercompany service agreements where the related party service provider is purported to be an independent contractor and not an agent of the principal. Despite the label, the actual activities and decision making go far beyond what any independent contractor service provider would normally do. Consistent with this, the principal company will have few if any employees and no management personnel in its country of residence who are actually capable of making company-wide business decisions or directing the activities of the purported related independent contractors.

Despite these common factual situations, the countries in which these purported service providers (really *de facto* agents) operate on behalf of the non-resident principal company make little or no attempt to tax the profits recorded by that non-resident principal company. I believe that this is due primarily to two factors. First, local tax authorities in these home countries and third countries are not aware that locally-based personnel are acting as *de facto* agents of a non-resident taxpayer. To the extent that they do consider such situations, their attention is normally at whether there might be a local PE for some overseas seller of products being imported into the local country. They are not paying attention, and normal tax authority audit procedures are not focused on, local personnel conducting a non-resident's foreign business that doesn't involve sales to local customers. Second, some countries do not have adequate PE and profit attribution rules that facilitate taxation of such operations that involve an undeclared PE of a non-resident.

Considering the above, I recommend that the Task Force on the Digital Economy study how many BEPS structures involve zero and low-taxed group member principal companies whose operations are, in fact, conducted by personnel of related group members. I believe that such an effort will show that in many instances three factors will exist. These factors are:

- (i) Critical value drivers are outside of the country of residency, and will typically be found in the home country of the MNE and sometimes within significant operations conducted by MNE group members in third countries;
- (ii) Actual control and decision making of the principal company's business will be exercised within the facilities of one or more group members outside the country of residency, usually in the MNE's home country but sometimes in third countries; and
- (iii) A lack within the country of residency of capable management personnel or any CEO who actually manages the principal company's entire business.

Once the Task Force confirms this,<sup>5</sup> I suggest that the Task Force recommends that the OECD, perhaps through the Forum of Tax Administrators, initiates a project for the development of model PE and profit attribution rules focused on undeclared PEs involved in these sorts of profit shifting structures. In addition, best-practice audit procedures should be developed to identify and impose tax on such undeclared PEs.

In addition to focusing on strengthening local laws and tax authority audit practices, the Task Force should consider changes to Article 5 of the OECD Model Tax Convention and its Commentary to make clear that the PE concept will include the conduct in one contracting state of the operations of a business of a resident of the other contracting state. Examples in the Commentary of such arrangements where a parent in the home country acts as a *de facto* agent for its subsidiary should be particularly helpful.

Taking these steps would lead to the unwinding of some existing BEPS structures and the discouraging of new structures.

Although this suggestion would directly benefit the home countries of MNEs and the third countries in which MNEs conduct their principal company's management and operations, it would benefit other countries as well. Where a profit shifting structure is no longer effective in avoiding tax in the countries where actual business is conducted, there will be less motivation to spend the money and effort to shift profits out of other countries where an MNE conducts a portion of its operations. See discussion concerning this at the end of the below bullet point concerning the full-inclusion taxation system.

(Note that this bullet point focuses on the country in which the principal company's business is factually run and is not a focus on the BEPS project's expansion of Article 5, which expands the PE definition for countries from which a non-resident is earning revenue.)

---

<sup>5</sup> For further details and discussion, see the following:

Jeffery M. Kadet, "Attacking Profit Shifting: The Approach Everyone Forgets," Tax Notes, July 13, 2015, p. 193. (<http://ssrn.com/abstract=2636073>)

Jeffery M. Kadet and David L. Koontz, "Profit-Shifting Structures and Unexpected Partnership Status," Tax Notes, Apr. 18, 2016, p. 335. (<http://ssrn.com/abstract=2773574>)

Thomas J. Kelley, David L. Koontz, and Jeffery M. Kadet, "Profit Shifting: Effectively Connected Income and Financial Statement Risks," 221 J. Acct. 48 (Feb. 2016). (<http://ssrn.com/abstract=2728157>)

Jeffery M. Kadet and David L. Koontz, "Profit-Shifting Structures: Making Ethical Judgments Objectively," Tax Notes, June 27, 2016, p. 1831, and July 4, 2016, p. 85. (<http://ssrn.com/abstract=2811267> and <http://ssrn.com/abstract=2811280>)

- **Expanded Use of the Profit Split Method and Development of Concrete Allocation Keys and Weightings**

As explained in Section C-1 below and more fully in Appendix A, an expansion of the use of the profit split method could go a long way to reversing the effects of BEPS structuring. In particular, given the many MNEs that use common business models, I recommend that the Task Force work with Working Part No. 6 to develop concrete allocation keys and weightings that would be applied to these models. Such an approach for the profit split method could significantly simplify compliance for MNEs and the work of local tax authorities. It would also add certainty for both MNEs and tax authorities alike. Its use also eases the difficulties of attempting to include the users of an internet-platform based MNE as a value factor in the determining profit attributable to a PE. See in particular Example 1 in Appendix A on page 21.

- **Abandonment of Territorial Tax Systems in Favor of Something Better**

Territorial taxation systems have gradually become the predominant taxation system over the past several decades. Their inherent structure of exempting foreign business profits has been a motivation for MNEs to move operations to other lower taxed countries. This motivation, though, has affected more than actual business operations. It has been the impetus for many of the profit shifting structures that have moved profits out of both home countries and source and host countries and into tax havens. It is simply the motivation for much of the game-playing that MNEs have engaged in. It is clear that CFC and transfer pricing rules have been ineffective in either curbing MNE enthusiasm for profit shifting or in seriously countering its effects.<sup>6</sup>

There must be a clear and unequivocal rejection of territorial taxation systems in favor of a *residency-based full-inclusion* approach.<sup>7</sup> In brief, under this approach, a country that is the home country for one or more significant MNEs would impose current taxation at the home country rate on the worldwide profits of the group. The tax base would include all profits of subsidiaries wherever established. To prevent double taxation, a foreign tax credit would be allowed, though to prevent cross-crediting games, the foreign tax credit limitation would be narrowly drafted (e.g. on a country-by-country basis rather than on a global basis).

Particularly attractive features of a full-inclusion system include:

- (i) virtual elimination of profit shifting motivation,

---

<sup>6</sup> While most countries today use a territorial system, countries such as the U.S. and China that use the deferral system, are in the same position. Their taxation systems that allow a deferral of most foreign business profits have been strong motivators for the game playing that has been so commonly described in government reports and the media. It is also clear that their respective CFC and transfer pricing rules have been mostly ineffective.

<sup>7</sup> See Jeffery M. Kadet, “Worldwide Tax Reform: Reversing the Race to the Bottom”, *Tax Notes Int’l*, 11 March 2013, p. 1133. Available at <https://ssrn.com/abstract=2231915>.

- (ii) real simplification through elimination of CFC and transfer pricing rules as applied to home country MNEs,
- (iii) a more level competitive playing field amongst MNEs since all would be subject to their home country tax with none holding a competitive advantage due to their tax structuring,
- (iv) a more level competitive playing field between a country's purely domestic taxpayers and that country's MNEs that can move operations to more tax efficient locations, and
- (v) expansion of the tax base.

Since a full-inclusion system would also motivate corporate migration, appropriate deterrents to such behavior would have to be put in place or strengthened. With many countries using management and control as the determinate of residency, this will typically not be an issue. However, consideration of best practice for application of this concept to MNEs so as to prevent game-playing could be useful.

A formulary approach, which is briefly mentioned in the next bullet point, is a long-term solution since the approach and how it would be applied require the buy-in and agreement of all significant countries. On the other hand, adoption of a full inclusion system is a practical short term solution since all that is required is adoption by the relatively few countries that are home to the majority of MNEs. Further, there is no need to agree on one approach to determining taxable income or to harmonize tax rates, sourcing, and other rules. Each country can continue with its present tax rates and rules or change as it sees fit.

The focus of a full-inclusion system may be on the home country. However, it has been clearly acknowledged that home country taxation of foreign profits will lower or eliminate the motivation to shift profits out of source and host countries. For example, the BEPS Action 3 Final Report issued 5 October 2015 states on page 13:

...if CFC rules effectively tax profits at a sufficiently high rate, they may also increase taxing opportunities in source jurisdictions by reducing or eliminating the tax incentives for multi-national enterprises (MNEs) to shift income into subsidiaries in low-tax jurisdictions.

In short, the current taxation systems are a significant part of the problem. Because so many countries now utilize territorial systems, they are thought of as the norm. Politicians and others do not realize that they are a major part of the BEPS problem. With the right declaration by the OECD and others, countries that are home countries to MNEs could recognize the damage being caused by their taxation systems and could institute a change to full-inclusion systems.

- **Formulary Approach—Long-Term Solution**

There is no need here to go into detail. It is enough to say that a formulary approach is a long-term solution that would truly align profits with value creation. Now is the time to recognize this and initiate the dialogue among nations that will

allow this to occur. With the new Inclusive Framework along with the United Nations, there are now platforms where this real discussion can begin.

## B. Challenges and Opportunities for Tax Systems

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?

Using the separate entity principle and the general ability to structure tax-motivated intercompany agreements, MNEs have been able to limit the profits reported within many countries, including both home countries and source and host countries.

The BEPS project has changed neither the separate entity principle nor this freedom of MNEs to break up their business operations using tax-motivated intercompany agreements. Accordingly, taxation policy must recognize this and seek other potential solutions.

See four suggested solutions discussed above in Section A.

## 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.

I wish that I could be more optimistic, but I am concerned that these BEPS measures will not be enough. I mean that I expect many BEPS motivated structures will continue.

Action 3's intent to truly strengthen CFC rules had the potential to significantly reduce both MNE home country profit shifting and shifting out of the source and host countries in which MNEs operate. Sadly, though, I am concerned that few countries will make any serious effort to achieve this.

Actions 6 and 7 will in some number of cases strengthen the hand of relevant tax authorities. However, the changes were too limited, reflecting the need to reach agreement amongst the various OECD member countries that worked on these Action Points.

As for Actions 8-10, few countries, including many developed countries, have sufficient trained and knowledgeable resources within their local tax authorities to be able to effectively pursue many transfer pricing cases. I am concerned that the continued application of the separate entity concept to MNEs that operate as integrated unitary businesses is simply perpetuating the use by MNEs of transfer pricing as one additional tool to execute BEPS structures.

The one bright light, so to speak, is the potential for a very much expanded use of the profit split method. *I have written about the development and use of concrete allocation keys and weighting for common business models that would allow simplicity and ease of application for taxpayers and tax authorities alike.* Considering that transfer pricing methods and their application are subjective exercises that result, at best, in ranges of acceptable pricing levels, such a simplified approach would create significant benefits with little or no effect on the reasonableness or accuracy of transfer pricing results.

*This approach to applying the profit split method using concrete keys and weightings is especially appropriate for the new business models that digitalization has facilitated, whether for traditional industries that have integrated digitalization into their operations or for new digitally based businesses.* Since this approach is so applicable to this Action 1 project, I have attached as Appendix A an article that describes this practical approach and includes details with specific examples. This article, “Expansion of the Profit-Split Method: The Wave of the Future”, dated 30 March 2015, was published in *Tax Notes International* (77 TI 1183). It is also available at: <http://ssrn.com/abstract=2593548>.

#### 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”:

In the new internet-based businesses, profitability critically depends on their bases of users around the world. As such, it is necessary that the definition of PE be expanded to reflect this aspect of these business models.

Above in the response to C.1., I noted the applicability of the profit split method to both new internet-based businesses and more traditional industries that have adopted digital technology. I have also written in A.1. above of the application of the profit split method to common business models using concrete allocation keys and weightings. This profit split method and use of concrete keys and weightings works perfectly as well for determining on a fair and easy to apply basis the portion of a taxpayer’s profits that would be attributable to a PE in a host or source country where a user base exists. Example 1 in Appendix A, which involves an internet-based business, includes “Users” as one of two allocation keys.

See also BEPS Monitoring Group’s comment letter submitted on 14 September 2017 in response to the public discussion draft “Additional Guidance on Attribution of Profits to Permanent Establishments”. That letter commented on situations where the profit split method may be the most appropriate method for determining the profits of a PE.

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).

The basic intent of the diverted profits tax (DPT) is to force local recognition of revenues from sales and services. For many types of businesses, for example, purchasing and selling products, the effect of the DPT would normally be to force recognition locally of appropriate profit from the trading activities. Where, however, the DPT is applied to an MNE that is using valuable intellectual property (IP) in the pursuit of its business, then the DPT may have a very much broader and, I believe, appropriate result.

Consider as an example an MNE that maintains a structure involving a highly profitable Irish subsidiary that provides services to customers around the world through an internet platform. As part of this structure, the Irish subsidiary pays substantial royalties and other similar intercompany payments to a group member established in a zero or low-taxed group member with such payments not being subjected to any royalty withholding tax. Through this mechanism, a relatively small taxable profit is left within Ireland and there is no taxation by the countries in which the customers are located.

The United Kingdom DPT might be applied directly to the Irish subsidiary. Alternatively, the MNE may decide to change its group structure by using a locally established UK company to earn and report revenues from local UK customers. In either case, there may be two important effects.

- First, of course, is the application of local UK taxation to profits.
- Second, though, and potentially much more significant in amount, is the 20% UK withholding tax on the royalties paid in connection with the local revenues.

Because of these two potential effects, I believe the DPT should be a particularly powerful deterrent to some profit shifting structures.<sup>8</sup>

---

<sup>8</sup> See (i) Tommaso Faccio and Jeffery M. Kadet, “Will Bringing Sales Onshore in the U.K. Lead to Higher Taxes?”, 82 *Tax Notes Int'l* 679 (May 16, 2016), available at <https://ssrn.com/abstract=2789833>, and (ii) Antony Ting, Tommaso Faccio, and Jeffery M. Kadet, “Effects of Australia's MAAL and DPT on Internet-Based Businesses”, *Tax Notes Int'l*, Volume 83, Number 2, p. 145 (July 11, 2016), available at <https://ssrn.com/abstract=2815782>.

## APPENDIX A - EXPANSION OF THE PROFIT SHIFT METHOD: THE WAVE OF THE FUTURE

Jeffery M. Kadet

Tax Notes International, 77TI1183, 30 March 2015<sup>9</sup>

December 2014 saw the OECD issuing a number of BEPS (Base Erosion and Profit Shifting) discussion drafts, one of which was titled: [\*BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains\*](#) (“DD10”). Issued on 16 December, DD10 is a response to both BEPS concerns about “value chain” planning articulated in Action 10 of the 2013 [\*BEPS Action Plan\*](#) and transfer pricing issues raised in [\*Addressing the Tax Challenges of the Digital Economy\*](#), issued on 16 September 2014 in connection with Action 1 of the BEPS *Action Plan*. As a discussion draft, DD10 of course is not a final document and only invites responses about how current transfer pricing guidance might be amended. The guiding principle of DD10 is how the profit split method can achieve the [\*G20 mandate\*](#), which states: “Profits should be taxed where economic activities deriving the profits are performed and where value is created.”

This article first provides background on why expanded use of the profit split method is needed. It next provides some description of the method. Finally, it suggests a simplified approach to applying the method. As is covered below, resource-constrained tax authorities in most countries are normally unable to administer or intelligently analyze and contest transfer pricing results presented by multinational groups. The overriding need at the present juncture is for rules which are easily administered and that provide results for taxpayers and countries that all regard as fair.

### BACKGROUND

Despite all the continuing rhetoric about how arm’s length pricing and the separate entity principle are sacrosanct, there are compelling reasons why the OECD BEPS project has focused on the possible expanded use of the profit split method, a method which clearly flies in the face of these sacrosanct icons. In short (and definitely with pun intended), a principal reason is the extreme shortcomings of the separate entity principle and arm’s length pricing of transactions as applied to the big picture effort to match transfer pricing outcomes with value creation. Recognizing this, DD10 in paragraph 3 comments, in a very understated manner:

The integrated nature of many MNE groups and the ways in which they interact with each other means that finding comparables (or comparables for which reasonably reliable adjustments can be made) can give rise to practical difficulties. In some such cases, transactional profit split methods may provide an appropriate solution.

To provide more background, a combination of factors has strongly motivated the highly successful tax structures that have so significantly lowered the effective tax rates of multinational corporations (“MNCs”) and eroded the tax bases of so many countries. The existence of these

---

<sup>9</sup> This MS Word version of the article as published in Tax Notes International (TNI) does not include stylistic changes made by the TNI editors.

factors means that some of the transfers pricing methods are a part of the problem; they are not a part of the solution. These factors include:

- The Separate Entity Principle—Internationally, pretty much all countries accept each legal entity as being a separate legal person for tax purposes, independent of its owner(s) and related entities, including those who control it and direct its activities. It doesn't matter whether the country of formation is a major country, an island tax haven, or someplace in between.
- Fragmentation—Similar to an artist who starts with a blank canvas, an MNC's in-house tax personnel and its outside advisors start with a blank sheet of paper. On that sheet of paper, they can create whatever legal entities they choose to create and they can define exactly what functions and activities each entity will conduct, what assets each will own, and what risks each will bear. In so doing, they minimize profits in higher tax countries and maximize profits in low or zero-tax countries. The [\*Discussion Draft on Revisions to Chapter 1 of the Transfer Pricing Guidelines \(including Risk, Recharacterisation, and Special Measures\)\*](#) ("DD8-10"), issued 19 December 2014, recognizes this by saying in paragraph 21:

A particular feature relevant in a functional analysis is that an MNE group has the capability to fragment even highly integrated functions across several group companies to achieve efficiencies and specialization, secure in the knowledge that the fragmented activities are under common control for the long term and are coordinated by group management functions. ...

DD8-10 goes on to say in paragraph 85:

Attributes of non-arm's length arrangements can be facilitated by the ability of MNE groups to create multiple separate group companies, and to determine which companies own which assets, carry out which activities, assume which risks under contracts, and engage in transactions with one another accordingly, in the knowledge that the consequences of the allocation of assets, function, and risks to separate legal entities is overridden by control.

With the grave respect given to the separate entity principle by tax authorities and courts worldwide, all this careful construction of an MNC's organization chart is treated as real and is the basis for taxation in each relevant country.

- Respect of Related Party Contracts—As a corollary to fragmentation, tax authorities and courts have for the most part fully respected related-party contracts, despite their having been carefully drafted to a large extent to achieve profit shifting goals.
- The Arms' Length Standard ("ALS")—The ALS, which has been for the past few decades the guiding principle in transfer pricing, has required that the pricing between related parties reflect the pricing that would occur between unrelated parties considering the functions, assets, and risks relevant to each group member. By its nature, and despite all the detailed discussion in the 2010 [\*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations\*](#) ("Guidelines"), transfer pricing analyses under the ALS approach normally only provide highly subjective ranges of acceptable pricing. So, in addition to using fragmentation to shift profits out of higher taxed countries, MNCs will also seek to set pricing within the subjectively-determined ranges that further skew profits into low or zero-tax countries.

- Inability to Effectively Audit MNC Transfer Pricing—The Guidelines require a serious analysis of matters that include (i) the various legal effects of forms of intangible property concerned, (ii) the various commercial and legal effects of any contractual terms concerning those intangibles, and (iii) the functions performed, assets owned and risk assumed by the various parties. Each MNC that has implemented BEPS structuring has a relative army of in-house legal, tax, and other specialty personnel whose jobs it is to understand and protect the MNC's interests. Most MNCs also engage outside counsel, tax advisors, economic analysts, and other specialists as well. On the other hand, the tax authorities of most countries in this world, if not all countries, have neither the sophisticated specialists nor the budgetary resources to truly conduct the work necessary to critically review the integrated and complex structures of most MNCs. This is particularly true for the many developing countries in this world. It may be noted that [recent reporting](#) has indicated that even the United States tax authorities have hired outside counsel to help them with an on-going transfer pricing review of Microsoft at a cost in the millions of dollars.
- What the Capital Markets Value—Capital markets reward successful reductions in an MNC's effective tax rate through higher share prices.
- Personal Motivation and Greed—MNC managements are highly motivated to minimize effective tax rates due to equity-based compensation based wholly or partly on share price.

## THE PROFIT SPLIT METHOD

Expanded use of the profit split method would counteract and seriously discourage the profit shifting that has been so prevalent and successful, and which is so dependent on the separate entity principle. What is the profit split method and why would it discourage BEPS behaviour?

Paragraph 2.108 of the Guidelines gives a concise statement of what the profit split method is. It states:

The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate...) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. The transactional profit split method first identifies the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged (the “combined profits”). ... It then splits those combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. ...

Additional guidance in the existing Guidelines (paragraphs 2.132ff) makes clear that the criteria or allocation keys on which the combined profits are split should be “...independent of transfer pricing policy formulation...”. Hence, these criteria and allocation keys “...should be based on objective data (e.g. sales to independent parties), not on data relating to the remuneration of controlled transactions (e.g. sales to associated enterprises)...”. Paragraph 2.135 makes this objective basis clear by stating:

In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets, capital employed) or costs (relative spending and/or investment in key areas such as

research and development, engineering, marketing) are often used. Other allocation keys based for instance on incremental sales, headcounts (number of individuals involved in the key functions that generate value to the transaction), time spent by a certain group of employees if there is a strong correlation between the time spent and the creation of the combined profits, number of servers, data storage, floor area of retail points, etc. may be appropriate depending on the facts and circumstances of the transactions.

Further discussion in the Guidelines provides various approaches to splitting the combined profits amongst the relevant group members. While these approaches need not be detailed here, the point to make is that the approaches set out and discussed required a facts and circumstances case-by-case analysis before they can be implemented.

## **A SIMPLIFIED APPROACH**

The Guidelines require a facts and circumstances case-by-case analysis for determining the most appropriate transfer pricing method for any particular case. Once it is determined that the profit split method is the most appropriate method for a particular case, then again, a facts and circumstances case-by-case analysis is required to determine how the combined profits are to be split amongst the relevant group members.

The reader may recall the bullet point in the Background section above headed: “Inability to Effectively Audit MNC Transfer Pricing”. Any time that transfer pricing rules require a facts and circumstances case-by-case analysis for a complicated MNC structure, the chances are very high that the relevant tax authorities will have neither the in-house expertise nor the budgetary resources to effectively analyze anything. As stated at the start of this article, there is an overriding need for transfer pricing rules that are easily administered and that provide results for taxpayers and countries that all regard as fair.

We believe the following approach answers the needs for simplicity, fairness and ease of administration. Further, given the investment of time of in-house personnel and the exorbitant costs of outside legal, tax, and economic consultants, it should as well be attractive to any MNC that chooses to focus more on its business and less on aggressive BEPS motivated tax structures.

The **first step** of this simplified approach is that the profit split approach will be deemed to be the most appropriate transfer pricing method for various categories of MNC businesses. Such categories would include:

- Any MNC operating a value chain involving multiple group entities conducting operations in multiple countries, and
- Any MNC involved in the digital economy that maintains supporting group members in various countries.

To provide concrete guidance, we suggest that the Guidelines include both a listing of these categories as they exist today and the principles on which such categories are determined so that as MNCs evolve new forms of business conduct and organization, these new forms can be added to this listing.

This presumption that the profit split method is the most appropriate method to apply would be rebuttable to the extent that an MNC establishes to the satisfaction of all relevant tax authorities the clearly superior applicability of one of the other methods.

The **second step** of this simplified approach is the allocation of combined profits amongst the relevant group members.

Specifically, we suggest that the Guidelines include clear guidance stating concrete objective allocation keys and relative weightings for all business models now commonly being used. Anticipating the likely emergence of new business models, the Guidelines should also articulate the principles on which concrete objective allocation keys and weightings should be determined. There would be no facts and circumstances case-by-case analysis.

Such a simple and clear approach would be easy to administer, and greatly reduce conflicts both between tax authorities and companies, and among tax authorities. They would make an enormous step towards achieving the aim set by the G20 that: “Profits should be taxed where economic activities deriving the profits are performed and where value is created.”

An obvious question is whether such a simplified allocation approach would achieve reasonable results that governments and taxpayers can be comfortable with. We strongly believe the answer to this is “yes”.

It is clear that any allocation of profits of a complicated corporate structure that results from the current approach based on a detailed facts and circumstances case-by-case analysis of functions, assets and risks will, by its inherently subjective nature, only result in a very wide range of possible profit allocations. The use of simple-to-apply concrete objective allocation keys that are appropriate for the particular business model used will result in profit allocations that will virtually always fall within this wide range.

With tax authorities no longer hobbled by a need for detailed analyses, which they seldom have the resources or expertise to achieve, the adoption of such a simplified approach will greatly enhance their ability to actually administer and collect taxes. It will also reduce conflicts both between tax authorities and taxpayers and among tax authorities. In addition, the application of such rules should result in a reduction in complex BEPS motivated structures since all combined profits will be spread amongst the group members that actually conduct activities with little or none left within low-taxed group members that do not conduct economic activity and thereby contribute little if any to value creation. In sum, a simplified and standardized approach for each common business model will provide significant benefits as well as give results that are fair to MNCs and all relevant governments.

To provide an idea of how this simplified approach would work, the box beginning on page \_\_\_\_ includes examples of allocation keys and weightings for two business models.

## EXAMPLES OF ALLOCATION KEYS AND WEIGHTINGS FOR TWO COMMON BUSINESS MODELS

### 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 recognizes 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.)

## **Example 2**

This example is taken from DD10's Scenario 3.

“Company P, located in country P, is a manufacturer of high technology industrial equipment. Company S, a subsidiary of Company P, markets and distributes the equipment to unrelated customers in country S. Both companies are members of Group X. Company P conducts extensive R&D activities to develop and improve the technological features of its equipment. It funds and has legal ownership of all the technology intangibles it develops. Company P also owns the global trademark, and provides broad guidance to its subsidiaries around the world on its overall marketing strategy. There are several global competitors making equipment which is similar (in terms of functionality, performance, and reputation) to that made by Group X. These global competitors also operate in Country S, which is a large market for such equipment.

“Company S is responsible for sales of the equipment and undertakes marketing activities. Due to the nature of its business, this entails developing very close relationships with customers, including providing on-site services (often in remote locations), carrying an extensive stock of spare parts, and a highly proactive maintenance programme to detect likely problems before they arise. Company S also provides extensive advice to customers on equipment choice, makes modifications for particular local conditions, and for maximising performance efficiency and effectiveness. These activities provide a significant competitive advantage as customers place high value on the reliability and performance of the equipment. In this case, Company S is recognised as not merely a “routine” distributor, but its activities constitute a key source of competitive advantage for the Group.”

### Simplified Allocation Keys

For the combined profits of this common business model, three allocation keys with the indicated weighting are defined as follows:

- Sales (weighted at 25%)

The inclusion of sales as one of the allocation keys reflects the importance of each market and its customers to the global business of Companies P and S. The country of sale should be determined by the location of the customer and not the legal terms of the sales contract. (See further comment below concerning this sales allocation key.)

- Marketing and Distribution Expenses (weighted at 25%)

Total marketing and distribution expenses make an excellent allocation key that reflects the amount of resources that a taxpayer invests in each market. This key would include categories of expenses such as:

Salaries and bonuses of marketing and distribution personnel (allocated by location of personnel)

Advertising expenses (allocated by market that advertising targets)

All other direct and allocated expenses of marketing and distribution, not including transportation costs of inventory (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for marketing, distribution, and after-sales services and support (allocated by location where the other party provides the services) (A taxpayer will often pay other legal entities, whether related or not, for sales activities, other sales support, and/or after-sales service and support activities. These payments economically include all personnel costs, office and warehouse costs, etc. of the legal entity performing the marketing and/or distribution 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.)

- Expenses Other than Marketing and Distribution Expenses (weighted at 50%)

This allocation key recognizes all inputs other than those for marketing and distribution. As such, it covers all manufacturing activities, research and development, management and support functions, etc.

This key would include categories of expenses such as:

Salaries and bonuses of all personnel other than those involved in marketing and distribution functions (allocated by location of personnel)

All other direct and allocated expenses other than those related to marketing and distribution functions, not including transportation costs of inventory (allocated by location of personnel or facility to which the expenses relate)

Commissions and service fees paid to other parties for all operational functions other than marketing, distribution, and after-sales services and support (allocated by location where the other party provides the services) (For example, this category includes situations where a taxpayer pay another legal entity, whether related or not, for contract manufacturing 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.)

There is no allocation key suggested for either property or inventory. Regarding property (including rented and leased property), the value and extent of facilities will most typically be reflected by the labor retained by each group member. This reliance on labor thus avoids all the difficult property valuation issues that inevitably arise if property is included as a direct allocation key. It also avoids the many varying methods, lives, and inconsistent treatments if depreciation (book or tax) were used. Regarding inventory, the sales allocation key measures the

importance of the source market and suggests that inventory and inventory transportation costs could be duplicative, to some extent.

Note that neither risks nor intangibles (e.g. patents, manufacturing processes, trade names, knowledge of market channels, etc.) are directly included. Consistent with the guidance in the Guidelines regarding objective allocation keys and given the integrated nature of the associated companies' businesses and the fact that both parties are contributing their own unique and valuable intangibles, it is both appropriate and simpler to ignore these risks and intangibles as separate allocation keys. Both are, however, indirectly included through the other factors. For example, to the extent that risks and intangibles are related to manufacturing that is solely conducted in the home country or elsewhere outside the source country, then the higher-weighted allocation key (50%) for all expenses other than those for marketing and distribution will reflect them. Such expenses include on-going R&D, the bulk of which will be in country P. As for marketing risks and marketing intangibles, the marketing and distribution expenses factor will similarly reflect them. For example, if relatively higher paid marketing executives in country P make sales and credit decisions regarding buyers, then relatively more profit will be allocated to Company P and relatively less to Company S, thereby reflecting the risk that is being managed from Company P. On the other hand, if sales personnel in Company S are performing important functions such that they are paid bonuses based on their productivity, then the value they add will be reflected in their bonuses with relatively more profit allocated to Company S.

Finally, an alternative approach would be to eliminate the "sales" allocation key and then equally weight the remaining two keys. This would leave the "sales" key to be used only in cases where there has been a meaningful creation of value due to participation of local users and consumers. If the "sales" key were eliminated, then consideration should be given to including a key for the value of inventory allocated by location where maintained.

**APPENDIX B – LETTER OF 23 JANUARY 2013 TO OECD RE WORLDWIDE FULL-INCLUSION**

**Jeffery M Kadet  
511 West Prospect Street  
Seattle WA 98119  
USA**

**+1 206 374-3650  
[kadetj@u.washington.edu](mailto:kadetj@u.washington.edu)**

January 23, 2013

OECD  
Centre for Tax Policy and Administration  
2, rue André Pascal  
75775 Paris Cedex 16

Attn: Mr. Raffaele Russo (via [Raffaele.RUSSO@oecd.org](mailto:Raffaele.RUSSO@oecd.org))

Dear Mr. Russo,

I have watched the growing international concerns that have lead to the creation of the BEPS initiative. From my background of having been both within the international tax services community that advises multinational enterprises (MNEs) and within an academic environment, I have some knowledge of the mechanics of international tax avoidance as well as some appreciation of how this has reduced the tax bases of many countries. I will provide briefly in this letter my thoughts on actions that could actually change the behavior of MNEs such that they would discontinue, or at least curtail somewhat, their profit shifting activities.

By way of background, I was in private practice working for 32 years in international taxation for several of the major international accounting firms, 16 of those years as an international tax partner. While I have worked eleven years within the U.S., which is my home country, the majority of those 32 years were spent living and working in various countries around the world. These included Japan, China, Singapore, Hong Kong, Russia, and Turkey. In each of these countries, I lead teams of professionals providing advice to MNEs and other foreign investors on how to structure their businesses and investments within those local countries and how to properly comply with local country requirements. For eight years now, I have taught several international taxation courses within the Tax LLM program at the University of Washington School of Law.

## Recommendation and Benefits

MNEs currently find profit shifting very much worth the effort because they achieve both of two objectives:

- Reduction of tax imposed by the country where actual business operations take place or where sales or services occur, and
- Avoidance of tax in the MNE's home country (easily achieved under the territorial and deferral systems)

If either one of these objectives cannot be met, and especially the second objective concerning home country taxation, then there will be much less motivation to go through the often significant effort necessary to plan and execute complex profit shifting strategies. This means that the current behavior of MNEs will change if all of their international activities are subject on a current basis to their respective home country's corporate tax.

Accordingly, I recommend that the OECD through its BEPS initiative strongly suggest to OECD member and non-member countries that they abandon the territorial and deferral systems that they currently use. To replace these systems, they would implement full-inclusion systems under which all foreign income, including profits in foreign subsidiaries, would be currently taxed by each MNE's home country. A foreign tax credit mechanism would prevent double-taxation.

Benefits from implementing this change in taxation systems include:

- An expansion and broadening of all countries' tax bases
- Significantly reduced MNE profit-shifting structures that erode the tax bases of all countries and require considerable time and resources of all tax authorities
- Simplification of tax rules in each home country by eliminating the need for, or reducing the importance of, complicated CFC and transfer pricing rules
- A more level competitive playing field internationally as each MNE would be subject to a minimum level of taxation as imposed by its home country
- A more level competitive playing field within each country amongst its pure domestic businesses, MNEs based therein, and foreign MNEs doing business therein, thereby reducing or eliminating taxation as a factor in deciding where to conduct business operations, assume risks, employ personnel, and own tangible and intangible assets

- The potential for each country to reduce its corporate tax rate due to its broadened tax base, thereby making such a tax system change politically acceptable

## **Background to Recommendations**

Growing international fiscal concerns and the success of MNEs in lowering their effective tax rates have motivated the OECD's BEPS initiative. There are many factors that have contributed to the MNEs' motivation and their high degree of success. These factors include:

- Acceptance internationally as separate and independent legal persons of corporations and other legal entities established under applicable legislation in any country
- Ability of MNEs to "break-up" their business activities by freely placing functions, assets and risks within both newly created entities and existing entities that contract amongst themselves
- Despite the inherent non-arm's length nature of related-party contracts structured to a large extent to achieve profit shifting goals, acceptance internationally of such contracts as long as they reflect some degree of commercial reasonableness
- The arms' length standard in transfer pricing that by its nature causes some subjectivity in developing ranges of arguably acceptable pricing that spreads group profit amongst the group members
- Markets rewarding successful reductions in an MNE's effective tax rate through higher share prices
- MNE management personnel being personally motivated to minimize effective tax rates due to equity-based compensation based wholly or in part on share price

All of the above factors are integral to our worldwide legal, tax, and investment environment. As a practical matter, they cannot be changed.

Some number of developed countries maintain a territorial taxation system under which the home country does not tax certain overseas earnings. And the U.S. has its "deferral" system, under which U.S. based MNEs normally pay no U.S. tax until dividends are distributed. These tax systems create a great incentive for MNE management teams to conduct operations, spread group risks and own group assets in manners that shift income into low-taxed group members.

It must be admitted that territoriality does have some theoretical attractions. It can also be said that residency is not a great theoretical basis on which to build a taxation system because place of incorporation and management and control can often be easily manipulated. However, given the clearly demonstrated ability of MNEs to transfer assets, risks and activities

and achieve tax savings that so significantly reduce the tax bases of many countries, the continued use of the territory and deferral approaches is simply not tenable.

An alternative approach that actually reduces or eliminates MNE management's motivation for profit shifting is what's needed. Lesser approaches (e.g. tightening up transfer pricing rules concerning intangibles, more robust thin-cap rules, etc.) will only be band-aides easily side-stepped by our high-powered tax consulting community with its century-long tradition of working around anti-avoidance and other tax rules.

### **Additional Recommendations and Comments**

Foreign Tax Credit—The foreign tax credit mechanism that would accompany the full-inclusion system to prevent double-taxation must be tightly drawn. By “tightly drawn”, I mean a country-by-country or other foreign tax credit limitation mechanism that would severely limit the ability to cross-credit high foreign taxes paid on certain income against home-country tax on low-taxed foreign income. A broad foreign tax credit limitation mechanism that liberally allows cross-crediting will often leave in place the ability to avoid some amount of home-country tax. And that will mean continued motivation to achieve both objectives.

Full-Inclusion Mechanisms—While direct taxing of foreign subsidiaries will carry jurisdictional issues, the CFC mechanisms found in many countries under which the locally incorporated parent is taxed based on a hypothetical income that includes the income of its foreign subsidiaries provides a realistic mechanism already in use within many countries. Other possible mechanisms include worldwide consolidation and treatment of foreign subsidiaries as being transparent for home-country tax purposes. The OECD BEPS initiative could analyze the alternatives and provide guidance to OECD member and non-member countries.

Corporate Migration—Needless to say, there will be a need for strong rules preventing corporate migration by MNEs from their home country to new home-countries in tax havens. Again, the OECD BEPS initiative can analyze and provide guidance.

New Businesses—It of course would be possible when starting up a new business to establish it in a tax haven so that profit shifting will continue to be beneficial. This, however, should be a relatively rare event. When one or more entrepreneurs start up a new business, they do it domestically since they typically neither think about long-term international tax structuring nor do they have the funds to pay the high-priced international accountants and lawyers able to instruct them how to do it. By the time the new business is large enough and valuable enough to think about migrating to some other home-country, the above suggested strong rules to prevent corporate migrations should discourage them.

New businesses are not always started by penniless entrepreneurs. Sometimes sophisticated wealthy individuals are involved or two or more corporations form joint ventures to pursue some joint business. Consideration should be given to approaches that assure that such new

businesses when established in tax havens are treated as having a home-country based on ownership or other relevant factors.

Developing Countries—Some developing countries that offer tax incentives might have concerns about the wide use by developed countries of the full-inclusion system. They might maintain that the tax incentives they offer foreign investors, which represent real costs, would merely benefit the home countries of the investors and not the investors themselves. As such, their tax incentive programs would be less effective in attracting foreign investment and increasing local jobs and employment.

While this is a legitimate concern, there are two points to make. First, tax sparing is a well-known mechanism available to such countries. To the extent not already within their existing tax treaty networks, such countries are free to negotiate tax sparing provisions in tax treaties with important investor countries. Second, many MNEs have been very successful through their profit shifting efforts at reducing their taxable income within these developing countries. A full-inclusion system that truly changes MNE behavior and reduces the motivation for profit shifting will benefit such countries.

Greater Identity of Book and Tax—Another benefit of a full-inclusion system is that there would be a greater level of identity between publicly reported financial statement consolidated earnings and the home country taxable income computation. Where there's identity between the two, management tends to be less interested in tax planning that reduces reported earnings as well as taxable income.

### **Summary Comment**

There will be many important details that must be worked out, but the basic concept is simple. By being subject to current home-country taxation on its worldwide earnings, an MNE's motivation for complicated structures that shift profits into tax havens from countries where operations, sales and services take place is significantly reduced or eliminated.

Any new approach must be saleable politically within each relevant country. The larger tax base that would result from a full-inclusion system will provide a basis for a reduction in a country's general corporate tax rate. This could make acceptance of such a system politically palatable.

\* \* \* \* \*

I hope that the above thoughts are useful to the BEPS initiative. Please let me know if you have any questions.

Faithfully,

:



Jeffery M. Kadet

Jeffery M Kadet  
511 West Prospect Street  
Seattle WA 98119

206 395-9849  
[kadetj@u.washington.edu](mailto:kadetj@u.washington.edu)  
[jeffkadet@gmail.com](mailto:jeffkadet@gmail.com)

October 13, 2017

Task Force on the Digital Economy  
OECD  
Paris

Via email to: [TFDE@OECD.org](mailto:TFDE@OECD.org)

Re: Submission Concerning Tax Challenges of  
Digitalization

This submission is in response to the OECD's 22 September 2017 invitation for public input on the tax challenges of digitization. I am submitting this personally and am not representing any group or speaking on behalf of any other person. This submission adds to what I submitted in my letter dated 11 October 2017.

I would be pleased to respond to any questions.

Cordially,

:

A handwritten signature in black ink, appearing to read 'Jeff Kadet', with a stylized flourish at the end.

Jeffery M. Kadet

c.c. Sol Picciotto

#### **D. Options to address the broader direct tax policy challenges**

After sending to you my submission of 11 October 2017, I had several further thoughts about Section D. of the Request for Input, which concerns “Options to address the broader direct tax policy challenges”. I hope that the following, which concerns Section D.1 a) in particular, is useful to your thinking.

It is clear from the behavior of early investors, strategic acquirers, and the stock markets that some internet-based companies are highly valued (maybe grossly valued is a better term), despite their being in an ongoing loss position with future profitability being only a hope. Amazon is a good example of such a company that was in this position for many years after its initial founding. Maybe two of today’s best examples of this are Uber and Twitter.

What are factors that make such companies so valuable, despite their tenuous position regarding future profitability?

One obvious factor, of course, is the perception of their technology and business model for attracting users (whether free or paid) and advertisers and others seeking access to the user base. A second factor is the size, quality, and perceived stickiness of that user base. An additional factor that is corollary to this user base is the accumulated data on the user base and the content that users provide.

Without going into unnecessary detail, it is clear that an accumulated user base and the accumulated data on that user base are identifiable assets that have value to specific strategic acquirers and to investors and the markets more generally.

One issue is whether a user base and/or accumulated data could be sufficient presence to justify a taxable nexus.

I believe that the answer is yes. In many cases, an MNE’s fragmentation of what is truly one worldwide business causes one zero or low-taxed group member to be earning revenues from the user base and/or advertisers and other revenue sources while one or more other group members conduct some level of physical activities locally. In such cases, the MNE’s activities should be viewed on a holistic basis, a process that will establish that a PE exists under today’s standards. In other cases, there may be no local physical activities performed by any group member. Even in these cases, I believe that the user base and accumulated data will often be such significant and real assets of the MNE that new rules should be inserted into countries’ domestic laws and in tax treaties to find that a PE exists.

*With this in mind, I suggest that the Task Force consider practical “best practice” approaches for determining some minimal level of digital presence that would be treated as a PE. The Task Force should recommend language that individual countries could insert into their domestic laws as well as into tax treaties including appropriate provisions that would be included in the OECD and UN models and commentary.*

In my submission to the Task Force of 11 October, I commented on the use of the profit split method and included as Appendix A an article on this subject recommending that the OECD and other applicable bodies expand the use of this method by developing concrete allocation factors and weightings for common business models. In the submission to the OECD made by the BEPS Monitoring Group on the Action Point 7 issue of attributing profits to PEs, a project to which I contributed, it was noted that the profit split method will often be appropriate for determining the profits attributable to a PE.

The point here is a user base and/or the accumulated data on that user base (including website content created or posted by that user base) are real and substantial assets for some firms whose businesses rely heavily on users and their information. These are real assets that help generate revenue. As such, one or the other of these assets (or perhaps in some cases a combination) will be an appropriate factor in applying the profit split method.

*I suggest that the Task Force begin a dialogue and consideration of applying the profit split method with standard concrete allocation factors and weightings to common business models found in the digital economy. This dialogue and consideration would include where and how these user base and accumulated data factors would be used in common models.*

As was noted above, an element of some internet-based firms is their initial growing of a user base and accumulated data which is reflected in their valuations. In some cases, even though a firm might not yet be profitable, the founders and early investors may realize significant capital gains upon disposition of their ownership interests that would normally be taxable in the country of residency of the investors. While I imagine that this would not normally be the case due to the global nature of most internet-based firms, it is possible that such a firm's value might come to a large extent from the user base and accumulated data in one country. In such a case, the disposition of such a firm at a substantial gain might trigger indirect transfer concerns, such as were studied in the recent discussion draft issued on 1 August 2017 by the Platform for Collaboration on Tax. Where a specific country chooses to impose tax on indirect transfers of more than just immovable property, this could be relevant. *I suggest that the Task Force initiate some discussion of this indirect transfer issue and provide its input to the Platform for Collaboration on Tax.*

To OECD Task Force on the Digital Economy

Date October 2017

From KPMG International

Ref OECD Digital Economy – KPMG  
Comments.docx

cc Chris Morgan, KPMG International  
Manal Corwin, KPMG in the U.S.  
Brett Weaver, KPMG in the U.S.  
Matt McNeill, KPMG in the U.S.

**Comments with respect to the Request for Input with respect to the series of questions related to the BEPS Action 1 report on *Addressing the Tax Challenges of the Digital Economy* (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers**

Professionals in the member firms of KPMG International (“KPMG”) welcome the opportunity to comment on the OECD’s Request for Input with respect to the series of questions posed related to the BEPS Action 1 report on *Addressing the Tax Challenges of the Digital Economy* (the 2015 report) and the Draft Outline of the Interim Report for the G20 Finance Ministers.

KPMG appreciates the openness of the OECD to comments and recognizes the complexities of the issues.

KPMG’s comments in response to the Request for Input are presented below.

**General Comments**

We recognize the significant political pressures driving the debate regarding the tax challenges of the digital economy. The political dialogue is often framed in a manner that identifies highly digitalized companies as not paying their ‘fair share of tax.’ This assertion is supported by claims that such companies derive significant revenues in market countries without paying any, or at least proportionate, tax in those jurisdictions. We believe that framing the challenges of taxing the digital economy in this manner is counterproductive. It mischaracterizes the real concern of some countries over the current division of jurisdiction to tax and impugns the motives of digitalized companies that are playing by the rules (including the new rules of the BEPS package).

At the heart of the debate on the taxation of the digital economy is dissatisfaction by some countries with the status quo regarding the scope of jurisdiction to tax. In many cases these countries seek to expand source-based taxation rights, by moving beyond traditional conceptions of ‘source’. Other countries, however, prefer the current balance between residence and source-based taxation – particularly within the framework of the BEPS package designed to limit double non-taxation. Such countries seek to address BEPS concerns related to digitalized business models through the existing agreed international tax framework. Rebalancing residence and source-based taxation rights is a significant endeavor that requires global consensus which is likely to be reached only through a

KPMG International Cooperative (“KPMG International”) is a Swiss entity.

Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm.

thorough and inclusive global process. This will require time and further research into expected implications for cross border trade and investment. Special tax measures targeting highly digitalized business models obscure these fundamental challenges, create additional complexity, foster uncertainty and lead to economic distortion (i.e., taxing various sectors differently). Consistent with the original consensus reached in the 2015 BEPS Action 1 report (*Addressing the Tax Challenges in the Digital Economy*) and the G-20's mandate on the importance of certainty to promote economic growth, these concerns warrant a well-developed global effort that focuses on how tax policy should develop to promote overall economic growth in light of the inevitable digitalizing of the world economy.

Additionally, the BEPS package is only now being implemented. Time is needed to determine the extent to which the BEPS package has adequately addressed the unique tax challenges of the digital economy. As explained further below, at this early stage, there are positive signs that the BEPS package is effectively addressing many of these concerns. We encourage the members of the OECD's inclusive framework to adhere to the original consensus reached under the 2015 BEPS Action 1 report and defer further action that would ring-fence or target highly digitalized companies until the effectiveness of the BEPS package can be objectively determined and the broader underlying international tax policy considerations can be adequately addressed. If governments believe that immediate action is required to respond to the digitalization of the economy and protect their tax bases, we suggest that the best way to do that is to create a regulatory and economic environment that encourages the use of digital technologies to increase economic activity in their jurisdictions, including through appropriate investment in infrastructure.

Finally, we note that there are significant legal and practical considerations that must be addressed with any targeted special tax measures. These considerations should be fully addressed before any recommendations are made for taxing the digital economy through 'special measures.' To do otherwise would only create more tax uncertainty, risk of double taxation and impediments to global trade and investment.

## Specific Comments

### **A. Digitalization, Business Models and Value Creation**

*Question A.1 - The process of digitalization 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, organization, supply chains and cost structure).*

The process of 'digitalization' encompasses a range of transformative changes occurring across the economy as a whole. Digitalization refers to the conversion of analogue or physical goods and services into digital goods and services as well as the creation of innovative digital products and services – e.g., digital music or remote engine maintenance checks over the internet. Digitalization also includes the concept of 'Digital Transformation', that is, the adoption, by multi-national enterprises ('MNEs'), of digital business strategies and deployment of sophisticated software and algorithms in order to gain deep business insights to transform the way an organization operates or engages the market. Digital Transformation allows MNEs to be more effective at core business processes (e.g., marketing to key customer demographics through social media) and to drive efficiency gains by reducing operational expenses, freeing up capital and labor for investment in activities yielding higher ROIs, and improving the success rate of strategic investment choices. Significantly, these digital capabilities have allowed for innovation in business models previously unimaginable – e.g., digital

platforms that connect buyers and sellers anywhere in the world, social media, and digital content driving on-line advertising sales.

Digitization of the broader economy is only in its early days. It is clear that we have entered a new era of rapid change and disruption. By removing, or reducing, many of the physical limitations which once shaped operating models, businesses are now able to more efficiently and effectively deliver goods and services to customers on a global scale. Digital Transformation has enabled new market entrants to remake entire industries, unseat traditional dominant players, and capture market share while in many cases doing so at a fraction of the cost and footprint of established industry participants.

Digitalization is not a process limited to a particular industry or segment of the economy. Digitalization is enabling innovative business models and allowing businesses to drive more efficient global value chains across all industries and segments. Indeed, as the 2015 BEPS Action 1 report (*Addressing the Tax Challenges in the Digital Economy*) concluded, “the digital economy is increasingly becoming the economy itself . . .”

Policymakers should avoid picking winners and losers among businesses through tax policy which unequally targets or exempts certain business models.

*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.)?*

Digital business models generally do rely heavily on intangible property. However, such reliance is not unique to digitalized businesses models. Traditional business models across multiple sectors also place significant reliance on intangible property – e.g., consumer goods, pharmaceuticals, etc. If there is a unique aspect of how digitalized business models rely on intangible property as compared to traditional business models, it is that digitalized business models place greater reliance on algorithms. The significance of this difference is likely to diminish in the near future as traditional business models also increase their reliance on algorithms. The development, enhancement, maintenance, protection and exploitation (DEMPE) framework established through the OECD’s recent revisions to Chapter VI of its Transfer Pricing Guidelines, if appropriately applied, should serve to appropriately identify how and where digitalized businesses, as well as traditional businesses, create value with regard to intangible property.

*Question A.3 - Digitalization 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 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?*

Sales operations across the entire economy continue to evolve as new technology enables smaller-footprint distribution models. Remote selling is not unique to highly digitalized businesses. Traditional businesses are quickly adopting ‘digital strategies’ that include remote selling channels in order to capture market share, drive efficiencies,

connect with customers and respond to customer preference. Some of the relevant business considerations driving remote selling models are:

- 1) Consumer preferences – changing customer preferences have driven more retail business online to enable sales by responding to increased customer affinity for on-demand delivery and wider variety of inventory items.
- 2) The low barrier to enter a market – the diminishing need to hire local personnel or establish a local office in order to sell products into a particular market reduces the cost of entry. This is a particularly powerful consideration for start-ups and early stage businesses without the resources to expand via traditional distribution channels. At the same time, remote sellers still have real people creating value within their organization. Remote seller models have enabled non-traditional market participants to flourish globally where historically they may have encountered significantly more challenge.
- 3) Operational efficiency – a remote seller model allows an organization to centralize global or regional sales activity creating efficiencies by eliminating redundancies, reducing costs, and enhancing their competitiveness in the marketplace.
- 4) A growing services economy – digital and technology-enabled services make up an increasing share of economic activity and they are uniquely suited to a remote seller model where digital delivery or performance is both efficient and responsive to customer demands.

***Question A.4** - Digitalization 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 digitalized business models, and what types of data are being collected and analyzed?*

Companies have always collected data (customer, market, demographics, etc.) to inform business decisions. New technologies are enabling a massive increase in the collection of customer and market data. The collection of raw data is becoming increasingly ubiquitous with the growth of the internet of things (“IoT”) technologies, wearables, and similar technologies. However, as a leading technology company noted in 2016, approximately 80% of data comes from untapped or unstructured data (sometimes called ‘dark data’).<sup>1</sup> Broadly speaking, the value of data lies along a spectrum with raw and unstructured data being of relatively low value, processed data being of more value, and ‘smart data’ (actionable data that is available in real time) that informs business decisions being of greater value.

Although customer and user data are often front and center in the discussion regarding the tax challenges of the digital economy, the digitization of the global economy highlights that broad spectrums of data hold the promise of being used as ‘smart data.’ For example, one company has utilized fiber optic sensors along oil and gas pipelines to monitor and analyze the temperature, vibrations and audio patterns of oil and gas flow to detect potential pipeline disruption earlier – thereby preventing oil spills, reducing operating expense and ensuring more stable supply.

***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*

---

<sup>1</sup>Data is Everywhere and That’s a Good Thing; <https://www.ibm.com/blogs/business-analytics/data-is-everywhere>

*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?*

Global online platforms, social networks, online communities, and similar “digital commons” are merely virtual manifestations of historic networks. However, digitalization has increased the speed, scale, and reach of such interactions and given rise to innovative digital business models that offer these features to networks’ stakeholders. Businesses innovating through digital networks create value through the development and exploitation of intangibles, effective risk management, and operational excellence. However, digital networks have also introduced significant business risk as companies must manage, maintain, and protect customer and user data. Security, reputational, and financial risks presented by digital networks are unique and present considerable challenge to digitalized companies.

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).*

As the digitalization of the economy increases in velocity and across sectors, it is impossible to predict *what* will emerge as the next successful innovation that will drive disruption and innovative business models. However, we can observe some clear trends that have emerged over the past decade that can be extrapolated into the future:

- 1) An increasing pace of change – Digitalization is enabling businesses to move faster, gain efficiencies and decrease the time to develop a product or service and get it to market.
- 2) More ‘smart data’ – New technologies such as artificial intelligence, machine learning and quantum computing, coupled with greater data volumes (e.g., through IoT and increasingly miniaturized data collection tools becoming ubiquitous), will give rise to new business models currently unforeseeable.
- 3) Lower barriers to entry / “democratization” of technology tools – Competition and traditional market forces will reduce the cost of new digital technologies that will empower new market entrants. New market entrants will bring innovation and increase competition across sectors.
- 4) Digital v. human labor – Machine learning and automation will continue to increase efficiency of traditionally manual tasks performed by humans. While we expect some tasks to be fully automated in the future (merely continuing a trend which has occurred since the dawn of the industrial revolution – e.g., steam locomotion, combustion engines, power tools, automatic coffee machines), we expect human activity to shift to tasks which are more difficult to automate (e.g., creative, empathetic, strategic, and evaluative tasks). In those areas not easily susceptible to full automation, we expect human machine interfaces and augmented reality tools to further enhance the scope and scale of human impact.
- 5) Political/regulatory responses to disruption – Business models exist within, and are enabled by, a social and political framework maintained by government and civil society. We recognize the unique challenges that highly digitalized business models place on government and civil society (in addition to traditional tax systems) as they seek to address matters of data privacy and security, transparency, labor market stability, and economic growth. It must be recognized

that digitalized business models are driving new sources of economic growth and new labor markets which help offset the disruption caused by digitalization. They are also enabling efficiencies in the administration and enforcement of laws and policies. Governments that foster a stable social and political framework promoting growth of the digital economy should reap significantly greater economic benefit than governments that do not.

The trends reducing barriers to market entry offer the potential to usher in a 'golden era' for small and medium size businesses ("SMBs"). New digital technologies will increasingly see SMBs 'born global' rather than requiring the traditional path from local to global reach. For example, with developments in AI, a pattern-matching, machine-learning algorithm operated by a centralized expert staff in a new SMB could allow the company to offer a specialized life sciences research service to customers around the world without the need to duplicate extensive capital or human resources in each market. Fostering a regulatory and social framework to support such innovation can bring great economic benefits to countries. Alternatively, a global tax landscape defined by uncertain and ambiguous tax rules, divergent approaches to taxing cross-border transactions, and increased controversy, would be infinitely harder for an SMB to manage than for a large MNE, given their limited resources. To avoid such barriers to innovation and healthy competition, tax policy makers should place a premium on achieving tax certainty and the principle of tax neutrality.

## B. Challenges and Opportunities for Tax Systems

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

We observe the following trends within the current international taxation framework:

- 1) Increasing compliance burden: Businesses continue to face steadily increasing compliance burdens globally. Companies operating in the cross-border context face significant challenges in meeting the demands of multiple tax and regulatory bodies. This is a real cost to taxpayers, and we suggest that it is important for governments to thoroughly evaluate the costs and benefits of both existing and incremental reporting requirements.
- 2) Inconsistent indirect tax rules: Inconsistent global VAT / GST rules and non-existent double tax agreements in VAT matters (except EU Directive) contribute to uncertainty, add administrative burdens and increase potential issues of double taxation.
- 3) Move towards less objective standards: Countries have implemented less objective rules in order to cast a wider net against tax avoidance and tax evasion (e.g., UK DPT rules and Australia MAAL rules). While we understand the government concerns that motivate these less objective measures, they drive significant tax uncertainty and can lead to double taxation.
- 4) Unilateral action: Perhaps in response to the underlying lack of consensus, and in association with the move towards less objective standards, we see a rising trend of unilateral actions that are undermining consensus and leading to increased uncertainty regarding the global tax environment. This uncertainty hinders decision making, limits innovation and investment, and broadly undermines the growth of international trade.

*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?*

The implications of highly digitalized business models go far beyond tax policy. They reach the entirety of the political, regulatory and social framework of sovereign nations. Tax revenues of countries will be affected significantly more by the country's ability to foster economic growth in the digitalizing economy than they will by tax policies designed to raise revenue by targeting select sectors or taxpayers using targeted business models. Such targeted tax policies in fact cost a country far more in its overall tax base than it collects through measures that violate principles of tax neutrality.

### ***Unilateral action undermines economic development***

We recognize the substantial progress as a result of the broad consensus reached as a result of the BEPS project, yet we see significant risks globally from countries enacting or pursuing unilateral measures that depart from international norms whether long-standing or recently achieved. These unilateral measures, often borne from political pressures, apply new punitive tax regimes that unequally target the “digital economy” (however nebulous that term might be). These efforts create tax uncertainty and lack the international coordination and consensus needed to promote global trade and investment. Further, the desire to find a quick solution to issues raised by the digital economy has meant that there has been no comprehensive analysis of the reach and economic impact of the measures being considered. Without adequate consideration, there is risk that such proposals will in fact harm economic development, stifle start-up innovation and expansion, contribute to GDP contraction and increase the economic impact of technology-driven worker dislocation. Unilateral efforts, in particular, are not conducive to a stable, more certain tax environment which contributes to the OECD’s mission, and indeed the mission of its constituents - to promote policies that will improve the economic and social well-being of people around the world.

### ***The OECD BEPS project needs more time to determine its effectiveness***

The principal focus of the OECD’s BEPS initiative was to address the double-non-taxation of business profits. Early signs indicate that the BEPS initiative is effective in reducing double-non-taxation. More time is needed to determine whether the BEPS initiative will also be effective in addressing the tax challenges of the digital economy.

We observe MNEs changing behavior, exiting historic low-substance operating structures and increasing alignment of profit recognition with Significant People Functions and the control of business risk. Country-by-country reporting has provided a stark illustration of business alignment (or misalignment) with profit recognition and has elevated tax as a c-suite and corporate board level issue in unprecedented ways. The BEPS initiative is shoring up country and regional tax bases by encouraging increased focus on the alignment of value creation and profit alignment. Nevertheless, a number of challenges remain. Specifically, significant disagreement exists globally as to where value creation occurs. Further, there remains a lack of global consensus on the appropriate standards for profit attribution and insufficient willingness to adopt measures to relieve administrative burdens associated with divergent perspectives. The question of profit attribution is further exacerbated in the context of digital nexus. These two technical points highlight the more fundamental policy question underlying these matters – source versus residency based taxation.

### ***Source versus residency based taxation***

The fundamental issue behind the so-called ‘fair taxation of the digital economy’ appears to be driven by a desire to revisit the long-established balance between residency-based versus source-based taxation.

To a certain extent, the digital economy tax debate reflects the dissatisfaction by some countries with large shares of the digital economy tax base concentrated in jurisdictions where business risk is managed and significant people functions are performed. One side of the debate is of the view that the BEPS outcomes have already identified where profits should be taxed. The other side is dissatisfied with this result and wishes to shift more of the tax base to the markets where companies sell their goods and services. As noted above, consensus has been achieved and is driving changes in corporate behavior to align around historic understandings of value creation and arm’s length principles; however, these changes are not resolving the

concerns of countries that wish to rebalance the standards based on new concepts of source-based taxation.

An issue as important and far-reaching as striking the right balance between source and residency based taxation requires global consensus. As the OECD's Task Force on the Digital Economy ("TFDE") has already noted in its 2015 Action 1 report, the digital economy 'is' the economy. This tax policy debate should be pursued deliberately, multilaterally, and constructively to arrive at an agreed global consensus. Such collaboration and consensus is increasingly necessary when the international tax policy debate is viewed not in light of current disruption but rather the trends of digitalization across the entire global economy over the coming decades.

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

There are significant opportunities to use digital technologies to improve tax administration and compliance burdens. Additionally, we see these technologies reducing reporting burdens in areas outside tax. However, we believe a detailed discussions on this topic is more appropriately addressed in different fora.

## C. Implementation of the BEPS package

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

As mentioned above, a number of recommendations emerging from the BEPS package have already been adopted by a number of jurisdictions and therefore can be expected to affect all sectors and business models, including digitalized business models. Below we provide comments on key elements of the BEPS package relative to digitalized business models:

BEPS Action 6	<p>In practice, the implementation of BEPS Action 6, via MLI articles 6 and 7, has resulted in virtually all MLI signatories adopting the Principal Purpose Test (“PPT”). The impact of this change in addressing the challenges of digitalization is unclear. While the PPT is intended to provide tax administrations with a tool to address cases of abuse, it also introduces significant uncertainty into the double tax treaty context.</p> <p>Highly digitalized businesses, with minimal local country footprints and highly efficient centralized global or regional sales operations may be disproportionately vulnerable to challenges under the PPT. Specifically, a significant concern exists that more aggressive taxing authorities may seek to utilize the PPT to deny treaty benefits to organizations with limited footprints without regard as to the extent to which such structures contribute to value creation in an organization.</p> <p>Establishing clear guidelines implementing the PPT would assist local country tax authorities in distinguishing abusive tax and finance structures from new, innovative operating models that reflect genuine economic activity.</p>
BEPS Action 7	<p>BEPS Action 7 changes to the permanent establishment standard were designed, at least in part, to limit perceived abuses by certain taxpayers operating centralized sales models. By expanding the scope of dependent agent permanent establishments (“DAPEs”) market jurisdictions will have claim on a portion of the tax base of digitalized business model taxpayers making use of DAPEs in their distribution function.</p> <p>BEPS Action 7, and the associated Articles 12 – 15 of the Multilateral Instrument (“MLI”) have prompted businesses to reassess both their tax reporting practices and their operating models.</p>

BEPS Action 8-10      The deliberations as part of the BEPS project reaffirmed the understanding that 'control' is at the core of value creation. Enterprise value creation is the product of the control of assets and processes internal to an enterprise. In confirming this, OECD members essentially have rejected the argument that enterprise value creation can be the product of actors/processes external to an enterprise.

The focus of BEPS Actions 8-10 has been to align the profits earned by members of an MNE group with their contributions to value creation. In order to achieve this alignment, the BEPS Actions 8-10 guidance requires that an associated enterprise earning returns from an intangible or from the assumption of economically significant risks at arm's length must have people making significant decisions regarding the risks or intangibles.

In response to BEPS Actions 8-10, MNEs are reviewing and, where needed, reinforcing the alignment of their intangible ownership, risk assumption and associated profits and losses with important functions related to the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles and the control of economically significant risks.

This alignment of profitability with value creation is occurring across industries—wherever intangibles and risk assumption are significant value drivers. Given the importance of intangibles to the digital economy and the risk profiles of digital businesses, this alignment necessarily covers digital businesses of MNEs throughout all industries, not just those with a specific digital focus. BEPS Actions 8-10 has been sufficiently broad to lead to realignment in both digital and non-digital businesses.

*Question 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?*

We note that VAT/GST legislation has resulted in a heavy administrative burden on businesses. The shift of the burden of collection from governments to businesses has contributed to this burden. We think a continued debate regarding the appropriate balance of burdens associated with the VAT/GST collection function is fair and reasonable.

We observe inconsistencies in application of principles set out in OECD Guidelines:

- scope (just few digital services v. all services; B2C v. B2C + B2B);

- liabilities of electronic data processors (“EDPs”) vary greatly between jurisdictions; registration threshold (nil v. same as domestic businesses);
- registration (simplified registration v. standard registration);
- returns (complex v simple returns; monthly v. quarterly returns);
- invoicing requirements (required or not);
- bookkeeping requirements; data collection requirement (is the customer a business or not; where is the consumer located, etc.)

Often rules are implemented in local countries without detailed guidance that allows businesses in various sectors to adequately determine their VAT responsibilities. In certain jurisdictions we have seen new VAT rules implemented without leaving enough time for businesses to (1) determine their new VAT obligations and (2) adapt their systems to the new rules.

Some examples of VAT/GST administration best practices include:

- Focusing on B2C supplies and clearly identifying what constitutes a B2C (as opposed to B2B) supply
- Adopting a VAT registration threshold similar to the one available to domestic businesses
- Provide a simplified registration mechanism (i.e., only for collection and payment of VAT) with simple returns with longer filing periods (e.g., quarterly at least for most businesses subject to the rules)
- Do not require issuance of VAT invoices or at a maximum issuance of simplified invoices
- Provide flexibility in data set chosen to identify customer location as not all businesses have same data available
- Clarify VAT obligations of remote sellers and EDP’s
- Publish guidance on VAT obligations relating to the digital economy
- Provide sufficient time to businesses and tax authorities to prepare for the implementation of new rules
- Ensure that dispute resolution between countries is not be overly burdensome or harmful to businesses.

#### **D. Options to address the broader direct tax policy challenges**

*Question 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?*

Any recommendation by the OECD to implement a digital PE standard would be counter-productive to the success of the OECD’s BEPS initiative. Such a recommendation would lead to disparate rules across jurisdictions, tax uncertainty, and barriers to innovation. The DAPE PE standard recommended by BEPS Action 7 has, to date, only been adopted by a minority of countries participating in the BEPS Action 15 Multilateral Instrument. There is currently more disagreement amongst countries on the concept of virtual PE than there was with the DAPE concept. Thus a recommendation to adopt a virtual PE standard would lead to either: (i) a limited number of countries agreeing to modify their treaty definition of PE to include a virtual PE – thus creating tax complexity across jurisdictions, or (ii) domestic legislation intended to override treaty obligations – thus creating tax uncertainty, double taxation and barriers to cross border investment.

The creation of an economic nexus standard for digital businesses based on location of customers / users, rather than activities of the MNE taxpayer, would represent a fundamental shift with potentially far-reaching ramifications (see our earlier comments regarding the appropriate debate to be had regarding the balance between source and residency based taxation rights). For example, the Authorized OECD Approach (“AOA”) to profit attribution to a PE and the Transfer Pricing Guidelines (“TPG”) as revised by Actions 8-10 place significant weight on the location of Significant People Functions (AOA) and risk control functions (TPG) in determining the appropriate attribution of profit, and in fact the TPG were specifically revised by Actions 8-10 to limit the attribution of profits to jurisdictions where the taxpayer MNE had little or no significant functions or assets.

Therefore, any introduction of a concept of economic nexus to which profit should be attributed, based on digital presence, would require extensive revisions to the TPG as well as the AOA to achieve consistency and prevent double taxation. Further, as the Final BEPS Action 1 report stated, it is not possible to ring-fence the digital economy, and an economic nexus concept attributing value based on location of customers / users rather than location of functions, assets and risks of the enterprise cannot be limited to narrowly-defined digital enterprises. The concept of source-based taxation has far-reaching implications for any enterprise with significant disparities in the

location of its customers versus the location of its value creation activities as currently defined under TPG.

*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?*

Alterations to the economic nexus standard, the imposition of a digital economy specific withholding tax, or an equalization levy all present substantial challenges to the OECD's goal of driving global tax rule consensus and create significant tax uncertainty and risk of double taxation. In particular, a gross basis tax such as an equalization levy or withholding tax are likely to result in double taxation and cascading tax liabilities. Although these concerns might be mitigated through an input credit or an option to pay on a net basis. Any netting mechanism would raise the same profit attribution challenges discussed above in connection with the virtual PE proposal and might even duplicate VAT regimes. Further, there is a question of whether any such measures are ultimately sustainable within the global trade framework. Below we provide some additional specific areas of concern we see with these types of unilateral measures.

**WTO Rules**

Under the General Agreement on Tariffs and Trade (GATT) members of the WTO have limited power to impose protectionist measures with regard to the import of goods. The application of the Most Favored Nation (MFN) rules by WTO members means that WTO members cannot discriminate amongst each other. A special condition granted to one member automatically applies to all other WTO members. A clear definition for digital products or digital trade is not made under GATT. However digital products distributed on tangible media and shipped from one country to the other may be subject to customs duty, while digital products electronically transformed from one country to the other are not subject to customs duties.

Under the WTO umbrella also falls the General Agreement on Trade in Services (GATS). Under GATS, services are defined as: "any service in any sector except services supplied in the exercise of governmental authority." A digital tax that may have cross border implications should therefore align with the non-discrimination conditions of the WTO.

While further analysis is certainly necessary, the implementation of a digital PE standard, the imposition of an equalization levy, or withholding tax on digital transactions may face significant challenges under the anti-discrimination rules under either GATT or GATS. Practically speaking, such rules would likely have to apply equally to all inbound transactions and would require modifications to domestic law and tax treaties.

**The EU as a Test Case**

In the following comments we have evaluated some of the recent proposals with respect to various digital economy related tax initiatives being discussed by the EU Commission. In this respect, the EU really serves as a test case for many of the policy issues raised in our comments above.

On 22 September 2017, the EU Commission released a Communication on digital taxation. Proposals were discussed at the ECOFIN meeting in Tallinn on 29 September but without resolution. There have been suggestions that the EU should progress with adopting some kind of digital tax on a coordinated basis and, if the chosen system proves to be efficient, it could be later adopted at a global level.

We set out below some considerations on the EU introducing an EU wide digital tax through a Directive.

An initial proposal for an EU Directive would be presented by the European Commission and would have to be discussed and approved at unanimity by the Member States. In such procedure, the European Parliament has a consultative role only.

Under this scenario, the following legal checks would have to be performed:

- Is the introduction of a new tax (e.g. equalization tax or withholding tax) or of a new taxation nexus (i.e. “digital” PE) allowed under the Treaty on the Functioning of the European Union (TFEU)?
- Do the proposed rules comply with the principles of subsidiarity and proportionality?
- Once adopted, would the new rules be compatible with the existing bilateral tax treaties (1) between two Member States and (2) between Member States and third countries? In this respect, could EU law be considered to modify the domestic rules of all Member States and therefore override intra-EU treaties?

Any legislation implemented at a national level will need to comply with existing EU rules, including the fundamental freedoms, state aid rules, and existing directives (e.g. VAT Directive).

The potential requalification of a “digital” tax as illegal state aid will primarily depend on the particular features of the final legislation implemented. However, any challenge under EU state aid rules is likely to be based on the considerations that the tax provides a selective advantage to a particular sector or a certain number of companies:

- e.g., if the legislation provides an exemption for SMBs or start-ups
- e.g., progressive tax on turnover has been consistently considered by the EU Commission as illegal state aid (see Hungary’s advertisement tax and Poland’s tax on the retail sector)

Depending on the final characteristics of the tax, it could also be argued that a “digital” tax constitutes an infringement of the freedom of establishment, if it discriminates between resident and non-resident EU based companies (e.g. a German resident company taxed in France on its French digital transactions, while a comparable French company performing digital activities would be exempt).

Such tax could for example take the form of a levy based on the revenues derived from transactions carried out remotely by non-resident businesses with local customers. In this case, it would be necessary to further examine the following issues:

- Does the tax or withholding explicitly discriminate between resident and non-resident businesses?
- In case of a covert discrimination, does a correlation exist between the place in which a company has its seat, and a distinguishing criterion to be subject to taxation?

- If a discrimination exist, can it be justified and is it proportionate? (e.g., effectiveness of fiscal supervision and the need to prevent tax avoidance)?

The implementation of an “equalization” tax or any (withholding) tax levied on the gross value of certain payments to non-resident providers of goods and services online could raise net taxation concerns, i.e. not allowing non-residents to deduct expenses directly related to the taxable activity would, in principle, be an infringement on the freedom to provide services and/or on the freedom of establishment, if residents in a comparable situation can claim such expenses and therefore pay tax on a net basis.

A system based on a virtual PE presents similar concerns with regard to profit attribution. A non-resident with a virtual PE may be taxed on greater measure of profit than it would have been had it been a resident company (e.g., because not all relevant costs would be deductible) and this could constitute unfavorable treatment and a breach of the freedom of establishment.

Finally, the EU VAT Directive also raises significant matters which, depending on final legislation, may invalidate an EU wide “digital” tax. Member States are prohibited to levy turnover taxes, other than the VAT foreseen in the directive.

### ***The EU as a Test Case - A Revised Economic Nexus Standard***

A revised economic nexus standard might be designed based on revenue factors, digital factors and/or user-based factors as noted in Paragraphs 278, 279 and 280 of the Final BEPS Action 1 report and as discussed above. However, even with a revised nexus standard, existing arm’s length profit attribution rules (as affirmed in the Final BEPS Actions 8 – 10 report) would require that profit be allocated to the Significant People Functions, control of risk and value driving activities performed by a remote seller outside of the PE. As noted in the broader policy discussion above, there remains significant disagreement regarding the appropriate profit attribution standards.

In this respect, the following questions should be addressed:

- Is the “digital” PE definition compatible with the provisions of existing bilateral tax treaties (e.g. would it result in a modification of the allocation of the rights to tax between Member States or with third countries under existing bilateral treaties)?
- If there is an incompatibility (i.e. there is a provision in the existing bilateral treaty that would prevent a Member State to tax a “digital” PE in accordance with its domestic legislation) should the provisions of the bilateral treaty prevail over the directive?
- If such incompatibility results in a double taxation (e.g. the “digital” PE income is taxed by both the PE and the headquarters’ jurisdiction), would the taxpayer have any recourse?
- If a credit mechanism is developed to address potential double taxation scenarios, would the tax be paid up front subject to an input credit? If so, hasn’t this created a second VAT potentially in violation of the TFEU and VAT Directive?

For example, if such a revised standard were adopted by the EU, there is no clear-cut answer as regards the hierarchy of norms between treaty law and EU law. While it may be argued that treaty law should prevail over the conflicting provisions of a directive, article 351 TFEU and the principle of cooperation in good faith between Member States embedded in the fundamental treaties of the EU also support the view that Member States have the obligation to eliminate the incompatibilities between tax treaties and EU law.

An alternative to renegotiating all existing bilateral tax treaties would be the implementation at EU level of a multilateral instrument similar to the OECD MLI, under which existing bilateral tax treaties between Member States would be modified in a synchronized and efficient manner to implement the definition of a “digital” PE. Nevertheless, it would still leave unresolved any incompatibilities as regards the bilateral tax treaties negotiated between Member States and third countries.

In particular, in case a double taxation event occurs e.g. the “digital” PE income is taxed both by the PE jurisdiction (arguing the existence of taxable presence in its territory based on the “digital” PE definition available under its domestic legislation) and the headquarters’ jurisdiction (not recognizing a separate PE in the other jurisdiction, based on the PE definition available in the relevant bilateral tax treaty) it is questionable whether the taxpayer could still rely on the dispute resolution mechanisms foreseen by the relevant bilateral treaty.

Adoption of a revised economic nexus standard without robust multilateral agreement and coordination on the above types of issues will generate additional uncertainty, administrative burden and tax litigation that will hinder economic growth.

### ***The EU as a Test Case - An Equalization Levy***

An equalization levy raises additional issues as regards its compatibility with bilateral tax treaties. In this respect, the following questions should be addressed:

- Would an “equalization” tax qualify as a tax “on income and on capital” and therefore potentially fall within the scope of taxes covered by existing bilateral treaties?
- If the relevant bilateral tax treaty does not apply and this results in a double taxation, would the taxpayer have any recourse?

In order for an equalization tax to be compatible with the fundamental freedoms it would have to be levied on both resident and non-resident enterprises. It is unlikely that it could be justified as substitute for corporate income tax and only levied on non-residents. Therefore there would be increase in the tax burden on all digital businesses, including domestic ones, which may well be contrary to the overall tax policy of the country in question. Furthermore, this would raise state aid issues as it could result in a company selling via a digital channel having a greater tax burden than one selling through tradition means.

### ***The EU as a Test Case - Withholding Tax on “Digital Transactions”***

A withholding tax on “digital transactions” raises issues as regards its compatibility with bilateral tax treaties, in particular the following questions should be addressed:

- Would the withholding tax qualify as a tax “on income and on capital” and therefore potentially fall within the scope of taxes covered by existing bilateral treaties?
- If the relevant bilateral tax treaty is applicable, is the withholding tax compatible with such provisions (e.g. would a provision in the treaty prevent the application of the withholding tax)?
- If there is an incompatibility, should the provisions of the bilateral treaty prevail over the Directive?

- If this results in a double taxation event (e.g. the “digital” transactions are taxed both in the source state and the residence state), would the taxpayer have any recourse?

In summary, any of the special tax measures discussed herein are likely to be counterproductive as they thwart global tax consensus and foster tax uncertainty. Tax uncertainty is further exacerbated by the significant legal and practical impediments to implementing these measures. Many of these impediments are likely to take a prolonged time to resolve.

## About KPMG

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 189,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

KPMG Contacts	Firm	e-mail
Steve Blough	KPMG in the U.S.	sblough@kpmg.com
Manal Corwin	KPMG in the U.S.	mcorwin@kpmg.com
Jesse Eggert	KPMG in the U.S.	jeggert@kpmg.com
Matt McNeill	KPMG in the U.S.	mgmcneill@kpmg.com
Chris Morgan	KPMG International	christopher.morgan@kpmg.co.uk
Michael Plowgian	KPMG in the U.S.	mplowgian@kpmg.com
Conrad Turley	KPMG in China	conrad.turley@kpmg.com
Robert Van der Jagt	KPMG EU Tax Centre	vanderjagt.robert@kpmg.com
Grant Wardell-Johnson	KPMG in Australia	gwardelljohn@kpmg.com.au
Brett Weaver	KPMG in the U.S.	baweaver@kpmg.com

POSTAL ADDRESS P.O. Box 71170  
1008 BD AMSTERDAM  
OFFICE ADDRESS Fred. Roeskestraat 100  
1076 ED AMSTERDAM  
The Netherlands  
TELEPHONE +31 20 578 57 85  
FAX +31 20 578 58 00  
INTERNET loyensloeff.com

By e-mail (TFDE@oecd.org)

OECD  
Task Force on the Digital Economy

FROM Jan Bart Schober / Pierre-Antoine Klethi / Ruben van der Wilt / Maarten de Wilde  
REFERENCE 25625914  
DATE 13 October 2017  
RE Tax challenges of the digitalised economy

Dear Sirs,

We have noted with interest the Request for Input on Work regarding the Tax Challenges of the Digitalized Economy (the RFI). We are grateful for being offered the opportunity to share our views and considerations on this topic.

The questions listed under A. (Digitalisation, Business Models and Value Creation) in the RFI seem to be aimed at identifying characteristics of digital businesses that could form the basis for the ring-fencing of the digital economy. As an international law firm, we choose to address only matters of tax law and tax policy in the context of questions listed in the RFI under B through E in the Annex.

Nonetheless, we would agree with the statement in the 2015 Report on Action 1 (Addressing the Tax Challenges of the Digital Economy) of the OECD/G20 BEPS Package, that – from a conceptual and technical point of view – it will be very difficult or even impossible to ring-fence the digital economy.

Businesses in virtually all sectors are now impacted by – or even embrace – the digitalisation of the economy to a certain degree. It can be safely assumed that this trend will continue to develop exponentially. Digitalisation has become a core element of the current business environment, both for tech companies and for companies in the more traditional parts of the economy.


Although it may be possible to identify certain cash flows that are largely derived from certain digital businesses, we think that a true ring-fencing of profits derived from digital activities will in practice not be feasible in a robust and sustainable manner.

The public limited liability company Loyens & Loeff N.V. is established in Rotterdam and is registered with the Trade Register of the Chamber of Commerce under number 24370566. Solely Loyens & Loeff N.V. shall operate as contracting agent. All its services shall be governed by its General Terms and Conditions, including, inter alia, a limitation of liability and a nomination of competent jurisdiction. These General Terms and Conditions may be consulted via loyensloeff.com. The conditions were deposited with the Registry of the Rotterdam District Court on 1 July 2009 under number 43/2009.

AMSTERDAM • ARNHEM • BRUSSELS • HONG KONG • LONDON • LUXEMBOURG  
NEW YORK • PARIS • ROTTERDAM • SINGAPORE • TOKYO • ZURICH

Finally, any attempt to ring-fence the digital economy in order to tax digital companies different from non-digital companies would raise the issues of how to tackle the risk of manipulation.


Yours faithfully,  
Loyens & Loeff N.V.



Jan Bart Schober



Pierre-Antoine Klethi



Ruben van der Wilt



Maarten de Wilde

## **Annex – Observations in respect of Questions B through E**

### **B. Challenges and Opportunities for Tax Systems**

Perhaps the most serious issue raised by the OECD and various academic scholars, is that the current international tax framework seems not to have been updated at the same pace as business operations and practices have evolved. Today's corporate tax systems were originally set up in the 1920s – the early days of international taxation. They have been amended regularly since then, but in the public and media view, they struggle to achieve their public financing and redistribution purposes in an era of increased and continuous digitalisation of businesses.

The two main pillars of the current corporate tax systems, i.e., the legitimacy to tax and the enforceability of taxes, are still largely based on the presumption of locally organised businesses operating in close proximity to their customers. This is materialised either through tax residency or through a permanent establishment. Today's markets increasingly operate in a different reality, whereby MNEs structure their business operations on a regional or even global basis, develop products and services, commercialise intangible resources, and provide goods and services to customers remotely. The internet expanded these opportunities; as a result, physical presence is less of a necessity for serving local markets.

The place of incorporation and the place of effective management, which are the criteria defining residency for tax purposes, are increasingly geographically mobile. As a result, the place where value is created has become more difficult to pinpoint, and hence some persons argue that the place of residence is losing legitimacy as a basis for attributing taxing rights to jurisdictions. Although the emphasis in the public debate appears to be on digital companies, the latter seems to hold true for both digital companies and more 'traditional' companies, as traditional companies – like digital companies – increasingly use the opportunities offered by digital technology to boost revenue and profitability and develop a global footprint.

The apparent consensus is that profits should be taxed in the jurisdiction in which value creation occurs. The difficult question is how to determine where value is created. The globalisation of the economy, perhaps accelerated by digitalisation, has fostered an increasing geographic disconnection between the 'supply side' and 'demand side' of 'income production'. It emphasises the need to further examine the question of how to assign the corporate tax basis to countries. The lack of international consensus on this fundamental matter lies at the heart of the current digital economy taxation debates, which debates are likely to also encompass the traditional economy.

Defining the geographical location of value creation first requires agreeing on splitting value creation between the different functions. For example, where a digital business derives profits from the exploitation of data, how much value is created when the data is collected, how much value is created when the data is processed and how much value is created when the data is made available to third parties against a remuneration?

The geographical split is the second step and is not always easy to determine. The geographical allocation of profits often seems to revolve around a 'source' versus 'residence' debate. It should be noted, however, that particularly the term 'source' is used ambiguously (as shown below). Therefore, the question of geographical allocation may be better addressed on the basis of 'origin' versus 'destination'. Should income be seen as being created in the investment jurisdiction, at 'origin'? Or is income (also) created in the market jurisdiction, at 'destination'?

In this respect, the term 'origin' represents the supply side of income production, where the production factors of capital and labour ('business inputs') converge, i.e., the place where a business enterprise is being operated. The term 'destination' represents the demand side of income production, i.e., the place where the goods and services produced are delivered to the market ('business outputs'). Profit making requires both, as profit is the resultant of the interplay of supply and demand. Without production one cannot sell and without a sale any production seems a waste. This, however, sheds no light on how to disentangle supply and demand in a meaningful way to geographically divide profit for corporate income tax purposes. In a globalised market environment, both the production and the demand are spread on a worldwide basis, particularly in a digitalised economy.

Under current tax treaties, the right to tax income is attributed to countries by reference to both supply-side oriented and demand-side oriented distributive rules. In this respect, as mentioned above, the term source is used ambiguously: for both sides, reference is made to the term 'source'.

- On the one hand, the transfer pricing concepts generally attribute tax base to the state of residence, i.e., the 'source' country on the supply side. Consideration is given to '(significant) people functions' (labour), 'assets used' (capital) and 'risks assumed'. Particularly since the implementation in the OECD Transfer Pricing Guidelines of the recommendations made in the final report on BEPS Actions 8-10, the risks seem to follow the assets, which in turn are economically allocated in line with the (people) functions. The primary focus in transfer pricing is therefore on business inputs, disregarding the 'demand side' of income production, i.e., at origin.
- 'Source' taxes, on the contrary, allocate taxing rights to the demand side, albeit not specifically in those words. Reference is made to the phrase "*income arising...*" in the treaty distributive rules with regard to some classes of income such as dividends, interests payments, and royalties, and certain service fees on some occasions. The point of reference in source taxation for determining the jurisdiction for such service providers' income is consistently the location of the payer of the financial flow involved. The party providing the services is taxed at the place in which the services are received, i.e., at destination. For example, the creditor is taxed in the debtor's state, the licensor is taxed in the licensee's state, and the provider of rights to use equipment or expertise is taxed in the user's state.

In this respect, it is important to note that the taxing rights allocated under tax treaties to the supply side generally concern the 'profits' of the business, while the taxing rights allocated to the demand side are usually determined on the basis of 'gross amounts paid', so disregarding the actual profit – and hence the economic capacity to bear the tax – of the business.

### **C. Implementation of the BEPS package**

The supply-side (i.e. origin) oriented OECD/G20's BEPS Package seeks to address base erosion and profit shifting by adjusting the existing international tax regime rather than departing from it. Some argue that it addresses the symptoms, but not the underlying causes for base erosion and profit shifting. It is, however, undisputable that the BEPS Package introduces changes that will effectively put an end to certain traditional and 'easy' forms of tax planning.

The BEPS Package is still in its early implementation phase and has consequently produced little effects so far in terms of effectively addressing the perceived tax challenges raised by digitalisation. More time is needed to see the impact of the BEPS recommendations. In this respect, a distinction may have to be made between actions relating to transparency and actions relating to anti-abuse. The increased transparency may well have an impact on the consistency of international taxation. However, the BEPS initiative does not extensively address fundamental questions such as where value is created (both in the digital economy and in the traditional economy) and which jurisdiction should be entitled to tax such value, the expectations in respect of the anti-abuse measures may be more conservative. Answering these fundamental questions is a prerequisite to more radical reforms and is a separate (political-economic) exercise from tweaking the (technical) features of the current international tax system.

The internet has made it possible for businesses to supply markets often without a local physical presence and without the necessity to own substantial assets. This has caused an almost unlimited and surely unprecedented scalability of digital businesses. These factors, together with the difference between defining the principles governing international tax law and laying down technical rules to implement them, may explain why tax policy makers are now exploring ad hoc approaches and means to tax (foreign) 'tech-firms' outside the existing international tax framework.

It is worthwhile noting that these ad hoc approaches include 'virtual' permanent establishment tests, withholding taxes on payments for 'digital' supplies, 'digital equalisation levies', or 'diverted profits taxes', which typically regard the demand side of the market.

For reasons of enforceability, policy makers are likely to base these levies on gross amounts paid, and in doing so they may, perhaps unintentionally, gradually move away from taxing businesses on actual profits. Obviously, the lack of a coordinated or systemic approach may bear the risk of arbitrary taxation and market distortions between local companies versus MNEs and digital companies versus traditional companies.

## **D. Options to address the broader direct tax policy challenges**

### *General remarks*

Contrary to BEPS Package policy directions, recent tax policy efforts in the 'digital' area now all seem geared towards enforcing tax base distribution with regards to ring-fenced 'digital' supplies to 'market' jurisdictions. This is particularly true for the recent French-led initiatives in the European Union calling for an equalisation tax. Assigning taxing rights to the market jurisdiction would indeed entail a paradigm shift and the interactions with the existing tax rules would generate uncertainty and double taxation risks.

Where should we tax income in relation to a computer game developed in Country A, downloaded and used by a registered player in Country B? Recent tax reform initiatives seem to be favouring the latter. A key related question is: if we ring-fence the digitalised parts of the economy from the rest of the economy, what would that mean for the non-digitalised part of the economy? Should we then also push direct taxation of the non-digitised parts of the economy to market jurisdictions? If a car manufacturing company develops and produces automobiles in Country A and sells these in Country B markets, where should that company pay its corporate tax bill? In origin country A, as we have been pursuing in international taxation to this date, or in destination country B? Does any relevant or meaningful difference exist in the first place, between tangible and intangible or 'virtual' supplies? These questions seem to have been left unassessed, at least so far.

### *Significant economic presence: the virtual permanent establishment*

The concept of 'significant economic presence' would establish a nexus for an intangible or 'virtual' presence with the market jurisdiction. A key problem would be that, under the current international tax law rules, it is impossible to assign any substantial amount of profit to such a newly established virtual permanent establishment. The current transfer pricing guidelines stick to the (traditional) significant people functions and do not add value to, e.g., consumers or users of the digital economy products. This is similar to the now rapidly appearing difficulty of attributing any significant amount of profit to the newly developed permanent establishment concepts within the context of BEPS Action 7. This is because permanent establishment profit attribution is about assigning tax base to the production jurisdiction. It is not about assigning tax base to the market jurisdiction. Should we desire the latter, then we should proceed to alter the profit attribution paradigm too, and transfer pricing as a corollary.

It is no coincidence that we cannot effectively tax the new commissionaire permanent establishment. The principal does not perform any functions in the market jurisdiction in addition to the functions of its commissionaire, for which the latter receives an appropriate remuneration. Any introduction of a 'virtual' permanent establishment in the market jurisdiction will inevitably have that same fate of becoming a fairly 'profitless' permanent establishment, at least as long as the transfer pricing tax base division paradigm is left unaffected, let alone any definition issues arising in this regard. It underlines that the 'digital' economy cannot be ring-fenced from the 'non-digital' economy.

If the OECD comes up with a proposal for a virtual permanent establishment, issues that have to take into account are, for instance.

- The definition of the taxpayer: how to determine the scope of the digital activities that would create a virtual permanent establishment and separate it from the 'traditional' economy. The latter is already (partly) based on digital services.
- The relationship with current OECD rules, for instance: could one taxpayer have two permanent establishments (one physical and one virtual)?
- How will the income be allocated: new transfer pricing rules that also allocate value to user-based factors (e.g., monthly active users), or methods based on fractional apportionment or deemed profit methods?
- Should the threshold of significant presence also include a time threshold (for instance only a deemed virtual PE after a certain relationship with customers/users over 'x' months)?
- Should the exemption of auxiliary services in art. 5(4) OECD Model be deleted?
- How should the new definition be implemented: in each tax treaty separately or through a multilateral convention?

#### *Withholding tax on certain types of digital transactions*

Any introduction of a withholding tax on digital supplies, similar to withholding taxes on dividends, interests and royalties, would create a nexus in, and grant taxing rights to, the market jurisdiction. Contrary to the permanent establishment alternative described above without a fundamental shift in transfer pricing concepts, such withholding tax may actually increase the tax receipts in that market jurisdiction. A withholding tax on digital supplies, however, seems problematic for two reasons.

The first is that such a tax would be levied on a gross basis. As a consequence, it would raise cost prices of digital supplies and hence become economically distortive, similar to current withholding taxes. It could easily transform a pre-tax profitable business into an after-tax loss-making venture. Such a tax would also create inequitable differentials in tax treatment in comparison to non-digital firms. In the EU context, discrimination issues would likely arise. The market distortions and inequities would particularly arise if such a withholding tax were to fall outside the scope of tax treaty networks, thereby leaving such a tax ineligible for double tax relief. In such cases, a withholding tax would effectively operate as a sales tax on digital supplies.

Secondly, similar to the virtual permanent establishment alternative, the suggestion of introducing such a tax implicitly presupposes the feasibility of properly defining its scope of operation. Such a tax would for instance need a definition of the digital transactions covered.

Since it may be difficult to adequately separate the digital part of the economy from the non-digital part, such a task seems quite daunting. Let us take the example of a consultant who prepares an advice for a client abroad and sends the advice, either per express mail (hard copy or USB-stick), as an attachment to an e-mail, or via some online platform in the cloud, together with the invoice.

Which of these supplies should be the taxable digital supply? Should it matter in the first place? Should it matter for instance if the supply were to be a book or an e-book? Or a tangible cd or streaming music content?

It would not seem inconceivable that any such action towards source-taxing digital supplies could result in arbitrary taxation, tax cascading, legal uncertainty and problems of an administrative nature.

#### *Digital equalisation levy*

A digital equalisation levy is – like the permanent establishment or withholding tax options – seeking to establish nexus and tax-jurisdiction in the market jurisdiction. Such a tax would be levied from digital companies as a percentage on their turnover in the respective market, and hence constitute some form of turnover taxation at destination. Similar to source taxation, such a tax would seem problematic for two reasons.

Firstly, levied on a gross basis it would basically constitute a contemporary version of the cascading turnover levies, or sales levies, that have been replaced by VAT in many countries already since the mid-1950s. Such tax would likely not be creditable against corporate income tax under current rules. The reason for the abolishment of these taxes in favour of introducing VAT was because of these taxes' distortive properties.

Secondly, as explained above for the digital withholding tax option, the scoping of such a equalisation tax would also be posing some severe issues, for instance in terms of properly tying down the targeted digital economy firms and their digital supplies. A digital equalisation levy presupposes the feasibility of properly defining the scope of the tax. The recent French-led initiative in the European Union would target companies operating in market jurisdictions where they conduct significant (virtual) business interactions with clients and users. For the time being, much remains uncertain about the scope of the proposal.

As said, it will be very difficult to ring-fence tech-firms with their digital supplies from 'non-tech firms' with their 'non-digital supplies'. This will result in potential confusion, distortion and red tape. Moreover, it should be noted that equalisation levies, for instance the levy that is currently being discussed within the EU institutions, have already been suspected of violating WTO rules.

#### *Other reform options*

Other reform options may include suggestions to introduce levies by reference, for instance, to online advertising revenues, online advertising space, website trafficking, 'mouse-click' numbers, 'click-through' numbers, 'likes', perhaps 'search-engine results', etc..

Issues involving revenue-based taxes on digital transactions (sales taxes, basically) echo those mentioned above with regards to withholding taxes and equalisation levies (tax cascading, economic distortions, etc.).

Taxes based on website traffic, mouse-clicks, etc., seem little more than modern-day versions of ancient 'window taxes', and 'poll taxes' (or 'head taxes' or 'capitation') levied in many (European) countries until the 19th century. These taxed by reference to counting window numbers in taxpayers' dwellings as a proxy for measuring their economic wealth. Head taxes were levied in the early days simply as a fixed amount on each liable individual. Any 'digitaxes' that would tax by reference to mouse-click numbers and the like would basically do the exact same: resorting to counting interactions with users as a proxy for measuring economic accretion.

Countries abandoned capitation and other similar taxes for a simple reason: they are completely arbitrary. It would therefore seem to make no sense at all to reintroduce such ancient forms of taxation to address today's tech-industries that operate in the forefront of innovation and technological development in a globalising market environment.

#### *Enforceability and manipulation*

In addition to the above, all of the above mentioned options for taxing the digital economy only, are likely to raise issues in respect of enforceability of the tax and risks of manipulation. How to enforce tax on digital businesses that are difficult to pin down? Moreover, the technical possibilities of digitalisation in conjunction with a difference in tax treatment of digital and non-digital sales may mean that the ability to manipulate or avoid the digital taxes could become a widespread problem.

#### **E. Other comments / final remarks**

Based on the above, we come to the conclusion that it will be very difficult from a corporate tax point of view to treat the digital economy separately or differently from the rest of the economy in a world that is becoming increasingly digitalised. It is in consequence remarkable that all tax reform initiatives forwarded in the OECD questionnaire seem to be pursuing that exact objective of ring-fencing a digital economy. All noted reform options share a requirement of separating 'tech-taxpayers' and 'tech-transactions' from 'non-tech-taxpayers' and 'non-tech-transactions'. This seems to increase the risk of arbitrary taxation (who is in and who is not), market distortions, inequities, tax cascading, legal uncertainties and red tape.

A 'quick fix' for the relevant inadequacies of the international tax framework with respect to the digital economy may not be readily available. Perhaps one should consider breaking status quos in company taxation instead and proceeding to explore some true and fundamental corporate tax reform. A wide range of suggestions perhaps worth exploring have already been forwarded in literature. Suggestions submitted include:

- Supply-side oriented global (residual) profit splitting systems – echoing transfer pricing approaches though without pesky separate accounting and comparability issues;
- Supply-side and or demand-side global formulary systems, to even destination-based cash flow taxes; or
- The taxation of multinationals solely in the ultimate parent jurisdiction.

If we cannot separate digital from non-digital, we should perhaps not even try. The solution also does not seem to lie in the current international tax framework. So the real policy question on the table perhaps should be: true corporate tax reform or no corporate tax reform?

\*\*\*

Milan, 12 October 2017

OECD - Task Force on the Digital Economy  
2, rue André Pascal  
75775 Paris Cedex 16  
France

E-mail to: [TFDE@oecd.org](mailto:TFDE@oecd.org)

**Re: Request for Input on Work regarding the Tax Challenges of the Digitalised Economy**

Ludovici Piccone & Partners ("L&P" or "us") welcomes the opportunity to comment on the impact of digitalisation on business models and value creation, challenges and opportunities for tax systems, the implementation of the measures outlined in the BEPS package and potential options to address the direct tax challenges of digitalisation.

L&P supports the OECD efforts to develop rules to find solutions ensuring a fair and effective taxation as the digital transformation of the economy accelerates. It is a fact that the rules currently in place within the international tax framework were originally designed for "brick and mortar" businesses and - as they apply today - have become outdated.

In particular, our comments focus on Chapters II and III of the interim Report for the G-20 Finance Ministers, dealing respectively with Business models and value creation in the digitalised economy and Tax policy developments in the taxation of the digitalised economy.

To this end, L&P suggests the development of a working hypothesis associated with:

- (i) the amendment of the existing permanent establishment definition ("PE"); as well as
- (ii) the possibility to refine the application of transfer pricing methodologies such as the profit split method ("PSM"). Such a conclusion would achieve the complimentary purpose of allowing tax administrations to better prevent BEPS phenomena, balance an equitable allocation of income amongst countries reflecting the value-adding activities taking place

along the value chain, while granting taxpayers the certainty needed to navigate competitively in the current economic scenario.

The above-mentioned proposals are preferred *vis-à-vis* the introduction of a new form of tax, as the latter should present a number of obstacles including – above all – the type of tax (income tax or excise tax?) as well as its taxable basis. On the contrary, both proposals under (i) and (ii) would entail the recognition of what L&P refer to as “hidden contributions” by active users, which are then translated into valuable assets attributable to the associated enterprise of the so-called market jurisdiction.

We present our feedback and proposals to the request for input below.

\*\*\*

## **1 BUSINESS MODELS AND VALUE CREATION IN THE DIGITALISED ECONOMY – THE CONCEPT OF “UNCONSCIOUS CONTRIBUTIONS” AS PROXY TO SUPPLY OF DATA BY CUSTOMERS**

Technological advances over the last twenty years affected the evolution of the supply chain of many businesses under various standpoints. In this regard, what stands out is the disruption occurred within the value creation process whereby entities (either individuals or separate enterprises) generate value to multinational enterprises (“MNEs”) by means of what we would refer to as “**unconscious contributions**”, i.e. value-generating activities not necessarily accompanied by the proactive willingness of the user itself.

In particular, we believe the express recognition of such a notion seems mandatory irrespective of whether the solution achieved will be towards the introduction of a new form of tax (akin to an “equalization” or “excise” tax) or the refinement of existing international concepts, such as that of PE or the use of the PSM.

In the current – digitalized – economic scenario, an unconscious contribution is often associated with the **supply of data**. For the sake of a proper identification of the newly introduced notion, “data” is a term to be construed extensively, ranging from one customer providing online a clothing model to a large MNEs active in the retail business to an individual shooting a video with her/his smartphone and posting it on a e-platform.

As a result, it is our impression that the April 2018 Report mandated by the G-20 will have to accurately delineate such “unconscious contributions” into the business models of MNEs. Such an effort should not be translated into a sterile theoretical exercise, but it should rather be aimed at justifying a new taxable

nexus within the domain of domestic and international tax rules.

Acknowledging the relevance of the “unconscious contributions” as an element to factor in both the PE and PSM application would be important also in light of the fact that the timing of their monetization may be immediate or deferred over time, i.e. years after the contribution of data by the user, triggering consequences on the moment in time with respect to which the taxable event would arise.

The most common forms whereby the above-mentioned contributions are “cashed in” by MNE rely on the different means of data usage, which may be found in the following business models:

1. Direct sale of data to interested stakeholders;
2. Use of data for indirect sale of dedicated advertising; and
3. Use of data to increase sales and customization.

Based on the above factors, it seems apparent that current tax provisions (both at the domestic and international level) pose significant challenges for the tax system of a country and as such require an intervention instrumental at capturing the value embedded in the above contributions.

### **1.1 How to capture “unconscious” contribution within the MNEs supply chain**

In light of the above, one possible solution – preferred by L&P for better ease of administration vis-à-vis the introduction of a new tax - may lie in **amending the PE definition** to capture the activities associated with “unconscious contributions” as well as the activities of monthly active users (“MAUs”) as an identifiable taxable nexus.

In the latter regard, a feature to factor into the PE existence would be the amount of MAUs reflecting the percentage of revenue per country. MAUs are identified as those individuals/entities interacting with the digital technologies of the enterprise at stake and contributing “unconsciously” to its value creation accordingly.

On the other hand, should the option of introducing a new tax be pursued, an alternative could be to impute a minimum level of marginality relative to the consolidated turnover of the MNE (e.g. 4%) to those groups leveraging on MAUs to generate value in their value chain. However, the OECD should also acknowledge the possibility for taxpayers to rebut such a presumption by introducing quantitative (e.g. turnover level) and/or qualitative (absence of certain functions related to collection or processing of big data related to users) factors in order to guarantee fairness and equity to the tax system.

Irrespective of the option eventually pursued - i.e. amending the PE definition vis-à-vis the introduction of a new tax - the underlying economic soundness of both seems in any event to be supported by the way with respect to which MNEs active in the digitalized economy unfold their supply chain and that normally are referred to as “over the top” enterprises (“OTT”).

For the sake of clarity, an OTT like Facebook states that in calculating the average income generated by its users the revenue calculation is done [...] *by user geography based on our estimate of the geography in which ad impressions are delivered or virtual and digital goods are purchased. We define ARPU as our total revenue in a given geography during a given quarter, divided by the average of the number of MAUs in the geography at the beginning and end of the quarter. Annual ARPU is the sum of respective quarterly ARPU amounts in that year. **The geography of our users affects our revenue and financial results because we currently monetize users in different geographies at different average rates***”.

Stated otherwise, it seems that MAUs are the proxy to which the concept of “unconscious contributions” may be related to and with respect to which both the PE concept and the application of the PSM may apply effectively.

## **2 SOME FEASIBLE SOLUTIONS – THE DIGITAL PE OPTION AND THE ENHANCEMENT OF THE PSM**

It is a fact that digital businesses are now able to have a significant economic presence in a market jurisdiction without necessarily having a substantial physical presence.

As already outlined in the interim Report by the TFDE, factors to be used in assessing the “significance” of such a presence could be based on the following: (i) the level of revenue generated from digital transactions, (ii) the number of users of a digital platform, (iii) the volume of data collected from users through a digital platform or the local domain name.

It is also known that in a European context certain countries have submitted the proposal for the introduction of a digital permanent establishment (“digital PE”), the nexus of which would be given by the data exchange taking place between the OTT and the number of citizens of that very specific jurisdiction.

Therefore, it seems to us that the prominence given to data gathering in a certain country is able to capture a very specific feature of MNEs operating in the digitalized economy. In this respect, collection and use of the so-called “big data” constitute one of the most relevant **assets** with respect to which MNEs, irrespective of the industry sector, rely on in creating and enhancing value. It

may also be the case that some countries may go against the option of considering data an asset (for both direct and indirect tax purposes) owned by MNEs.

Against the above-described background, it seems to us though that (big) data are indeed owned (in an economic as well as legal standpoint) by an MNE as the transaction entered into with the customer is not gratuitous (as many wrongly perceive), as the consideration paid by the customer for e.g. having a web search, is represented by the supply of her/his/its personal data.

In the latter regard, the market of the State where the user is resident is not only a “distribution entry” for the MNE, but it is as well a “procurement/source” market as far as data mining is concerned. In our view, it is indeed the latter feature of the State where “big data mining” activities take place which should be further explored by tax administrations to accurately delineate a tax system capable of capturing the real economic value generated in each jurisdiction by an MNE function.

In our view, stressing the importance of big data acquisition by MNEs would allow tax administrations to retain the PE concept consistent with the traditional principles of international tax law, in the sense of simply requiring an update of the current notion as laid down in Article 5 of the OECD MC, without carrying out any major overhaul to the concept itself.

In this respect, according to definition contained in the current article 5, para. 2, letter (f) of the OECD MC, a PE may be constituted by “[...] *a mine, an oil or gas well, a quarry or **any other place of extraction of natural resources*** (emphasis added)”. Such a PE definition was conceived at a specific point in time where notions such as “extraction” and “natural resources” referred to the “materiality” of these activities. Stated otherwise, nobody in 1930s could have imagined that personal data could be labelled as “resources” or refer to “extraction” of such data with respect to data mining activities.

Based on the above, we maintain the view that MNEs operating in a digitalized economic environment carry on a significant data-mining activity (the value of which can mirror that of extracting oil or other commodities from the soil of a country). The latter activity, i.e. data sourcing from users in a certain jurisdiction is akin, from a tax standpoint, to the (intangible) resources with respect to which value is extracted.

As a result, reference to the notion of a “digital PE” should not be misinterpreted or simply not identified absent a territorial nexus within the jurisdiction of a country. On the contrary, its presence in the underlying economic tissue of a State is as “material” as any other fixed place of business

PE.

Should an agreement be eventually reached - whereby the only viable option to amend the nexus needed to justify a taxable presence is relying on the notion of big data (the latter being treated as an intangible) asset owned by the entity involved with distribution activities) - , a significant by-product of such process will relate to the further development of transfer pricing rules to guarantee a proper income attribution to the digital PE compliant with the arm's length principle.

In the latter regard, one of the major outcomes of Actions 8-10 of the BEPS Final Report was the need to further clarify and enhance the application of the transactional profit split method. We believe that, in the finalization of the discussions set out by the OECD Discussion Draft on the topic released in June 2017, it will be fundamental to factor in the outcome also the work carried out by the TFDE.

In the digital economy world, we would suggest a mandatory profit split – with a rebuttable presumption for the taxpayer - in all situations where the transfer pricing policy at group level features an enterprise acting as Principal, resident in a jurisdiction other than that where (big)data mining takes place and which is the legal owner of a valuable intangible asset (e.g. the algorithm used for processing the data on active users). Another associated enterprises carries out all the functions related with the management of big data, ranging from mining activities to marketing functions as well.

In such a scenario, a possible outcome could be identifying the allocation keys represented by either the sum of R&D and marketing expenses incurred by the associated enterprises involved in managing the intangibles and in performing data mining and data processing, respectively. In the event such information would not be available, it would be possible to consider as a proxy the obligation for the group to submit to the relevant tax administration the information/indicators on the benchmark used for valuing the group's performance (e.g. the same indicator normally used for valuing executive compensation).

Such a solution would be a practical one without contradicting the conclusions reached in Actions 8-9-10 of the BEPS Final Reports.

Lastly, another important aspect which we would recommend reasserting is the fact that it is practically impossible to define what "digital economy" means for tax purposes. As already stated in the Final Report of BEPS Action 1, every facet of the economy nowadays could potentially fall within the scope of being considered "digital". As a result, we believe more effective to focus the efforts

on listing the key elements to be considered an MNE operating in a “digitalized economy”. We would suggest the following factors in a non-exhaustive list:

- (i) Reliance on data mining activities;
- (ii) Creation of online market platforms;
- (iii) Existence of an e- commerce channel with at least 1 million customers;
- (iv) Turnover of at least 50 million euros/USD;
- (v) significant presence of intangible assets as identified from the transfer pricing documentation available at group level.

We very much hope that you find our comments useful, and we look forward to working with you on these important issues over the next months.

For clarification of any aspect of our responses presented above please contact:

Paolo Ludovici, Founding Partner

[paolo.ludovici@lptax.it](mailto:paolo.ludovici@lptax.it)

Giammarco Cottani, Partner

[giammarco.cottani@lptax.it](mailto:giammarco.cottani@lptax.it)

Milan, 13 October 2017

Via e-mail: [TFDE@oecd.org](mailto:TFDE@oecd.org)

OECD Task Force on the Digital Economy

### **Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy**

Dear Sirs,

We would like to thank you for the extensive work aimed at identifying issues raised by the digital economy and detailed options to address them. Moreover, we would like to thank you for the opportunity to submit our considerations on the Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy released on 22 September 2017. In particular, since proposing new tax policies is outside the scope of our work, with our input we will focus on questions B.1, C.1 and C.2 of the request, with the aim of providing you with our perspective on the current Italian tax practice in the context of the digital economy.

#### **1. Question B.1**

With the Final Report on Action 1 of the BEPS Action Plan ("Action 1 Final Report"),<sup>1</sup> the OECD addressed the main areas for aggressive tax planning that may arise from digital business models and discussed different options to mitigate BEPS risks in the area of direct taxation,

---

<sup>1</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2013).

Avv. Prof. Guglielmo Maisto  
Avv. Riccardo Michelutti\*  
Avv. Marco Cerrato LL.M.  
Dott. Andrea Parolini\* LL.M.  
Dott. Roberto Gianelli\*  
Dott. Marco Valdonio\*  
Dott. Aurelio Massimiano\* LL.M.  
Dott. Paola Marzetta\*  
Avv. Nicola Saccardo\* LL.M.  
Avv. Alessandro Bavila LL.M.  
Dott. Mauro Messi\*  
Dott. Ernesto Sacchi\*  
Avv. Massimiliano Lovotti  
Dott. Sara Montalbetti\*  
Dott. Andrea Annoni\*  
Dott. Luca Longobardi\*  
Avv. Roberto Zanni  
Avv. Giulia Paroni Pini  
Avv. Fausto Capello  
Dott. Mario Tenore\* LL.M.  
Avv. Michele Toccaceli  
Dott. Silvia Boiardi\*  
Dott. Giorgia Zanetti\*  
Avv. Francesco Morra  
Avv. Cesare Silvani LL.M.  
Avv. Alessandro Vannini  
Avv. Francesco Nicolosi  
Avv. Giulio Cuzzolaro  
Dott. Alberto Brazzalonga\*  
Dott. Mirko Severi\*  
Avv. Filippo Maisto  
Dott. Andrea Rottoli\*  
Dott. Arno Crazzolara\*  
Dott. Irene Sarzi Sartori\*  
Avv. Noemi Maria Bagnoli  
Avv. Biagio Izzo  
Dott. Gabriele Colombaioni\*  
Avv. Eleonora Finizio  
Dott. Matteo Cataldi\*  
Dott. Paolo Valacca  
Dott. Michele Vannucci  
Dott. Francesco Ricci  
Dott. Francesco Nino Vetrone  
Dott. Alice Bonini  
Dott. Francesco Giovanni Angelini  
  
*Of Counsel*  
Dott. Gabriella Cappelleri  
Prof. Paolo Arginelli  
Avv. Maria Cristiana Felisi

\* *Dottore Commercialista*

namely (i) a new nexus in the form of a significant economic presence, (ii) a withholding tax on certain types of digital transactions, and (iii) an equalisation levy. However, in such document the OECD did not recommend any of those options, leaving States with the decision to implement domestic actions for taxing digital businesses.<sup>2</sup> Such approach might clearly reduce international coordination and consistency and may affect legal certainty for the global (digital) players, which is among the major issues that one can experience with the current international taxation framework.

Against this background, Italy has repeatedly tried – without a concrete success – to legislatively address the tax issues raised by the digital economy.

Between 2013 and 2014, a “web VAT tax”<sup>3</sup> was introduced (and then repealed) which required Italian companies to purchase online advertising services<sup>4</sup> exclusively from suppliers registered in Italy for VAT purposes. This measure, which could have been regarded as contrary to the EU VAT Directive, was purported at monitoring the magnitude of advertising services provided in Italy by non-resident companies.

In 2015, a law proposal was issued<sup>5</sup> aimed at introducing a “virtual permanent establishment” provision, under which non-resident e-commerce providers are deemed to have a permanent establishment (“PE”) if they carry out their business in Italy on a continuous basis through

---

<sup>2</sup> Id., pp. 111-117.

<sup>3</sup> Article 1(33) of Law No. 147/2013, subsequently repealed by article 2(1)(a) of Law Decree No. 16 of 6 March 2014. Law No. 147/2013 also introduced a new transfer pricing provision according to which companies engaged in online advertising and in the provision of related ancillary services have to determine the income derived from intercompany transactions using profit indicators other than the cost-plus method, unless those companies enter into an advance pricing agreement with the Italian tax authorities (Article 1, paragraph 177 of Law No. 147/2013). Differently from the web VAT tax, this provision was not subsequently repealed and is therefore currently still applicable.

<sup>4</sup> Such as online advertising spaces or sponsored links appearing in the results pages of search engines.

<sup>5</sup> See Camera dei Deputati, Law proposal No. 3076 of 27 April 2015.

online activities.<sup>6</sup> Where a virtual PE is deemed to exist, a withholding tax (“WHT”) should be applied to any digital transaction incurred between non-resident e-commerce providers and Italian customers.<sup>7</sup>

A second law proposal<sup>8</sup> was issued in 2016, with a view to introduce a “digital PE” notion for corporate tax purposes. Under the proposal, non-resident enterprises are deemed to have a PE in Italy whenever they carry on their business in Italy on a continuous basis through qualified “dematerialized” digital activities.<sup>9</sup> Where the digital PE is deemed to exist, the Italian tax authorities (“ITA”) shall request the foreign enterprise to regularize its tax position.<sup>10 11</sup>

If either of such pending proposals were approved, it is maintained that their practical effects would be limited, as taxation in Italy would generally be prohibited by the tax treaties in force with the residence State of the foreign enterprises. Those unilateral measures would, at the same time, increase the level of uncertainty and complexity of the Italian tax system. The two combined effects support the view that the introduction of such unilateral measures should be avoided.

Another trend we have noted in the last few years is the new audit practice of the ITA, which has focused on non-resident digital enterprises by applying with hindsight the conclusions reached by the OECD in the Final Report on Action 7 of the BEPS Action Plan (“Action 7 Final Report”),<sup>12</sup>

---

<sup>6</sup> Continuing online activities are deemed to exist if the period of online activity of the non-resident e-commerce providers is not less than 6 months and if the income generated in the same period is at least EUR 5 million.

<sup>7</sup> In particular, a 30% WHT on business-to-consumer transactions and a 25% WHT on business-to-business transactions. In both cases, the financial institutions processing the payments would have to directly apply the WHT.

<sup>8</sup> See Senato della Repubblica, Law proposal No. 2526 of 14 September 2016.

<sup>9</sup> In particular, the foreign enterprise, during a semester, should (i) conclude more than 500 digital transactions and (ii) those transactions should generate income flows for an amount not lower than EUR 1 million.

<sup>10</sup> If the foreign digital enterprise does not regularize its tax position within 30 days, the ITA requests the financial institutions processing the payments on the e-transactions to apply a 26% WHT.

<sup>11</sup> It is worth mentioning that the 2016 Stability Act introduced a mechanism similar to the diverted profit tax in respect of taxable persons operating in the gambling and digital betting industries.

<sup>12</sup> OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015).

for instance with regard to auxiliary and preparatory activities. This new practice creates significant uncertainties, as regards the existence of a PE in Italy. In this context, foreign digital enterprises have been repeatedly labelled as “tax evaders” by the media, a fact that could provoke reputational damages to such enterprises. In addition, the assessment by the ITA of the existence of a PE in Italy often triggers criminal procedures against the directors of the foreign enterprises for not having declared the PE existence. Both the risk of a reputational damage and the uncertainty connected with the outcome of the criminal procedure have induced some non-resident digital enterprises to opt for quick settlements with the ITA in order to minimize those issues.

In order to avoid these drawbacks, the government has recently passed a law decree aimed at providing legal certainty on the application of the current tax rules on PEs.<sup>13</sup> As a result, large multinationals (“MNE”), not necessarily operating in the digital business, may now enter into a consultation procedure with the ITA aimed at establishing whether their past activities created a PE in Italy. If this is the case, taxpayers may pay the relevant taxes under a regularisation procedure, which also prevents the criminal authorities from punishing the failure to file the tax returns.

## **2. Question C.1**

### *2.1 BEPS Action 3*

BEPS Action 3 was aimed at strengthening domestic CFC rules in order to make them more effective in counteracting BEPS.<sup>14</sup>

In this respect, we believe that a large part of currently untaxed digital MNE profits would bear their fair amount of taxes if the home countries of those MNEs applied stricter CFC rules.

Although this would not solve the issue of the proper allocation of taxing rights between the different countries where MNEs operate, particularly

---

<sup>13</sup> Article 1-bis of Law Decree No. 50 of 24 April 2017.

<sup>14</sup> OECD, *Designing Effective Controlled Foreign Company Rules, Action 3: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015).

the market countries, which would require a revision of the current nexus rules, it would at least avoid MNEs structuring their business in order to reduce taxation in their home States.

## 2.2 BEPS Action 7

With Action 7 Final Report<sup>15</sup> the OECD proposed to expand the PE definition included in Article 5 of the OECD Model Convention<sup>16</sup> (“OECD MTC”), with a view of tackling more effectively BEPS. Some of the proposed changes can also prove relevant with reference to the tax challenges raised by the digital economy.

- a) *Artificial avoidance of PE status through commissionaire arrangement and similar strategies*: The new concept of the “principal role leading to the conclusion of contracts” may also be used to counteract certain structures adopted by companies operating in the digital business, where the local presence of employees in the source Country is relevant for the solicitation of potential customers. Indeed, the example included in para. 32.6 of Action 7 Final Report describes a situation where the employees of SCO – a company resident of State S – send emails, make telephone calls to, or visit, large organizations in order to convince them to buy the advertising services supplied by RCO, a company resident in State R. In the above situation, State S’ Tax Authorities may challenge the existence of an agency-PE of RCO in State S;
  
- b) *Artificial avoidance of PE status through the specific activity exemptions*: The proposed amendments may also be relevant for digital enterprises. For example, with reference to e-commerce players, the proximity to the customers and the need for a quick delivery are important success factors, so that the maintenance of a local warehouse might be regarded as a core activity for those enterprises (see para. 22 of Action 7 Final Report);

---

<sup>15</sup> OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015).

<sup>16</sup> OECD, *Model Tax Convention on Income and on Capital* (2014).

- c) *Fragmentation of activities between closely related parties*: By addressing this issue, proposed Article 5(4.1) OECD MTC is also relevant for digital enterprises, in case they spread their value chains across several business entities.

Some jurisdictions, such as Italy, have already interpreted some of the current provisions of the OECD MTC in line with the changes proposed by the OECD in Action 7 Final Report. With reference to the above let. a), already in the 2002 Philip Morris case<sup>17</sup> the Italian Supreme Court stated, inter alia, that the participation of representatives or employees of a domestic entity to the negotiation of contracts between a foreign company and another resident entity might fall within the concept of “authority to conclude contracts in the name of the company”, even where no power of representation is granted. As from that moment, Italian case law and practice followed the Philip Morris case as a leading precedent. Accordingly, Italy registered an observation in the 2005 OECD Commentary on Article 5 (para. 45.10), regarding the participation to contract negotiations, according to which “*Italy wishes to clarify that, with respect to paragraphs 33, 41, 41.1 and 42, its jurisprudence is not to be ignored in the interpretation of cases falling in the above paragraphs*”.

Similar considerations apply to the above let. c) (“*Fragmentation of activities between closely related parties*”). For instance, in 2011 the Italian Supreme Court affirmed that it is of no relevance whether activities are carried out in Italy via several distinct entities, rather than by a single entity, for the purpose of ascertaining whether non-resident parent companies have a PE in Italy. What is relevant is the fact that the entities carrying on their business activities in Italy, though formally distinct, are economically and substantially integrated into a unitary structure, the aim of which is to achieve the business purpose of the non-resident parent company in Italy.<sup>18</sup>

---

<sup>17</sup> Italian Supreme Court judgments Nos. 3367, 3368 and 3369 of 7 March 2002 and Nos. 7682 and 7689 of 25 May 2002.

<sup>18</sup> Italian Supreme Court judgment No. 20597 of 7 October 2011. The Supreme Court affirmed that “*the productive organization in Italy of the foreign company - rather than be composed of a single legal entity - was divided into a multitude of companies: formally*

That said, the amendments to the OECD MTC proposed in the Action 7 Final Report 7, while extremely relevant for “traditional” businesses (also known as “brick-and-mortar” businesses), could prove less effective in tackling the tax challenges raised by pure digital enterprises in terms of taxable presence in a country, as BEPS Action 7 targets structures with – at least – a minimum physical presence in the source country. This approach reflects the traditional distinction between an enterprise that participates in the economic life of a country and one that merely interacts with the economic life of a country.<sup>19</sup>

The measures developed within BEPS Action 7 may certainly be used to challenge, for instance, traditional e-commerce business models, in which (i) sales of physical goods are carried out through internet platforms, (ii) the seller is a non-resident company, and (iii) marketing, sales, clients’ support and warehouse functions are often carried out in the customers’ country. However, such measures would have a limited effect when dealing with MNEs operating through fully dematerialized structures, as also noted by the OECD,<sup>20</sup> the European Commission<sup>21</sup> and several scholars.<sup>22</sup>

---

*distinct but economically integrated into a unitary structure, aimed at achieving the commercial purpose in Italy of the foreign parent company”.*

<sup>19</sup> This goes back to the work of the Technical Experts group of the League of Nations in 1927-1928 and the policy at that time advocated by T.S. Adams, the US representative. As explained by Adams’ assistant, Mitchell Carroll, the US delegation was concerned with protecting the interests of US businesses operating abroad, at a time when the United States was a major net exporter of goods. In response, Adams successfully advocated the PE threshold, which prevented taxation unless the business was conducted through a branch, factory, agency, warehouse, office, or depot (*See Graetz/O’Hear, The “Original Intent” of U.S. International Taxation, Faculty Scholarship Series (1997), Paper 1620*).

<sup>20</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report*, pp. 51-75.

<sup>21</sup> European Commission, *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.

<sup>22</sup> See, inter alia, Brauner/Pistone, *Adapting Current International Taxation to New Business Models: Two Proposals for the European Union*, 71 *Bulletin for International Taxation* 12 (2017); Olbert/Spengel, *International Taxation in the Digital Economy: Challenge Accepted?*, 9 *World Tax Journal* 1, pp. 3-46 (2017); Schreiber/Fell, *International Profit Allocation, Intangibles and Sales-Based Transactional Profit Split*, 9 *World Tax Journal* 1, pp. 1-17 (2017); Hongler/Pistone, *IBFD Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy - Working paper 20 January 2015* (IBFD 2015); Baez/Brauner, *IBFD Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy* (IBFD 2015).

In order to supersede such difficulties, new nexus rules could be introduced specifically for the digital economy, based for example on the notion of “significant economic presence” (see BEPS Action 1). Under such rules, the taxable presence in a country of non-resident digital companies (“Digital PE”) would be triggered by unconventional factors, such as the revenues remotely earned from customers situated in a country, the presence of a local digital platform, the frequency of digital transactions, and the number of users.

Finally, it would be advisable that any measure agreed at the OECD level be, in any event, coordinated with the expected EU developments, as announced in the press release of the European Commission of 21 September 2017.

### 2.3 BEPS Actions 8-10

Even if the rules for establishing a taxable presence were modified as outlined in Action 1 Final Report, criteria used to attribute profits within multinational groups would need to be adapted, in order to properly address the tax challenges raised by digital economy. Indeed, the amendments to the OECD Transfer Pricing Guidelines (“TPG”) brought about by Actions 8-10, while useful to clarify certain aspects of the arm’s length principle<sup>23</sup> and of transactions involving intangibles<sup>24</sup> – which may be relevant also in the context of the digital economy – still rely on rules mainly developed for traditional business models.

This is particularly true with reference to the rules governing the attribution of profits to PEs under Article 7 of the OECD MTC.<sup>25</sup> A Digital PE would be characterized by little or no physical presence in terms of personnel and/or tangible assets, generating income through fully

---

<sup>23</sup> OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015) pp. 13-50.

<sup>24</sup> *Id.*, pp. 63-139.

<sup>25</sup> See Article 7 and related Commentary in OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2014* (OECD 2014).

dematerialized activities.<sup>26</sup> This clearly might jeopardize an orthodox application of the Authorised OECD Approach (“AOA”),<sup>27</sup> which relies on the (physical) allocation of significant functions, assets and risks to the PE. In this respect, it would be necessary either (i) to establish a new profits allocation rule, which should not rely on the physical performance of the significant functions in the PE State, or (ii) to introduce a deeming provision, which would deem certain functions – strictly connected with the economic presence factors used to set the Digital PE threshold – to be performed at the Digital PE, which would attract the related assets and risks.

For these reasons, we share the position of the European Commission<sup>28</sup> and a number of authors<sup>29</sup> that adjustments to existing transfer pricing rules are needed in order to properly apply the arm’s length principle within digital business models. Hereafter, we focus on the aspects that, in our opinion, are of particular importance.

First, the TPG should examine the technological features of the digital economy that must be taken into account when performing a transfer pricing analysis. This should include a detailed description of those “new” functions, assets and risks deemed to play a significant role in the value creation process of digitalized enterprises.<sup>30</sup> As observed by scholars,<sup>31</sup> such new value-drivers could comprise, for example, functions associated to content creation, data collection and customer support. With reference to the intangible assets to be considered within a functional analysis, the TPG should also clarify whether, and under which circumstances, the

---

<sup>26</sup> OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1: 2015 Final Report*, p. 111.

<sup>27</sup> OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD 2010).

<sup>28</sup> European Commission, *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, p. 9.

<sup>29</sup> See, inter alia, Olbert/Spengel, *supra* n. 22 and Hongler/Pistone, *supra* n. 22, at p. 34.

<sup>30</sup> As observed by the TPG, value creation is a fundamental aspect of the functional analysis. In particular, according to the TPG (OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), para. 1.51), “it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the contribution that the associated enterprises make to that value creation”.

<sup>31</sup> See Olbert/Spengel, *supra* n. 22.

market jurisdiction – including consumer-related data – may autonomously represent a value driver that has to be remunerated in the hands of the local enterprise. Since technological developments affect to a certain degree almost all businesses, when identifying these new value-creating drivers the TPG should ensure equality at an international and cross-sector level. Thus, on the one hand, it should fit with pure digital business models and, on the other hand, it should also apply to non-pure digital enterprises, regardless their level of digitalization.

Second, if future works converge on the need to assess, for transfer pricing purposes, the value created by the market jurisdiction in digital businesses, a clear guidance should also be provided on whether and how to apply such principle to traditional business models. This argument is particularly significant considering that some countries – e.g. Brazil, Russia, India, China and South Africa (“BRICS”) – in the last years have consistently argued that, also with reference to traditional business models, the market jurisdiction should have the right to tax at least part of the income of the profits of a MNE based on the consideration that the demand side creates value.

Third, the new guidance should guarantee the same treatment to both enterprises operating in a country with local subsidiaries and companies operating with local PEs (both traditional and Digital PEs). Under this perspective, an update of the AOA would be strongly recommended in order to clarify how the new value-drivers identified for transfer pricing purposes should be taken into account when attributing profits to PEs.<sup>32</sup>

Finally, any shaping of the income tax regime applicable to the digital economy should be construed so as to avoid additional and excessively burdensome compliance requirements and also to avoid changes in the corporate structure, which would not be otherwise required in order to

---

<sup>32</sup> Indeed, as indicated in the OECD 2010 Report on the Attribution of Profits to Permanent Establishments (paras. 54 and 55), “[o]ne issue in applying this approach is that for the purposes of Article 7, it is necessary to postulate the PE as a hypothetical enterprise that is separate from the enterprise of which it is a PE, whereas in an Article 9 case the enterprises being examined are actually legally separate. To reflect this issue, the authorised OECD approach is to apply the guidance given in the Guidelines not directly but by analogy”.

conduct the business operations in the source State. These issues come to light if one considers the possible expansion of the PE definition which would require MNEs to comply with separate burdensome additional reporting and other compliance requirements and formalities, which would go beyond taxation and include company law and accounting (e.g. creation of a branch, appointment of a legal representative of the branch, etc.). These additional compliance requirements would also trigger a proliferation of the audit activities to be conducted by the Tax Authorities and decrease the level of tax transparency, as a consequence of the fragmentation of the tax compliance procedures among different legal entities (local subsidiaries and foreign companies having PEs in the same country).

A possible solution to avoid these issues would be to shape the taxation of the digital economy through a revision of the TP rules that, as far as possible, allowed an increase in the taxing rights of the market States specifically for digitalised operators, without requiring an expansion of the PE concept.<sup>33</sup>

Should the shaping of the taxation of the digital economy include also the expansion of the PE concept, the new rules should provide for an election for MNEs to either (i) have the local subsidiaries to comply with the tax obligations of the PEs situated in their territories and so to determine the PE taxable income and make the connected tax payments without requiring the non-resident company to meet separate tax formalities, or (ii) attribute to the local subsidiaries the taxable income connected to the PEs, provided that the activities of the PEs and those of the local subsidiaries

---

<sup>33</sup> This path seems to have been already undertaken by the TPG. For instance, the new definition of marketing intangible includes “*customer data that is used or aids in marketing and selling goods or services to customers*”. This amendment to the definition of marketing intangibles can be read in conjunction with the “*BEPS Discussion Draft on the use of profit splits in the context of global value chains*” published in 2014, where the OECD called for comments on the application of the profit split method in a case involving a multisided and integrated digital economy business model. In an example included in the discussion draft, the OECD seems to qualify as value-adding functions the activities carried out by the local subsidiary consisting in the collection and processing of data, the provision of suggestions on the development of the relevant algorithms and technologies, and their adaptation to local market features. This approach suggests that these functions performed by the local subsidiary should not be regarded as mere routine functions.

constitute complementary functions that are part of a cohesive business operation. Such a possibility should extend to the PEs income resulting from tax audits. This solution would reduce the administrative complexities connected to the attribution of profits to PEs, preserving, at the same time, the taxing rights of the source States. In addition, it would enhance consistency with the new OECD approach to the fragmentation of business activities between closely related parties. Indeed, as new Article 5(4.1) of the 2017 OECD Draft MTC entails that the presence of a local subsidiary, whose activities are complementary to those carried out in the territory of the State by non-resident companies of the same MNE, makes the latter activities lose their intrinsic character of auxiliary activities (if taken in isolation), it appears reasonable that the taxation of the income stemming from the latter activities may accrue and be levied at the level of the local subsidiary. The shifting of tax compliance on a different taxpayer would be, under a certain perspective, conceptually similar to the reverse charge mechanism which has been experienced in the VAT context, whereby tax obligations by non-resident taxpayers are shifted to their counterparts in the source State.

A last comment regards the way in which some States currently apply the TPG to intercompany arrangements concerning the development of intangibles to be used in the digital business. It is our opinion that a stricter application of the existing TP principles,<sup>34</sup> especially in the case of cost contribution arrangements for financing key research and development activities, would ensure most MNE profits not to escape taxation, as they would be taxed in the countries where valuable intangibles are developed and to which those profits actually belong, rather than being diverted to untaxed (or low taxed) holding companies.

### **3. Question C.2**

The OECD document requests for input on work regarding the tax challenges of the digitalized economy considering experience from the

---

<sup>34</sup> In particular, we refer to the work done within the framework of the BEPS package on the Revisions to Chapter VIII of the Transfer Pricing Guidelines on CCA and on the hard-to-value intangibles.

implementation of collection models (e.g. compliance, impact on business operations) and some examples of best practice. This document highlights that a growing number of countries have implemented the new guidelines and mechanism relating to VAT/ GST (“Guidelines”) to level the playing field between domestic and foreign suppliers of intangibles and services. Work addressing the tax challenges of the digitalized economy should explore the practical impact of developments and provide for clear guidance with reference to following matters.

### *3.1 VAT taxable person vs private person*

The work done within the framework of the BEPS package and Guidelines argues that jurisdictions may consider adopting a requirement for suppliers to provide customers VAT registration numbers, business tax identification numbers, or other such indicia (e.g. information available in commercial registers) to establish their customers’ status.

That said, the digitalized economy raises sensitive questions regarding the VAT status of the players in the market. In particular, in many jurisdictions, and in particular under harmonized VAT EU legislation, a person is considered a VAT taxable person when it exploits tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis. This principle applies irrespectively from the turnover generated by the relevant person and this raises several challenges in a variety of sectors of the digital economy (such as sharing economy, collaborative production, personal data collection, app stores and the like). In fact, application of current rules could give origin to an incredibly high number of VAT taxable persons with a low turnover.

In this context, VAT systems should be adapted to develop more substantive criteria to identify taxable persons, such as providing with the introduction of generally accepted thresholds to exclude small players from the scope of application of VAT. This would also be beneficial for Tax Authorities since they will avoid issues of characterization of taxable persons and, in particular, all the problems connected to the need to control, assess and collect VAT in the hands of an extremely high number of small taxpayers.

### 3.2 *Permanent establishment*

The work done with respect to PE status in the framework of the BEPS package was aimed to ensure that taxes are collected where essential business activities of an enterprise are carried on and preventing the artificial avoidance of PE status.

Such analysis has a lower impact in the VAT/GST field since consumption taxes are normally designed in accordance with the destination principle, that ensures that final collection of tax occurs in the place where consumption takes place, that normally coincides in the market where goods or services are supplied.

In short, the assessment of a PE could also not amount to a loss of the tax revenue of a given State since VAT has been already collected at the last stage of the distribution chain: this would still be true in all cases in which the PE is deemed to be the recipient of the services (unless that PE suffers a limitation of its right of deduction input VAT/GST).

In all such cases, in the digital economy a dual approach should be applied in order to make sure that no consequences arise if VAT has been applied in the country of destination. In any event, detailed guidelines concerning requirements needed to set up a PE in the digitalized economy for VAT purposes would be helpful. Specifically, these guidelines should take into account the impact of business developments connected to digitalized economy such as automation processes and mobile warehouses.

### 3.3 *High volume of low-value imports of physical goods*

The digital economy creates challenges for VAT systems, particularly where goods, services and intangibles are acquired by private consumers from suppliers abroad. Specifically, e-commerce and online purchases of physical goods made from suppliers in another jurisdiction imply high volumes of low-value transactions with significant administrative burden and marginal revenues for Tax Administrations.

That said, the EU allowed Member States to “exempt” imports of goods of a negligible value. However, the significant and rapid growth in the

volume of low-value imports of physical goods on which VAT is not collected decreased VAT revenues and generated growing unfair competitive pressures on domestic retailers.

While we would agree in general with collection models suggested in the framework of the BEPS package and Guidelines, in our opinion, the impact of different models in order to increase benefits of harmonization should be more deeply explored.

Such an approach should also consider some model as an example of best practice. To this extent, it is our opinion that EU developments should be taken into account. Indeed, these are focused on the positive experience of VAT One Stop Shop and move forward through the registration of sellers from outside the EU giving them the chance to designate an EU intermediary (such as a market place, courier, postal operator or customs agent) to deal with VAT-related compliance.

\*\*\*

Please feel free to contact us at [TP@maisto.it](mailto:TP@maisto.it) with any questions or comments concerning this letter.

Sincerely yours,

Maisto e Associati  


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

## MEDEFs comments

Thank you for the opportunity of submitting input on digital economy taxation, which is probably one of the most challenging issues in the tax area.

While we acknowledge the difficulty of finding a solution quickly, we welcome the reflexions and work undertaken on this issue.

At this stage, we believe the notion of extended PE as recently defined by OECD and the other BEPS actions could be a valuable baseline to avoid the non-taxation of digital business without departing from the international agreed tax principles (residence vs source, arm's length principle, treaty) even though some adaptation may be needed (especially to attribute risks and profits to this PE). However, to ensure a secure environment for business further consultation and impact assessments are needed.

We will only provide general comments in relation to question D which focuses on the options to address taxation issues. A wide range of proposals has been made so far, via different channels, whether they be national, European or international. Before going into further detail we would like to focus on the principles that should, according to French business, underpin any reflexion on this issue.

- The digitalization of the economy impacts almost all sectors in different ways (online retail model, social media model, subscription model, collaborative platform model ...). Therefore the digital economy should not be treated as a separate sector, as sector-based taxation would neither be appropriate (difficulty to delineate a specific scope which might create competitiveness issues) nor feasible (different business model behind digital solutions leading to different value chain and therefore taxation). It would entail a delineation between traditional and digital business which is very artificial and difficult without discrimination since traditional business are also proposing digital solutions to keep their customers (ex : on-line subscription, on-line data) and digital business enters the chain of traditional business to improve their performance (ex : block chain). Thus, digital economy should as much as possible be analysed with traditional concepts (i.e. software, distribution channel, advertising ...) and not depart from internationally agreed principles. Moreover, the rapid evolution of business is such that a ring-fenced option will be outdated in a short future.
- Any tax on digital economy shall be covered by tax treaties (contrarily to equalisation taxes or diverted profit taxes).
- Consumption taxes shall be clearly differentiated from corporate taxes. The former aims at taxing the market (source taxation) and are levied on flows, while the latter aims at taxing the provider (offer) and is levied on its net income. Using a "consumption like" tax for taxing a corporate income is not appropriate since it is not aligned with the economic reality.

- Any unilateral action should be firmly rejected to ensure businesses are not facing different regimes of taxation according to the country they are working with leading to double taxation and heavy administrative costs.

It is very difficult to opt for a specific approach at this stage, since the options are not clearly outlined and the impact on business difficult to assess. However, it is already possible to underline questions that may arise.

## 1. Taxation on turnover

We are concerned that corporate taxes which are computed on a gross aggregate of the P&L (revenues, gross margin) convert into fixed charges for the business. They become fixed in the sense that they are automatically levied whether a company is profitable or not. That hinders growth and discourages groups from investing in new and innovative products/services.

Furthermore turnover is a notion that covers various realities according to accounting principles and its geographical allocation is not straight forward (ex: a subscription could be paid for individuals located in different jurisdictions; a sale could be performed by one company and the after sale service by another).

Moreover taxing turnover leads to cascading taxation : the same base will be taxed at different levels or through different entities of the same or different groups. VAT was created to avoid this unfavourable effect, creating a tax on turnover would represent a step backwards in the capacity of the economists/politicians to design performant taxes.

## 2. Significant digital presence (SDP)

We refer to the description included in the first draft of the OECD report on action 1. SDP was identified according to the number of contracts and/ or the amount of payments made online. If this definition were to be maintained, we are concerned by the term “significant”. The lack of a strict definition leaves the door open to arbitrary and subjective interpretations. As an example, should “a significant number of contracts” be understood as the majority of them (in number or in amount?) or according to a specific threshold?

It may be also difficult to determine the taxable base for the new nexus which would be mainly determined according to customers’ location. It would be necessary to have an agreement amongst countries to reach a clear and objective definition that could be used in tax treaties to avoid double taxation. Indeed, even if there were an agreement on the SDP concept it does not give a clear indication on what the taxable base should be.

We are concerned that this proposal will create a precedent and a new standard of corporate taxation by giving the consumers’ country the right to levy corporate tax, on top of consumption taxes specifically designed to finance the public spending of the source countries. In this respect, it would constitute a tremendous shift from current principles governing the OECD Tax Model Convention and existing tax treaties : source States are likely to claim heavier taxation of corporate profits for the mere reason that they have a market allowing foreign businesses to offer products/services, regardless of their local presence.

This phenomenon may have an impact not only on digital businesses but also on conventional ones since it is today already a trend of some countries to consider the market as an intangible

asset to value (in contradiction with the OECD guidelines) in the value chain. In this regard, “small” countries like France or any state within the EU would be disadvantaged compared to those which are more densely populated. Moreover, such taxation could be a deterrent to enter such wide markets and hinder international trade and growth.

From a transfer pricing standpoint, the new standard would give priority to the place of delivery rather than the usual standards of functions, risks and assets set out in the OECD Transfer Pricing principles.

### 3. Virtual PE

Since this option is not clearly outlined, we refer to the description included in the first draft of the OECD report on action 1, where it was defined in 3 specific situations. Such virtual PEs would probably result in new PEs being recognised, including for conventional businesses.

The concerns drafted for the SDP are also applicable for a virtual PE.

We believe that the modifications made notably through BEPS Action 7 (extension of the PE definition) and through BEPS Action 6 (avoidance of treaty abuse) should allow source countries to tax business through a PE -under the condition they apply the new definition which is not mandatory.

### 4. Withholding tax

Since this option is not clearly outlined, we refer to the description included in the first draft of the OECD report on action 1 where it suggests a withholding tax on certain payments made by residents of a country for digital goods or services provided by foreign e-commerce providers.

It raises several concerns:

- From a theoretical standpoint, the option is based on the recognition that the source State should be allocated a portion of the profit derived from consumption of goods or services by its residents (i.e. based on the place of location of the customers). As explained, we believe that withholding tax is not appropriate to levy corporate taxation (different from a consumer tax).
- From a practical standpoint, it may prove extremely difficult to tax such digital transactions, since the customer, the bank which realises the payment, the server where the transaction is realised and registered, and the provider may all be located in different jurisdictions.

As they are drafted, we believe these options might lead to a different result than the one expected :

- Risk of extra taxation for SMEs or start-ups unless a threshold is defined
- Risk of double taxation (even though the new tax were creditable against the CIT)
- Risk of inapplicability of double tax treaties (especially if the tax is not covered by tax treaties)
- No targeting of the companies concerned

# NATIONAL FOREIGN TRADE COUNCIL, INC.

1625 K STREET, NW, WASHINGTON, DC 20006-1604

TEL: (202) 887-0278



FAX: (202) 452-8160

Task Force on the Digital Economy  
Organisation for Economic Cooperation and Development  
OECD Centre for Tax Policy and Administration  
2, Rue André Pascal  
75775 Paris, France

Via email: [TFDE.oecd.org](mailto:TFDE.oecd.org)

October 13, 2017

Re: Comments on the Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy (2017)

Dear Members of the Task Force on the Digital Economy:

The National Foreign Trade Council (the “NFTC”) is pleased to provide written comments on the Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy (“TFDE Input Draft”).

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC’s Board of Directors is attached as an Appendix.

This letter provides comments on certain questions raised in the TFDE Input Draft. The NFTC strongly agrees with the statement issued as part of the final BEPS report on Action 1 that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes. As part of the final BEPS report, several proposals were made to mitigate some of the concerns about BEPS in the digital economy, e.g. changes in the definition of PE and revised transfer pricing guidelines. The MLI was signed only recently, so many of these proposals have not yet entered into force in many jurisdictions so no data is yet available to evaluate their impact on resolving digital economy concerns. According to the final BEPS Report on Action 1:

1” *It is expected that the implementation of these measures, as well as the other measures developed in the BEPS*

---

1 OECD, Action 1. Addressing the Tax Challenges of the Digital Economy, p. 6

*Advancing Global Commerce for Over 90 Years*

[www.nftc.org](http://www.nftc.org)

*Project (e.g. minimum standard to address treaty shopping arrangements, best practices in the design of domestic rules on interest and other deductible financial payments, application to IP regimes of a substantial activity requirement with a “nexus approach”), will substantially address the BEPS issues exacerbated by the digital economy at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so-called stateless income”*

The OECD has requested comments on specific topics, the NFTC comments on those issues are below.

## **A. Digitalisation, Business Models and Value Creation**

The distinction, if any, between a digital business and a digitized traditional business will become less relevant as digitization and the use of new business models rapidly accelerate. It was difficult to foresee, even ten years ago, the rapid explosion in the digitalization of business, and any tax policy changes must assume that the technological changes we will see in the future will accelerate. All businesses will continue to make investments in people, capital expenditures, and R&D and make goods and services production decisions based on the factors crucial to their business and how they can perform their functions most efficiently and at the lowest cost. When a business digitizes it does not change its inherent nature or the location of where it creates value. Every business relies on the personal skills of the employees, and the capital investment needed to maintain and grow the business. The risk profile does not change because a business becomes digitized, nor does it change the need for investments in property, plant, equipment, and employees who run the business.

There is a concern that digitalization has created new opportunities for remote selling to customers. This is not limited to the digital economy. For example, in the digitization of business, a standard catalog sales business still does business by sending out catalogs and then taking customer orders either over the phone, or over the company’s website via the Internet. The sale is conducted the same, regardless of the platform over which the sale was received. The goods are shipped, and if the company has a physical presence in the sales jurisdiction, it is subject to income tax. Sales tax or VAT is also collected and remitted on sales, with or without a physical presence. If a company does all of its business and sales digitally, should income tax be imposed differently than for a traditional sales model?

Both companies are likely to collect customer data. Both types of companies then analyze and manipulate the data in a manner that allows them to target those customers for advertising of items keyed to the customers’ preferences. Although the data can be collected much more easily by using digital technology, the data collected is not fundamentally different from customer feedback or surveys used by traditional companies. Where users are supplying their data to a digital company in return for a free service, (which is paid for through advertising), data collection is accomplished by traditional companies through market research, and they also target their advertising specifically to their customer base. Both traditional and digital companies pay income taxes under the current international tax rules, based on where the value of their company is created by development and production activities rather than where the products are consumed. A tax system specifically designed to target “digital” companies will inhibit cross-border growth and investment, foster uncertainty and increase double taxation.

Digitalization has given traditional businesses much more freedom in where they locate their assets, functions and risks. This leads to more efficient business outcomes. More traditional companies are also better able to communicate with their customers which has empowered new sales channels, supply chains and pricing structures. Companies create value by developing and producing their products and services and marketing to customers. With the advent of the internet of things in which virtually every product (including automobiles, airplanes, boats, home appliances, engines, wind-turbines and even clothing) will have internet-connected sensors that communicate with each other and their producers in the age of artificial intelligence and big data, the digital economy will become the entire economy. To remain competitive, companies must digitize, and whether they are digital or digitized companies they will rely on IP to integrate their businesses. Software is a critical infrastructure element, and a key value driver relative to physical products and hardware. Businesses invest billions of dollars in R&D, investment in data centers, property, plant, equipment, and high paying wages to create value in the digital world.

A company creates value by developing IP and producing its products and services. A sale to a customer is an exchange of something for value for consideration, it doesn't create the value. The recent OECD/G20 BEPS effort re-affirmed that value is created in the location where functions are performed, assets are deployed, and risks are assumed. If the OECD/G20 decides to radically alter longstanding tax norms by adopting the novel principle that value is created by a customer base, then that rule should apply to all businesses and cannot be limited to the digital economy. All businesses have customer bases, and a distinction cannot be drawn between the base for a traditional digitized company and a digital company.

Not all businesses considered digitized or digital share the same business model. There are a wide range of diverse business models within sectors, impacted by geographic location and the scale of the business. The business models of traditional and digital companies are evolving away from what is perceived as traditional business models. Rather than developing, producing and providing products and services to customers in multiple locations, the new business model is a platform that connects customers/users in different locations. The business benefits from the customer-centric business model. There are greater benefits to businesses but also greater risks if they fail to meet customer expectations. The ability of customers to select from a broader range of international suppliers of good and services, delivered through a broader range of mechanisms has driven greater competition and more innovative and customer-centric services and delivery mechanisms. 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.

Any business now has access to powerful, constantly updated web-enabled cloud computing power for a minimal subscription fee without the need to invest in costly data centers, software, and network infrastructure. They obtain this capability from cloud services businesses making multi-billion dollar investments in R&D, capital expenditures, operating costs, and employment. This allows their customers to use the cloud functionality to be more productive and compete in global markets.

## **B. Challenges and Opportunities for Tax Systems**

We expect that there are numerous ways in which digitalization could assist taxpayers and tax authorities in tax collection, tax compliance and improved taxpayer service at lower cost. Innovations such as on-line tax accounts, risk assessment, information exchange, greater automation and e-filing, as well as greater access to data and analytical tools, could provide taxpayers and tax administrators with systems that make interaction easier. Countries that have embraced the digital economy and provide a digital infrastructure and a welcoming climate that make it easier to do business, have benefited from increased investment.

## **C. Implementation of the BEPS Package**

The final report of BEPS was issued in 2015 and additional implementation and policy work is still on-going. Recent Discussion Drafts issued on hard-to-value-intangibles, guidance on the attribution of profits to PEs, and on profit splits represent significant issues requiring additional guidance. As mentioned earlier in these comments, jurisdictions are just now changing their tax legislation to deal with the final BEPS recommendations on transfer pricing and PEs. It will be many years until the full impact of the BEPS work will be known to tax administrators. Companies have converted local marketing entities into resellers that report all local customer revenue received in the local jurisdiction to that jurisdiction. Transfer pricing is being reviewed and adjusted into line with the BEPS recommendations.

When the BEPS report on Action 1 on the digital economy was released, it was anticipated that an interim report would be issued in 2018 with a final review being done by 2020. The entire BEPS project was expected to be subject to a review in 2020. The BEPS report, along with other announced tax changes (e.g. the Irish announcement to end a preferential tax regime, the EU anti-tax avoidance directive), and business structure and transfer pricing changes are eliminating many of the arguments that additional taxes are necessary for the digital economy.

The OECD VAT guidelines on B2B and B2C provided improved guidance and procedures for the indirect taxation of cross-border services. The Guidelines provide that the place of indirect taxation for digital services is where the customer is established, or has his permanent address. For B2B supplies, the reverse charge is the most efficient means of accounting for VAT/GST due. For B2C supplies, local VAT/GST should apply. This is achieved through the registration of the non-established business in the place where the customer is deemed to be located.

As recommended in the BEPS Action 1 Report, many jurisdictions have either proposed or implemented extraterritorial VAT/GST rules to tax the import of digital services into their country. The speed and scale at which VAT/GST changes are being introduced globally has produced a wide array of challenges for businesses operating in the global marketplace.

The EU Mini One Stop Shop (MOSS) and OSS programs have led to a better coordination of information from companies and has made it easier for companies to comply with cross-border sales and for tax administrations to more easily share the relevant sales information. Outside of the EU there is a great multiplicity of legal and administrative practices established by different

countries, including different registration regimes and collection mechanisms. There continue to be problems in countries that do not follow the OECD or EU Guidelines, particularly in those countries that do not make a distinction between B2B and B2C transactions according to the status of the customer. This creates unnecessary administrative burdens and costs for businesses that only provide B2B services, and creates problems for business to fully recover the VAT/GST charged. A simple flexible and standardized tax regime would make it possible to ensure that business is conducted on a neutral basis and also ensure that the tax revenues are collected. The NFTC recommends that there be greater electronic coordination across all VAT/GST countries to facilitate an easier transmission of the relevant data to tax administrators.

Both the OECD VAT Technical Advisory Group and the Global Forum on the VAT have been good opportunities for tax administrators and taxpayers to discuss coordinated efforts on how to make the tax collection systems work better for all involved. It is vital to design and implement new rules for taxing the digital economy in partnership with business. Business generally act as the tax collectors, and their knowledge of the systems and processes is key to the delivery of an efficient and cost effective tax regime.

## **D. Options to Address the Broader Direct Tax Policy Challenges**

As we mentioned previously, the BEPS report on Action 1 stated that it is not possible to ring-fence the digital economy, yet the options listed appear to do just that. These options are all special measures targeting the digital economy. They all would impose additional and special taxes on normal business profits. They cannot be reconciled with the BEPS view of value creation, the definition of a country's tax base, and the division of rights between countries of development/production and countries of consumption. Any consideration of these additional special measures should be based on a transparent discussion of whether the tax base should be shifted towards the country of consumption.

During the BEPS discussions it was decided that the taxation rights of residence v. source countries would not be part of the BEPS work. The OECD decided that the arms-length standard should be maintained, and the OECD Transfer Pricing Guidelines clearly follow this standard. Yet, arguments by those in favor of moving toward formulary apportionment and away from the arms-length standard are clear in their call for identifying the country-of-sale as one factor to be weighed in the formulary calculation for allocating profits and taxing rights. If this policy is considered appropriate for the taxation of the digital economy, and the digital economy is the economy, then this debate is a fundamental change to the international tax system for all business. Is the OECD endorsing the shift to formulary apportionment in the digital economy context? It is impossible to maintain the arms-length standard for certain industries, companies and transactions, while having a different policy toward a selected group of companies. Hopefully, the OECD is not endorsing a seismic shift away from the longstanding arms-length standard.

If any change is to be endorsed, it should be done in a transparent manner within the tax treaty framework with countries agreeing to relinquish taxing rights to prevent double taxation. Tax treaties are negotiated by countries in good faith and they define the parameters of business profits and transfer pricing. The OECD has never endorsed tax changes that would override tax

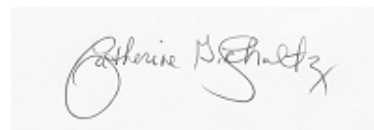
treaties.

If the OECD decides to recommend special measures for the digital economy, it will quickly have an impact on a much broader tax framework. Does the OECD expect to change how consumption is treated for income tax purposes? If so, then the other pending OECD work including on the attribution of profits to PEs will be significantly affected. The introduction of the concept of a “significant economic presence” threshold would untether the PE concept from physical presence. It would be a significant departure from existing rules and would also be incoherent with the existing profit attribution rules which are based in significant part upon the significant people functions located in a country. Any changes to the nexus threshold required to trigger the existence of a PE would need to be accompanied by a change to tax treaties and to the underlying profit attribution guidelines in order to be coherent.

A withholding tax on certain types of digital transactions and a digital equalization tax are both gross taxes that are unrelated to a company’s net income. A withholding tax on digital transactions presents considerable issues in terms of neutrality, scope and administration. A tax on gross income would also disproportionately harm small and medium size businesses, many of whom have not yet achieved profitability.

The NFTC recommends that any new tax measures must not lead to double taxation, must be implemented within the tax treaty system, and not be discriminatorily applied to certain select businesses. Business needs tax certainty and the ability to comply with whatever rules are put into place. Unilateral tax changes cause confusion and add to business expense as taxpayers must learn each system and how to comply with it. There needs to be systems in place to minimize double taxation, and processes for governments to resolve double taxation disputes. If the OECD determines that it should radically alter longstanding norms by imposing income tax based on the place of consumption, then such policy must be imposed universally.

Sincerely,

A handwritten signature in cursive script, reading "Catherine Schultz". The signature is written in dark ink on a light-colored background.

Catherine Schultz  
Vice President for Tax Policy  
[cschultz@nftc.org](mailto:cschultz@nftc.org)  
202-887-0278 ext. 104

October 13, 2017

OECD – TFDE

VIA EMAIL (TFDE@oecd.org)

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

Comments by Harlow Higinbotham, Pim Fris, Vladimir Starkov and Emmanuel Llinares<sup>1</sup>

Dear Madam, Dear Sir,

In the context of BEPS Action 1, the OECD has released on September 22, 2017, a request for input on work regarding the tax challenges of the Digitalized Economy (the Request for Input).

We thank you for the opportunity to provide comments in this regard.

We are pleased to provide our input on some of the questions raised by the OECD in the Request for Input.

## **1. Introduction**

In line with the overall conclusions of the BEPS project and specific conclusions of the 2015 Report on “Addressing the Tax Challenges of the Digital Economy”, we are of the view that the arm’s length standard is relevant in the context of the digital economy just as it is relevant in any industry. In the current environment, many multinational enterprises may have at least a portion of their business that relates to the digital economy, often strongly intertwined with the traditional business. Hence, having a different standard for the digital economy alone would be both unjustified and ineffective.

In other words, we firmly believe that there should not be an industry specific treatment of the digital economy. In addition to this, we are of the opinion that the main concepts developed in the context of international taxation (*i.e.*, the arm’s length standard, and in that context the link between the allocation of taxation rights and role of local entities in value creation, the

---

<sup>1</sup> This document expresses the view of the authors and not necessarily the views of NERA Economic Consulting.

permanent establishment concept and the attribution of profits based on the Authorized OECD Approach – “AOA”) potentially offer a powerful and effective toolset, and should continue to be defined in terms that are common to all industries.

## **2. Input on Section A. “Digitalization, Business Models and Value Creation”**

In Section A.2 of the Request for Input, the OECD asks for the role that IP may play in highly digitalized businesses. In this context, it is beyond dispute that the concepts developed in Chapter VI of the 2017 release of the OECD Transfer Pricing Guidelines (2017 TPG) should be relevant. In line with the definition of intangibles included in the 2017 TPG, we wish to point out that the concept of “intangible property” or “IP” may not be the most suitable one. The term IP overly suggests the use of a legalistic concept. Across all industries and in particular in the digital economy, a more relevant concept would be that of “intangibles.” In our opinion, intangibles are a broader concept than IP. The identification of relevant intangibles needs to be framed in the broader analysis of value creation (as pointed out in a number of occasions in Chapters I and VI of the 2017 TPG). Such intangibles may not be restricted to the illustrations provided in Section A.4 of Chapter VI of the 2017 TPG. Many of these intangibles go beyond the definition of IP for legal purposes and often are not reflected on companies’ balance sheets. Nevertheless, they embody major parts of the value of enterprises, whether digital, traditional or a mix thereof.

In our opinion, the analysis of value creation should be the foundation of the analysis of the role of intangibles in the context of any industry and company, and, ultimately, enable the identification of a “significant economic presence”. Only a value chain analysis which includes the identification of the critical success factors and the strategic risks associated with the business concerned enables the proper identification of relevant intangibles and forms the foundation of the assessment of their contribution to value creation (and ultimately their remuneration). The analysis of functions, assets, and risks needs to be framed in the context of the overall value creation analysis, *i.e.*, in light of the value drivers that were identified for a specific enterprise involved. Then, and only then, it is possible to understand the role of related entities (including the possible existence of permanent establishments). In this context, a characterization in terms of responsibility profiles (investment center, profit center, revenue center, cost center or expense center), as used for management control purposes, is much more relevant than the overly simplistic “routine” vs. “entrepreneur” characterization. In summary, in our opinion, only a proper value chain analysis of the specific company concerned can enable to provide consistent answers to the questions raised in Section A3 and A4 of the Request for Input. Looking for generic explanations of “drivers for remote selling models” or “the role of data” is an illusion. Namely, the relevant business considerations driving remote selling business models are likely to be specific to each multinational enterprise or at least to sub-segments of the industry concerned. They are also likely to evolve in time. Similarly, the role of data collection and analysis and the type of data being collected and analysed are also likely to be specific to each multinational enterprise or the industry sub-segment. Moreover, in both

cases, only an enterprise-specific value chain analysis can assess the relative contribution to value creation of each of the factors concerned in the specific case at hand.

One of the key features of the digital economy is that physical location of assets and operations is much less relevant to the operation of the business than in traditional business models. This means that the ability to generate business may not be as closely tied to physical presence as in traditional models. In section A5 of the Request for Input, the question is raised as to whether the establishment and operation of such global (or at least cross-country) user networks is new and specific to certain highly digitalised business models, and as to what would be the potential implications for value creation.

In this context, we believe that the analysis of where value is created and of what the responsibility profile is of entities involved needs to be addressed before a conclusion can be drawn on what constitutes an “enterprise”, per the meaning of Article 5 paragraph 1 of the Model Tax Convention. An enterprise can be defined as a durable organisation of capital and labor aimed at carrying on business in the market. In this respect, key characteristic of an enterprise is the responsibility for the continuity of the business. Many of the entities involved in the digital economy business models, often seen as “routine”, will in fact be expense centers or revenue centers. These entities may not have control of, and thus cannot carry the responsibility for, their own continuity. Consequently, they should, under circumstances, be characterized for purposes of article 5 paragraph 1 as part of the enterprise of their principal – with direct impact on their potential status of PE. The subsequent issue of attribution of a suitable remuneration to the PE can be faced following the AOA, with the toolset elaborated in the 2017 TPG.

In conclusion, many of the questions raised in Section A of the Request for Input can and should be addressed through concepts detailed in the 2017 TPG and considering Article 5 par. 1 of the Model Tax Convention. We would recommend that the OECD continues to frame the debate on the digital economy in the context of these concepts, the robustness of which has been enhanced following the BEPS project. The practice of taxation for globally active enterprises should take shape on this basis. If there is progress to be achieved, it is in the practical application of these concepts. Value chain analysis and the conclusions thereof as to the longer term relationships between, and attribution of jointly generated profits among, corporate entities of a multinational enterprise should become the foundations for an internationally consistent and acceptable global taxation practice.

### **3. Input on Section C.1, “Implementation of the BEPS Package” Actions 3, 6, 7 and 8-10**

We agree with the Action 1 report on the notion that the digital economy does not present unique BEPS concerns, although certain features of the digital economy may exacerbate BEPS (OECD/G20 *Addressing the Tax Challenges of the Digital Economy*, 2015, para 241). As mentioned earlier in this document, we believe that multiple measures targeting BEPS as

expressed in the Actions 3, 6, 7, and 8-10 should be effective when applied to the digital economy.

Transition of many types of economic activities to the digital platform brought about a profound transformation of the value chains for different types of businesses making the digital businesses simultaneously more integrated and more fragmented. For example, activities such as development of the software and data analysis may be centralized in one or a few locations of a multinational enterprise while data storage and user data collection may be distributed across the globe.

Because business models in the digital economy vary considerably from one company to the other and, in addition, digital companies tend to revise their business models at a rapid pace, the importance of applying the *value chain analysis* to the digital economy businesses cannot be overstated.

The value chain analysis builds on the concept of the value creation (the key concept for the BEPS project) that is addressed in paragraph 1.51 of the 2017 edition of the OECD *Transfer Pricing Guidelines* (“TPG”) and is further referred to in the context of its application to intangibles (TPG, 6.133).

We believe that the value chain analysis is especially important for the companies in the digital economy because their business models may be different in many ways from the “traditional” business models and because similar parts of the value chain may have different value in the context of different business models. For these reasons, we would recommend to include explicit references to the value chain analysis into the future editions of the Action 1 deliverables.

## **4. Input on Section D.1**

### **4.1. D.1.A - Tax nexus concept of “significant economic presence”**

First, we would like to emphasize that the issue of the definition and identification of a “significant economic presence” (“SEP”) should in the first place be approached with the toolset available within the BEPS toolkit, and cannot be considered separately from the attribution of profit to the SEP.

Practically, we believe that at arm’s length or under the principle of separate and independent enterprise, the existence of a “SEP” without any function, risk or assets would not be entitled to any return.

For the avoidance of doubt, the mere access to a market may not necessarily give access to any compensation at arm’s length. The arm’s length compensation for, respectively, a non-resident operating company and the resident SEP would mirror the outcome of negotiations between

independent parties. SEPs have neither costs nor distinctive features. If the SEP requests a non-nil compensation, it could be considered that the non-resident company could seek a lower price from another (hypothetical) SEP. Economic theory suggests that this competitive process would decrease the profit of the SEP down to zero.

In conclusion, we believe that the concept of “significant economic presence” is not needed per se. The sought concept can be identified with a proper use of the existing toolset of the international taxation, based on value chain analysis and with a correct characterization of entities within a multinational enterprise. The current Article 5 paragraph 1 of the Model Tax Convention, based on a relevant, *i.e.*, economic, interpretation of what constitutes an “enterprise”, will then allow the systematic and consistent identification of a “significant economic presence” for purposes of international taxation. For this reason, we would suggest not introducing this new concept as it is not needed

## **4.2. D.1.C - Digital equalisation levy**

The BEPS Action 1 Report explores the possibility of implementing a digital equalization levy. The levy “*could be imposed on data and other contributions gathered from in-country customers and users*” (§305). We understand that such a levy would be determined as a fixed charge multiplied by a certain base, for instance, the average number of monthly active users or the volume of data collected from in-country customers and users.

Such a levy would be completely disconnected from the results of the analysis of the value creation process within the company concerned. Such a levy could also result in disproportionally high charges in certain contexts and would be negligible in other contexts. We think that such levy would be both arbitrary and ineffective, and would result in radical distortions of the markets.

## **5. Conclusion**

We firmly believe that the arm’s length principle can and should be the relevant concept to address many of the issues related to the pricing of transactions in the digital economy. BEPS Actions 8 to 10 in particular have led to changes in the application of the arm’s length principle which, we believe, could help manage many of the challenges related to the digital economy. In this respect, the analytical tool of value chain analysis is essential, although its application in practice leaves room for significant improvement of its use in international taxation and of the digestion of conclusions therefrom to identify “significant economic presences”. We are of the opinion that alternative means of taxation of digital enterprises would be ineffective and

counterproductive as alternatives to the arm's length principle are likely to provide more arbitrage opportunities than one can envision at the moment.

We would strongly encourage additional work to strengthen the application of the arm's length principle to the digital economy as needed (e.g., the value chain analysis and possibly AOA and profit split), in combination with the full implementation of its findings for the identification of SEPs in terms of Article 5 par 1 MTC, rather than seeking industry or country specific measures which are unlikely to be effective and likely to result in distortions

We hope that the above is useful.

With kind regards,

Pim Fris, Harlow Higinbotham, Vladimir Starkov and Emmanuel Llinares

Porto Alegre, Brazil, October 13, 2017.

To  
The Organisation for Economic Co-operation and Development (OECD)  
Action 1 – Digital Economy  
Call for input

*B. Challenges and Opportunities for Tax Systems*

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

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

Dear Sir or Madam,

Recently, Mrs. Christine Lagarde<sup>1</sup>, IMF Manager, made a speech at a conference at London Bank. The speech title was: "Central Banks and Fintech - a brave new world?". Far from dismissing the importance and the potential of the virtual coins (aka, cryptocurrencies), Mrs. Lagarde talked about the new edge for the central banks. Nowadays, the virtual currencies do not represent a challenge to the "status quo" for technical reasons. However, Mrs. Lagarde also recognizes that the technical issues can be solved. And concluded: "So I think it may not be wise to dismiss virtual currencies".

In theory, virtual coins have the potential to break the "fiat" currency model which is the only model since early 1800's. But it is just one of its aspects - probably the obvious one. Fundamentally, virtual coins - and especially Bitcoin - were designed not just to take off the "fiat" of a currency, but to decentralize the economy all. It raises the possibility of a whole new unstoppable virtual economy taking place in a world without borders, governments and, of course, taxes. In the early days of the internet people and companies were interested to make real money in the virtual world. Nowadays, people and companies are working on making virtual money not just in the virtual world, but also in the real world.

By making real money in the virtual world, money necessarily goes through the international financial system. Even a trust in a tax haven is located in the real world. There is a jurisdiction. And when the tax haven is, in fact, in heaven, in a completely virtual world? And when the companies themselves become a smart contract running in a "blockchain"? Virtual companies making virtual money - and maybe even real money.

Actually, today jurisdiction is not imposed: jurisdiction is chosen. Lawrence Lessig, in his book "Code 2.0" says that: "The problem for law is to work out how the norms of two communities are to apply given that the subject to whom they may be in both places at once". The issue that virtual currencies - and the decentralization of the economy - is that the virtual jurisdiction offers no or minimum transaction costs.

---

<sup>1</sup> <https://www.imf.org/en/News/Articles/2017/09/28/sp092917-central-banking-and-fintech-a-brave-new-world>

The basis of the global tax system established by the OECD is based on the sovereignty and architecture that sovereignties have to track the assets of their citizens and companies in other jurisdictions. And fundamentally, the architecture is in access to the financial system. Therefore, since sovereignties have access to data in the financial system, and considering that sovereignties exchange information between them, the network is closed which allows jurisdictions to tax the assets of their citizens and companies in other countries.

In this scenario, the impact of virtual currencies can be overwhelming. There is no sovereignty and there is no financial system in the virtual world. Transactions are peer-to-peer, unstoppable and instant across any boundary. Today's architecture is completely innocuous to face this new model of the economy. How to establish an international tax system if there is no nation?

This is the point that has the potential to break the wheel. Judge Oliver Holmes Jr. once said that tax is what we pay to live in civilization. How to tax what is going completely decentralized of the sovereigns and the international financial system?

I truly hope to see this debate in motion.

Sincerely,

Orontes Pedro A. Mariani  
orontesmariani@gmail.com

715/504, Dr. Pereira Neto St.  
Porto Alegre, RS, 91920-530  
Brazil

**Michael Devereux and John Vella**  
**Oxford University Centre for Business Taxation**

**Response to the OECD's**

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

*October 2017*

- Starting from the same approach as the European Commission Expert Group and the OECD, we do not believe that it is sensible to attempt to “ring-fence” the digital economy as if it were distinct and separate from the rest of the economy such as, for example, natural resources. All industries are affected by digitalization.
- The existing system for taxing international corporate profit faces a host of problems. It is distortive, susceptible to tax avoidance and imposes huge compliance costs. Furthermore, it invites competition amongst states, thus making it unstable, and - we believe - unsustainable in the long run. The OECD's ambitious BEPS programme closed loopholes and tightened the system overall, however these broader problems remain.
- Broadly, digitalization does not affect the nature of these problem, but it exacerbates them. This is primarily because digitalization facilitates the internationalisation of all aspects of a company's business. In other words, as a result of digitalization it is easier for a company's shareholders, activities and customers to be located all over the world.

- As the flaws of the current system are deep rooted, we believe that the proliferation of a variety of uncoordinated measures implemented within the existing framework is unlikely to provide a long-term satisfactory solution to the challenges to the tax system presented by digitalization.
- Fundamental reform is required. Digitalisation poses challenges to these reform options but also opportunities.
- The tax base should be based on relatively immobile factors, either where shareholders are located or where consumers are located. Both types of reform have a significant advantage in that the conceptual basis of the system would be clear. But they also both raise practical difficulties. A tax on shareholders would need to associate corporate profit in one country with a shareholder in another. A tax in the place of sale would need to tax imports, possibly exported by a small company in another country. However, both problems might in principle be helped by digitalization. To the extent that tax records are digitized, and possibly combined with other data, for example, from banks, then the problems of information for these systems may eventually be overcome.
- There are also issues that arise particularly in digital companies. One involves the case where cash sales are made to advertisers in one country and where the advertisements appear on screens of users in another country. This may be combined with the use of information provided freely by those users. At the moment, there is little attempt to levy a tax in the country of the users, typically because no money changes hands in these locations. There is a case in principle for tax to be levied in the country of the user, but there remain significant practical and conceptual difficulties in doing so.

## **Input on work regarding tax challenges on the digitalised economy**

By H Padamchand Khincha & P Shivanand Nayak

---

1. The following write-up is in response to the request for input on work regarding the tax challenges of the digitalized economy. The inputs requested are categorized into 4 segments. Our comments are only with reference to Segment B: Challenges and Opportunities for Tax Systems; and Segment D: Options to address the broader direct tax policy challenges.
2. Digitization is here to stay. It is imperative to accept the dawn of digital world to remain relevant. The reach of digitization is magnanimous. It provides hitherto not visualized scope for innovation, investment and creation of new businesses and jobs. The business transactions that transpire within this digital circuit travels through countries without trail. The smokescreen which blurs the digital transaction trail has been a cause of concern for exchequers across the globe. The absence of trail and ease of accomplishment of business transactions due to deployment of technology has facilitated moving operations and profits to jurisdictions of choice. What were traditionally goods is available as utility [ie, in the genre of services]. Rendering of such services also could be automated. The interaction could be between 'man & machine' or 'machine & machine'. This involvement of machines has made the transactions 'less visible' or sometimes 'invisible'. The inability to ring-fence the transaction and levy an impost thereon has stirred brainstorming discussions around taxation of digital economy.
3. Typically, an income-tax is on a person. A person could be defined to mean individuals, entities or various forms of set-ups. Machine is not a person. In a digital transaction, a machine is the doer of the tasks. Income arises on the accomplishment of tasks by a machine. An attempt to tax the digital transactions is thus on the machine rather than the person. Such tangible machines are now replaced by processes that occur on the cloud. This makes the location of the tasks obscure. There is a wedge in relationship between the 'person', 'machine' and 'cloud'. This is giving rise to nexus issues. Which of these three facets of digital transaction is to be given priority [for establishing the nexus of income with a country] is a challenge. This difficulty is causing the global thinking caps to shift the focus from location of the service provider to the location of the service recipient or consumer.

4. Today, taxes are fastened on the basis of parameters such as residence, citizenship, activity, service utilization etc. Such basis depends on the genre of income. For instance, actual conduct of business may be the relevant factor for business income, locale of asset is the key in case of capital gains. Payer, being the utilizer is the yardstick for royalty, fees for technical services. The current challenge is around the choice of the appropriate yardstick to tax a digital transaction. Since the transaction trail is not discernible, can the right to tax rest only with the place of origin or should it be limited to the place of destination? The start point, ie the digital service provider may be subject to tax on the rule of residence; while the end point or the consumer may be roped in as a 'source of income' or 'consumer of service'. If the basis of taxation is in the 'source' state, the territorial nexus of such state with the income attains primacy. This nexus often delimits the sovereignty of various jurisdictions.
5. In a digital transaction, reckoning 'significant economic' presence is a challenge. The intricate dynamics of a digital transaction makes the study of economic presence difficult. The service provider; place of provision of services; place of rendering of services; situs of consumption and place of payer of consideration may not be co-located. The services in digital world are often carried out through online transmission of data. There is no physical locale of the actual services rendered. This being the case, the only alternative left for the taxman is to attack the consumers. The target of all commerce, whether e-commerce or otherwise, is always the consumer. However, the crux of the matter is whether such an approach is appropriate? Is this the intended end? Or are we moving from a direct tax regime to realm of indirect tax/ transaction tax by looking at the 'consumer'?
6. It is equally challenging to fix an event as economic presence. It is a collective amalgamation of software, technical expertise and intellectuals. This being the case, apportionment of income between each of these factors should be an issue for deliberation.
7. Many countries [including India] have elected to impose tax on the consumer. The question is whether such consumer is a source of income to enable the taxing of the service provider in the jurisdiction of the payer or is he just a payer of monies?
8. Doctrine of territorial nexus cannot be ignored for tax laws. Indian Courts have repeatedly insisted on a factual "*live link*" to be established between the income and locale of taxation.

Typically, a country does not tax income with which it has no connection. A territorial connection should justify the exercise of taxing jurisdiction. The justification is that a taxpayer should share the cost of running a country which has enabled him to earn income. The presence of 'payer' alone cannot establish such link or the territorial nexus.

9. Existence of fixed place of business is a pre-requisite for taxing business income. There is an inherent element of continuity and permanence in such establishment. Such presence in a specific locale could be by oneself or through an agent. Such a phenomenon is often called as a 'business connection'. Such place of business is not constituted by a presence of customer.
10. Indian legislature introduced Equalisation Levy. It is a levy on certain online transactions. The impost is coined as 'Equalisation levy'. It is clarified by the Government as not constituting income-tax and such levy is not creditable as 'foreign tax' under tax treaties. The non-availability of such levy as credit 'strains' the cross border digital transactions. This is because, no non-resident service provider would settle for a consideration with a "non-creditable" sufferance in consideration. This non-creditable aspect could invite retaliatory reactions from foreign exchequers. These countries may adopt differing versions of such a levy. Differential in levies and the character thereof paves way for another reason for 'gaps' in international taxation. The dream of global tax convergence by BEPS gets distanced in such an eventuality. A levy imposed without factoring in these ramifications appears to be limited in study of the issues involved. The introduction of such levy is a desperation in implementation or action. The levies such as Equalisation levy are unilateral mandate of countries. If states decide to tax on a unilateral basis without any sort of co-ordination or agreement with the counterpart corresponding state, the same income may get taxed more than once, creating hindrance to free trade. BEPS Action Plan may lose its focus and purpose if the countries choose to be "indifferent" or "different with each other".
11. It is seen as a radical alternative to income-tax. It is more akin to a transaction tax. It has assumed the form of an indirect tax although the genesis of this levy was a thought process of fasten income-tax on such intangible digital transactions. Being inherently a direct tax, the equalization levy should have been a charge on the income recipient. Contrastingly, rule of

convenience seems to have been adopted. The resident payer who is the service recipient is burdened with the obligation to pay tax and ensure compliance.

12. Since the availing of online advertisement transaction is made taxable, the principles of fixed place or business presence is given a go-by. The susceptibility of these transactions to be taxed is far more than the typical transaction of purchase and sale of goods. This brings in a differential treatment to a digitized transaction vis-à-vis an arrangement in brick and mortar industry. Modus operandi of a business cannot be a reason to treat it differently. There is no intelligible differentia to provide a different tax treatment for digital transactions. The inability of the current taxing regulations cannot be the reason for imposing tax on digital transaction on an 'consumption basis' or 'treat it like a transaction tax'.
13. Though the scope of a new levy is generally narrow in the initial years, it is invariably expanded in scope and reach as it evolves. Scope of taxing digital transactions would be a pivotal aspect in the immediate future. It is expected that the exchequer would tax the "digital world" to garner revenues. Defining the transactions which are to be enveloped within a new levy would be critical. There are 'Substantial tests' laid down today [existence of PE] for taxing business income. However, 'Fleeting tests' are proposed in case of digital transactions by tracing the economic value generation. Many studies have been inconclusive on taxation of digital commerce. The BEPS Report on Action 1 recommended that further work is required in digital economy taxation. The BEPS Report suggested that the development in digital economy needs to be monitored. A review of such developments in 2020 was advocated. However, the Committee expressed its doubts whether even if any further work even if undertaken, would yield any actionable outcomes. Countries [like India] did not heed to the 'wait and watch' approach of the BEPS Report. The mounting pressure to scale up tax revenues as in almost every nation, did not permit the exchequer to defer the tax collection adventure. The tax authorities should be hesitant to embark on something new solely as a reaction to an 'allegation' of a failure to devise a taxing norm for digital transactions.

\*\*\*\*

## **MR PORUS KAKA'S PROPOSAL ON DIGITAL TAXATION**

The objective behind this proposal is to ensure the following:

1. The taxation of business income any company/group should be based on fundamental principles of Source/Residence Taxation.
2. While allocating rights to tax in a source jurisdiction in the new business model of the Digital Economy, the concept of a fixed place of business and the old Permanent Establishment (PE) PE Rules are no longer relevant.
3. The Latest Report from the European Commission (EC) dated 21<sup>st</sup> September, 2017, states out the concerns on the digital business.

"In the field of taxation, policy makers are struggling to find solutions which would ensure fair and effective taxation as the digital transformation of the economy accelerates. These are weaknesses in the international tax rules as they were originally designed for "brick and mortar" businesses and have now become outdated. The current tax rules no longer fit the modern context where businesses rely heavily on hard-to-value intangible assets, data and automation, which facilitate online trading across borders with no physical presence. These issues are not confined to the digital economy and potentially impact all businesses. As a result, some businesses are present in some countries where they offer services to consumers and conclude contracts with them, taking full advantage of the infrastructure and rule of law institutions available while they are not considered present for tax purposes. This free rider position tilts the playing field in their favour compared to established businesses."

4. The developing world especially the market countries like India/China expect that the market/customer base must be a relevant criteria while allocating taxing Rights in a Global and digitized world.

5. The global concerns from the EC etc, contemplate 3 possible options for determining income for taxation of the digital economy.

(a) Level of Revenue from Digital transactions

(b) Number of users

(c) Volume of Data collected

6. The EC report further states -

“The underlying principle for corporation tax is that profits should be taxed where the value is created. However, in a digitalized world, it is not always very clear what that value is, how to measure it, or where it is created.

The two main policy challenges that need to be addressed can be summarized as follows:

- **Where to tax (nexus)** - how to establish and protect taxing rights in a country where businesses can provide services digitally with little or no physical presence despite having a commercial presences; and
- **What to tax? (value creation)** – how to attribute profit in new digitalized business models driven by intangible assets, data and knowledge.

These challenges need to be looked at together to find a meaningful solution for determining where economic activities are carried out and value is created for tax purposes.”

7. The proposed alternative short term options in taxing the digital economy in the latest EC Report contain the following:
  - (a) Equalisation Tax on turnover
  - (b) Withholding Tax on digital transactions
  - (c) Levy on revenues generated from the provision of digital services on advertising activity
8. In my view taxation at a gross level or turnover tax could rapidly result in double taxation and contrary to basic principles of net taxation for business income.
9. At the same time one must consider that in the Digital Economy Model, Significant Economy Presence (SEP) can be built up without the need to have a fixed place of business or the old concepts, under the PE rules.
10. The struggle therefore is to establish new rules that would capture/justify the taxation of business income, in the case of SEP within a source jurisdiction. The attempt is to find a median between the claim of being able to tax SEP and value creation in the digital world and fundamental principles of Source Taxation.
11. At the same time taxation should be of "income" and not necessarily the raw materials used to earn the income such as data, etc. though the gathering of data could be an item to determine SEP and/or profit attribution.
12. Also keeping in balance the interest of the Companies in this new model, computation of such income should be based on allocation of global expenses, with an emphasis to determine a reasonable attribution and

especially permitting deduction of expenses incurred globally, irrespective of the situs of the expenditure.

13. I have taken assistance from some of the clauses in the US - India DTAA for reference and drafting.

14. The suggestions below are still work-in-progress, to the extent that suitable commentary will have to be added to explain the Article, along with work on Transfer Pricing to determine principles for allocation of expenditure and profit attribution

### **Main Proposals on Model Convention**

1. A new sub article in Article 5 could be inserted

5 (8) Notwithstanding of provisions of para 1 and 2, where a person makes sales to or in a contracting State, exceeding an amount of (to be negotiated) and has the following additional activity carried out within that State:

(a) Collects data from users within such State that directly or indirectly facilitates the sales;

and / or

(b) Has number of users of its platform exceeding (to be negotiated) ;

and / or

(c) Carries out support activities such as after sales support services in relation to the sales;

then it would be deemed to have a PE for the purposes of this convention.

5 (9) For the purpose of sub para 8 above, the term person will include for the purpose of determining the threshold amounts, associated enterprises within the meaning of article 9.

2. A new sub article in article 7 ought to be inserted

Article 7(5)-For the purposes of this Convention, the profits to be attributed to the permanent establishment, as provided in Article 5(8), shall only include profits that can be reasonably attributed to the assets and activities in the other state and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

Article 7(6) In the case of a deemed PE arising under Article 5(8) the determination of profits shall be made after deduction of expenses, incurred directly or indirectly for earning of the said income, including an allocation of executive and general administrative expenses whether incurred in the in the state where the PE is situated or elsewhere. In any case where the correct amount of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.



By email to: [TFDE@oecd.org](mailto:TFDE@oecd.org)

13 October 2017

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

### ***1. Introductory Comments***

- 1.1. PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's *Request for input on work regarding the tax challenges of the digitalised economy* ("the Request for Input").
- 1.2. As a matter of process, we are concerned at the pace at which the OECD (and consequently stakeholders, through this consultation) are being requested to deliver quality output that could influence significant changes in the international tax system. The BEPS Action 1 report identified broader tax challenges arising from the digitalisation of the economy, and set out a timeline to monitor the impact of the BEPS recommendations and other changes to the economy. We do not believe it is possible to undertake the detailed analysis required to deliver by April 2018, and a three week consultation period has not been sufficient for a broad range of stakeholders to sufficiently consider the issues involved, nor the potential impact of proposed solutions which had already been ruled out by the OECD. We urge the OECD and other stakeholders to commit to more detailed thought and analysis, over a longer time period, with a view to having a better informed, productive, pro-growth global conversation around the issues identified.
- 1.3. Global profits of multinational companies are generated through many activities by many legal entities in many countries. Synergy-related profits are also realised. Allocating profits, based on functions, assets, and risks, in the various countries, has become an extremely complicated matter. Transfer pricing rules are increasing exponentially in number and complexity, and have resulted in high compliance and enforcement costs and increased risk of double taxation.
- 1.4. Digitalisation (both through a host of new products/services, and through impact on more traditional functions) is further altering value chains within multinational companies and leads to questions about where value is generated. How these new value chains will run through different legal entities and countries will change the tax analysis.

*PricewaterhouseCoopers International Limited*  
1 Embankment Place  
London WC2N 6RH  
T: +44 (0)20 7583 5000 / F: +44 (0)20 7822 4652

PricewaterhouseCoopers International Limited is registered in England number 3590073.  
Registered Office: 1 Embankment Place, London WC2N 6RH.

- 1.5. In short, business models and value chains are changing fundamentally and value creation is becoming increasingly independent of (physical) activities and physical presence in a market. Naturally, even 30 years ago, it was possible for French wine growers to send boxes of wine to Dutch customers without being physically present in the Netherlands. This type of trade is not normally classed as permanent establishment. The great speed with which information and communication technology is developing means the same French winegrower can upscale his activities in the Dutch market without being physically present in the Netherlands (and may even allow him to engage more easily with consumers, rather than intermediaries). However, all marketing, sales, distribution and after-sales activities may still take place in France; in that sense, the location of where the value has been created has not changed, and digitalisation has merely opened up new markets and reduced barriers to growth. It is hard to understand why the French wine grower's digital access to the Dutch customer should be considered to yield a different tax result than the result with the customer access of decades past.
- 1.6. It is worth reiterating that Action 1 of the final BEPS report of October 2015 concluded that the 'perceived challenge' to be addressed is the digitisation of businesses of all types and sectors rather than some idea of a digital economy that one can clearly identify and tax separately. Avoiding unilateral action would require a longer term global solution and we recommend below a framework (from a business and tax perspective) for further dialogue, while stressing the need to avoid unilateral and reflex actions, some of which were described in the Request for Input and have been called for by some countries. We include descriptions of some of the key features of modern business that should help clarify the nature of the underlying tax base, with a view to informing the discussion over the appropriate tax base.
- 1.7. Policymakers can and should view digitalisation as an overall accelerator for growth, with taxation as a potential and significant restraint if it is not done appropriately - withholding taxes and equalisation levies would inhibit growth with significant potential for double taxation. Countries will benefit from a bigger pot even if the tax share is smaller (not to mention the additional non-financial benefits to consumers and societies that increased digitalisation can bring).
- 1.8. In summary:
  - the digital economy is not a sector that can or should be identified clearly and taxed separately;
  - digitalisation is an accelerator for growth, and taxation should not inhibit that more than it does with traditional business;
  - there is a need to understand how value is created in digitalised business models and whether this is different from traditional businesses;
  - unilateral actions and potential solutions will have a negative impact overall (including particularly on growth); and
  - time should be taken to consider the perceived problems, the real challenges, their impact, and potential solutions that could attract multilateral consensus.

## ***2. Features of modern business models***

2.1. Before any changes are made to the tax system, our recommendation is to develop and obtain consensus on a framework to evaluate “value creation” within the digitalising economy with the purpose of first evaluating the adequacy and appropriateness of existing rules before considering options that might change how and where this “value” should be taxed and where.

2.2. This framework could include the following inputs:

- understanding the unique features of the digital economy which lead to the creation of digital business models;
- deep understanding of how digital business models function and how revenue is earned and costs are minimized;
- how profitability may be affected; and
- what is value creation and how do any new assets or value drivers interact with existing assets and impact people functions, capital and the analysis of risks.

2.3. We will briefly introduce the framework on an illustrative basis to provide some direction and explanation of how the digital economy and business models are truly disruptive and different, with a view to informing the debate on the tax challenges they pose. There is more detail in the [Report on our 2016 Global Industry 4.0 Survey](https://www.pwc.com/gx/en/industries/industries-4.0/landing-page/industry-4.0-building-your-digital-enterprise-april-2016.pdf)<sup>1</sup>, the biggest worldwide survey of its kind, with over 2,000 participants from nine major industrial sectors and 26 countries.

2.3.1. Digital business models originated from a need to serve customers better and at a lower cost and digital technologies could make this possible. Social media, mobile phones, and platforms allowed for a greater understanding of customer needs and the ability to build a stronger relationship with customers to continue to improve the customer experience. Serving customers with the best products or services at the best price has always been the objective of business. Now with greater customer insights and technology capabilities, digital business models are meeting that objective differently than traditional business models. But customers are not the only value driver.

2.3.2. Our key observations about the business models of “digital” businesses (and the impact of digitalisation on existing business models) are that:

- they overlap and may be combined, as discussed in BEPS Action 1;
- they will continue to evolve as emerging technologies such as Artificial Intelligence, Blockchain and Internet of Things (IOT) advance and new ecosystems emerge;
- they include new ways to maximize revenues and reduce cost; and
- they are able to leverage data, technology platforms, and customer relationships, etc in innovative ways.

---

<sup>1</sup> <https://www.pwc.com/gx/en/industries/industries-4.0/landing-page/industry-4.0-building-your-digital-enterprise-april-2016.pdf>

2.3.3. There are no universally accepted definitions of digital business models but several broad types have emerged. BEPS Action 1 describes most of these models in detail so we will identify them only briefly. There are four broad categories of digital business models are defined mainly by how they generate revenues and engage customers/users:

*(A) e-Commerce/ Online retailer model*

- trading through online platforms of “bricks and mortar” businesses ;
- trading through “digital only” offerings; and
- consumers trading with each other.

*(B) Platform models -*

- multi sided e-commerce platforms that allow two or more customers or groups to connect with each other through an online platform;
- cloud platforms that could take the form of Platform as a service or Software as a service model; and
- IOT platforms, whether connecting industrial equipment and machinery or cars or even people; and
- payment platforms and use of mobile wallets by consumers and mobiles in point of sale by merchants.

*(C) Social media/Online advertising model*

- location based;
- behaviour based; and
- other ways of differentiating users.

*(D) On demand/ Subscription model - in particular*

- the subscription model locks in a customer by taking a product or service that is traditionally purchased on an ad hoc basis and charges a subscription fee for continued access to the product/service; and
- the “freemium” model lets users sample the service for free and then charges to upgrade to the full offer.

2.3.4. Mapping a company’s business model maturity will be important to understanding its profitability and how that’s impacted by two factors:

- the investment required to reach a level of maturity that is viable, profitable and sustainable; and
- when commoditisation begins to occur with a product or service such that margins begin to drop – a late comer to an innovation will not reap the same benefits and profitability as a company at the forefront of innovation.

2.3.5. Digital technologies have changed the way an organization may be able to create value:

- new value could be increasingly captured by data, platforms and customer experiences;

- the combination of these value drivers will differ in each business model and may give rise to new intangible assets/IP; and
- disruption is not new, but never before has disruption affected all industries or happened so fast and it continues to pick up speed so that businesses have to re-think and sometimes re-invent their business models to survive.

2.3.6. Data may become valuable through the business outcomes it makes possible. Data comes in many different forms and from many different sources. It could be structured or unstructured, public or private. Companies can create proprietary data sets. These type of factors need to be considered to assess the value of data before any data analytics or transformation of the data occurs to add value.

2.3.7. By investing in data analytics capabilities, companies can uncover insights whether it is to identify new products or services, serve customers better, make operations more efficient or improve employee engagement and retention. More specifically, it may be necessary to consider whether value may be extracted through data analytics to produce these actionable business insights or further develop into algorithms and apps. Some algorithms or apps may be publicly available so it cannot be automatically assumed that all algorithms or apps are valued the same.

2.3.8. Platforms provide connectivity and provide the ability to scale quickly. Convenient access to platforms in the cloud has replaced the need for significant capital expenditures in hardware and software. It may be possible for value to be created by:

- opening communication channels and initiating transactions between various consumers and producers so that platform owners can observe and incorporate its users' behaviours and preferences to drive changes to its value chains, products and services, and
- the ability to scale quickly to enable companies to attract users to reach a level of adoption that sustains the business model and realize the network effects.

2.3.9. Where product and price differentiation is no longer sustainable, focusing on delivering superior customer experiences is key. Multiple channels and devices mean that companies have more ways to reach customers, but customers also expect to use their preferred methods at each stage, and on their own time.

### ***3. The post-BEPS tax environment***

- 3.1.** The OECD has committed to reviewing the implementation phase of BEPS in 2020 and at that point it will be necessary to determine whether sufficient time has passed to identify a clear picture of the impact of these changes. When sufficient time has been provided for implementation of the direct tax measures and any indirect tax (VAT/GST) measures have been reviewed and introduced it will then be possible to determine what other measures (if any) are necessary to tackle the challenges of the new economy.

### **3.2. Direct Taxes**

3.2.1. The delivery of the BEPS reports in October 2015 has given countries a number of recommendations to consider and implement. The implementation phase proposed by the OECD was from the date of release in October 2015 until 2020, and given the level of technical legislative change required this is a tight time frame. Aided by the multilateral instrument and EU Directives, significant progress has been made in addressing BEPS issues, and continues to be made. However, it is likely that the full impact will not be felt until 2020 and beyond.

3.2.2. As such, we believe that it would be unwise to overlay new measures onto the recommendations currently being adopted which, to a large extent, may address many of the concerns relating to the digital economy. We have outlined here the progress and impact of some of the actions expected to address BEPS issues and broader challenges raised by the digital economy (or the new digitising economy as a whole).

#### *3.2.3. Action 7 - Permanent Establishment*

3.2.3.1. Two significant changes brought forward by Action 7 centred around the dependent agent test and the specific activity exceptions. The reduced threshold for a dependent agent means that it is significantly more difficult for a company to avoid recognising a PE in instances where that company habitually has people in a jurisdiction who play the principal role leading to the conclusion of contracts. Hence it will no longer be possible for the sales of goods or services by digital companies to not be subject to tax in locations where they have related parties playing a principal role leading to the conclusion of those sales. This is a potentially significant shift from the pre-BEPS landscape.

3.2.3.2. Similarly, one of the recommendations relating to the specific activity exemptions is that they should only apply where the activities themselves are preparatory and auxiliary in nature. This, for example, would mean that the storage of goods for delivery may constitute a PE for an online company whose logistics operations are not merely preparatory and auxiliary to the rest of the business. The anti-fragmentation rules mean that it will not be possible to separate activities to avail of these exemptions.

3.2.3.3. The PE rules can be adopted by countries through the MLI. Some countries have indicated that they will not adopt these rules in their treaties due to either the factor not being a risk for their jurisdiction due to domestic legislation, or due to the lack of clarity on the profit that must be attributed to PEs. This is a continuing area of debate and we acknowledge that public consultations have been undertaken in 2016 and 2017. We await the outcomes of this work stream. It is likely that further guidance and clarity on profit attribution would lead to more jurisdictions gaining comfort on adopting these new standards.

#### *3.2.4.Actions 8 - 10 - Transfer Pricing*

3.2.4.1. The revised OECD Transfer Pricing Guidelines (“the 2017 OECD TPG”, which have been recently released) draw a clear distinction between the return due to the mere legal ownership of an intangible and the return due for the DEMPE functions that contribute to the value of the intangible. Alignment of profit with the functions which create value is a cornerstone of the BEPS project and the outcomes of this action should be appraised in advance of any other measures being introduced. Furthermore the introduction, or modification, of CFC rules (as proposed by Action 3) will act as a backstop to these transfer pricing initiatives in tackling the mobility risk commonly associated with the digital economy.

3.2.4.2. The increased and standardised documentation that has also been included in the 2017 OECD TPG as a result of the recommendations from BEPS Action 13 will also mean that tax administrations will have a much greater understanding of the functions being undertaken in their jurisdictions by companies (including digitalised functions digital businesses) along with how they fit into broader value chains through detailed Master Files and Local Files. Tax administrations will also benefit from country by country reports, which give them the information they need to perform high level risk assessment and focus their resources.

#### *3.2.5.Action 5 - Preferential regimes*

BEPS Action 5 examined preferential regimes, and reinforces the work undertaken as part of the transfer pricing actions. Setting rules relating to IP regimes and the instances in which preferential regimes are not deemed to be harmful has resulted in a wind down of certain structures and will, in conjunction with the TP actions above, result in a better alignment of profit with value creation.

### **3.3. Indirect Taxes**

#### *3.3.1. Business experiences*

3.3.1.1. Following the 2015 BEPS Action 1 report, 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.

3.3.1.2. Many of the new collection models follow, at least at a high level, the general principles of taxation set out in the OECD’s VAT/GST International Guidelines. However, the speed and scale at which changes are being announced around the world has produced a wide variety of challenges for businesses operating in the global marketplace due to inconsistent implementation at an international level,

even where governments have tried to keep compliance obligations for foreign vendors as simple as possible (e.g., by adopting simplified registration procedures).

3.3.1.3. The result, even if overall the broad aims of the rules are similar, is a great array of legal and administrative practices established by different countries. 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, where countries have VAT/GST regimes, more consistency is required between them to ensure that there is greater efficiency and cost effectiveness whilst safeguarding tax revenues.

3.3.1.4. The OECD work being undertaken on the implementation package ('Design and operation of efficient foreign vendor VAT/GST collection mechanisms') will be a vital resource for the consistent implementation of the framework set out in OECD VAT/GST International Guidelines both in terms of introducing legal and administrative best practices to those countries working towards new digital taxation regimes and also for those countries that have already adopted digital taxation regimes and are looking for ways to improve their current arrangements. Benchmarking against the OECD implementation guidance would help drive an even greater level of consistency.

### *3.3.2. Platforms*

The role of digital platforms and intermediaries in the VAT/GST collection process is a hotly debated topic. 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 constantly evolving business models and as a result no one-size-fits-all solutions. It will be important to develop solutions that are effective from a tax collection perspective without negatively impacting the growth in this rapidly expanding market.

## ***4. Key principles in tax policy design***

### **4.1. OECD identified principles**

4.1.1. The OECD's Final Report on BEPS Action 1 (chapter 9) identified tax principles (based in part on the Ottawa Principles) of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, and proportionality. We endorse these principles and consider that as proposals are developed they are assessed against them.

## **4.2. Broader principles**

- 4.2.1. Given the breadth of the impact that digitalisation is having on the economy (and on business models), it is clear that changes to the taxation system may not have their intended impact if they do not consider:
- the potential for digitalisation to even further change business models in ways that have not been anticipated;
  - the potential impact of competition on tax rates as a result of BEPS implementation and greater mobility in functions as outlined above;
  - whether corporate taxation gives the whole picture of the benefits (including taxes collected) arising from a digitalised economy; and ultimately
  - whether changes that may arise in the incidence of tax as a result of either changes to the economy, or the changes to the tax system<sup>2</sup> are as intended and desirable.
- 4.2.2. Tax on company profits is, from an economic perspective, one of the most disruptive forms of taxation and has a negative impact on decision-making. Alternative forms of corporate tax have been considered, mainly in academic studies. Each is designed to target the yield from different contributions (e.g. total capital, labour, economic rent). The actual impact of fundamental changes to this system would be substantial, and should not be entered into without clear and agreed global objectives regarding the incidence of taxation, and a realistic and globally agreed understanding of the best way in which to realise those objectives.

## **4.3. Growth**

- 4.3.1. Perhaps most importantly, we believe that the expectation of the G20 Finance Ministers was that their request to “examine the implications of digitalisation” for taxation was part of a paragraph on pro-growth tax policies, inclusive growth, and tax certainty.
- 4.3.2. Tax rules should align taxation rights with value creation, but pro-growth tax policies cannot be achieved without consideration of the impact on the broader economy, including detailed rigorous economic work, global cooperation, and compromise for the greater good. We encourage the OECD to remind stakeholders of this point.

# **5. Review of OECD considered options**

## **5.1. General comments**

---

<sup>2</sup> It is widely understood that the incidence of tax falls on individuals, or, (as is the case for all taxes paid by on-natural persons), ultimate groups of individuals. Taxes paid by businesses are ultimately borne by shareholders, employees, creditors, suppliers or customers. The allocation between these groups clearly depends on the underlying structure of the tax system, and the openness of the economies involved (in general, a larger relative burden falls on immobile factors in smaller countries).

- 5.1.1. The international tax framework proposed in the BEPS package seeks to align profit taxation rights with the economic activities where the corresponding value is created.
- 5.1.2. Advances in digital technology have not changed the fundamental nature of the core activities that businesses carry out as part of a business model to generate profits. To generate income, businesses still need to source and acquire inputs, create or add value, and sell to customers. Value creation is also critical to the digital economy and current rules amended in the BEPS Actions 8-10 recommendations provide the framework to identify value and align taxation with its creation.
- 5.1.3. The proposals in the Request for Input are fundamental departures from the existing international tax system that do not meet the principles identified in chapter 9 of the BEPS Report on Action 1, nor consider the broader impacts on tax incidence and growth, nor even support the BEPS objectives of aligning taxation rights with value creation.
- 5.1.4. At the same time, they would lead to a different treatment of the physical and digital economy. Therefore a sales based nexus or gross turnover based tax cannot be the appropriate approach for taxing enterprises that are internationally active in the digital economy.
- 5.1.5. Rather the taxation nexus must be based on taxation *in the jurisdiction where value is created*. This means that the approach used in calculating the taxable profits of the digital economy and determining the jurisdiction where those profits may be taxed should be based upon an analysis of where the value is effectively created. As under the physical economy, value may be created in the residence jurisdiction, in the market jurisdiction, in both jurisdictions or in a third jurisdiction. We do not consider that this question has been appropriately addressed in designing the three proposals.
- 5.1.6. Any approach to addressing tax challenges that arise as a result of the digitalisation of the economy should find its basis in the internationally agreed principles as agreed by the OECD / G20 BEPS project, and should discourage unilateral measures.

## **5.2. Turnover based approaches (withholding taxes and equalisation levies)**

- 5.2.1. A withholding tax on certain types of digital transactions would impose an additional administrative burden on the buyer / recipient of the digital services who would become liable for part of the tax obligations of the seller / provider of the services. Such withholding tax would also miss every connection with the jurisdiction where value is created and would also come very close to a sales tax.
- 5.2.2. Of all of the proposals for digital taxation, we are most concerned about the economic damage that taxes on turnover could bring. For the same reason as mentioned above (taxation in the jurisdiction where value is created) the digital equalisation levy is not an option that should be pursued. Like the concept of 'significant economic presence' such

levy would aim for the turnover of digitalised enterprises without a link to the value creation in the jurisdiction where the equalisation levy is levied. Moreover such levy could not consider the economic circumstances under which the digitalised enterprises operate and would pose a barrier to economic activity, in particular in markets or activities where the profit margins are already considerably low.

- 5.2.3. Both withholding taxes and equalisation levies would lead to double (/ multiple taxation) and would significantly inhibit the potential of the digital economy to deliver economic growth.

### **5.3. Nexus of “significant economic presence”**

- 5.3.1. The concept of a “virtual permanent establishment” is fraught with difficulty.
- 5.3.2. Unless arbitrary lines are drawn that encourage avoidance and break the neutrality principle, almost anything (and everything) could be a permanent establishment – live chat, an online order form, an interactive catalogue, etc. The result is that the concept of permanent establishment (which has historically required a degree of permanence, and an establishment) no longer seeks to balance the activities in one country with those in another – it simply asserts that there would always be a PE in the sales country.
- 5.3.3. Additionally, a move away from analysis of functions, assets and risks of the taxpayer would need new models for income attribution. In order to remain neutral, these same models would need to be applied to all businesses. It would be a significant challenge to identify such models, and it should not be desirable to do so without undertaking significant analysis on the potential impact on incidence and growth.
- 5.3.4. We consider that a swift move toward such a concept will not be met with universal agreement, and accordingly would expect additional complexity, uncertainty, and double taxation to arise.

## **6. Closing remarks**

- 6.1. Almost all countries have a form of conventional corporation tax with an exemption for international profit, sometimes supplemented by taxing rights on worldwide profits from so-called ‘passive income’, and sometimes supplemented by deduction of notional interest.
- 6.2. We do not believe it is appropriate to abandon these principles, and consider that any changes to their operation should be designed with growth at their heart, with their impact understood, and with global agreement. It will take time to fully examine the issues and understand the full impact of proposed solutions.



- 6.3. We believe that the OECD's Inclusive Framework is well poised to deliver such a consensus to avoid potential unilateral actions that would have a negative impact on cross border trade and growth.
- 6.4. Before making fundamental changes to the tax system, engagement from a wide range of taxpayers and other stakeholders would enable a thorough investigation of the ways that value is created by digitalisation and how that value can be appropriately and efficiently taxed. PwC would welcome further opportunities to engage on this issue.
- 6.5. For any clarification on this response, please contact the undersigned or any of the contacts below. We look forward to discussing any questions you have on the points we raise above. We would welcome the opportunity to contribute to the discussion and to speak at the public consultation meeting to be held in November 2017.

Yours faithfully,

A handwritten signature in black ink, appearing to be 'Stef van Weeghel', written over a horizontal line.

Stef van Weeghel, Global Tax Policy Leader

Stef.van.weeghel@pwc.com

T: +31 (0) 887 926 763

PwC Contacts	Email
Edwin Visser	edwin.visser@pwc.com
Phil Greenfield	philip.greenfield@pwc.com
Pam Olson	pam.olson@pwc.com
Stefaan de Baets	stefaan.de.baets@pwc.com
Emma Purdy	emma.j.purdy@pwc.com
Alenka Turnsek	alenka.turnsek@pwc.com
Joe Tynan	joe.tynan@ie.pwc.com
Aamer Rafiq	aamer.rafiq@pwc.com
Adam Katz	adam.katz@pwc.com
Brad Silver	brad.silver@pwc.com
Helena Hernandez Subias	helenax.hernandez.subias@pwc.com
Isabel Verlinden	isabel.verlinden@pwc.com
Steve Nauheim	stephen.a.nauheim@pwc.com

October 13, 2017

VIA ELECTRONIC SUBMISSION - [TFDE@oecd.org](mailto:TFDE@oecd.org)

Organisation for Economic Co-operation and Development  
Centre for Tax Policy and Administration  
2, rue André Pascal  
75016 Paris  
France

**Re:     Response of the Silicon Valley Tax Directors Group to *Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy***

Dear Sirs and Madams,

The Silicon Valley Tax Directors Group (SVTDG) hereby responds to the Task Force on the Digital Economy's Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy. The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace. SVTDG members are listed in the Appendix of this letter.

SVTDG members acknowledge and appreciate the very considerable outreach efforts and other attention devoted by the Secretariat in recent months on the work of the Task Force on the Digital Economy (TFDE). The TFDE's Request for Input now invites input on a number of important questions to inform its continued deliberations.<sup>1</sup> A number of our member companies have already provided or will provide specific input directly to the TFDE or the Secretariat on their business models or operations, so these comments will focus on points of collective relevance.

The SVTDG requests an opportunity to participate in the November 1 consultation to discuss these issues further.

---

<sup>1</sup> *Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy* (Sept. 2017).

**SVTDG comment letter on TFDE Request for Input on Work  
Regarding the Tax Challenges of the Digitalised Economy**

**Executive Summary**

OECD and G20 member countries correctly concluded in the 2015 BEPS Action 1 Report<sup>2</sup> that the digital economy cannot be ring-fenced. Therefore, although the Action 1 Report permitted the imposition of VAT (or GST) on cross-border business-to-consumer transactions, it wisely refrained from endorsing special direct tax measures for the “digital economy” before reevaluating the matter in 2020. All three of the options now offered for input are, however, special measures intended to ring fence the sector that the Request for Input refers to variously as the “digitalised economy” or the “highly digitalised economy”.<sup>3</sup>

All three options would permit market jurisdictions to impose additional corporate-level tax on the “digitalised economy” sector, on the premise that this would appropriately impose tax where value is created: the jurisdiction in which consumption occurs. The SVTDG respectfully submits that the consumption of goods and services does not create value; the production or development of goods and services does. A commercial sales transaction does not create value; it is merely an exchange of value. This is as true for digital sales of goods and services as for other transactions. Where value is created cannot differ based on whether the good or service is delivered digitally or physically.

Similarly, any value that user data may have arises from its aggregation, organization, and analysis, which does not occur at the user’s location. The collection and analysis of data on customer preferences long predates and is not unique to digital means of doing business in any event. Therefore, we submit that the collection of data does not create value at the location of the user.

Some hold an equally strong view that, at least in the digital or digitalized economy, value is created in the market or consumption jurisdiction.<sup>4</sup> This is inconsistent, however, with current international tax principles and treaty obligations, as embodied in the arm’s length principle and other provisions of the OECD and UN Model Conventions and the bilateral treaties based on them. Even if it were the case that value is created in the consumption jurisdiction, there is no policy justification for singling out the digital economy. In many cases, “digitization” involves the use of technology and automation to increase operational efficiencies or replace routine or administrative functions, which do not fundamentally

---

<sup>2</sup> Final Report on BEPS Action 1, *Addressing the Tax Challenges of the Digital Economy* (Oct. 2015).

<sup>3</sup> We note that the UN recently published a paper noting that some use the term digitalized to reflect the fact that “there is no distinct digital economy, but rather the global economy as a whole has been digitalized.” Secretariat Note for the Committee of Experts on International Cooperation in Tax Matters, *The Digitalized Economy: Selected Issues of Potential Relevance to Developing Countries* (Aug. 2017). The UN paper credits the BEPS Monitoring Group for introducing the term. *Id.* (citing response to the 2014 OECD public discussion draft of *Addressing the Tax Challenges of the Digital Economy, Action 1* (see <https://bepsmonitoringgroup.wordpress.com/2014/04/>, commenting on [www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf](http://www.oecd.org/ctp/tax-challenges-digital-economy-discussion-draft-march-2014.pdf))).

<sup>4</sup> See, e.g., *Political Statement: Joint Initiative on the Taxation of Companies Operating in the Digital Economy*, available at [http://www.mef.gov.it/inevidenza/banner/170907\\_joint\\_initiative\\_digital\\_taxation.pdf](http://www.mef.gov.it/inevidenza/banner/170907_joint_initiative_digital_taxation.pdf); Thomson Reuters Tax Talk, interview with Akhilesh Ranjan at 71st Congress of International Fiscal Association—Rio 2017, available at <https://tax.thomsonreuters.com/tax-talk/>.

## SVTDG comment letter on TFDE Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy

change how enterprises generate revenues. A measure targeting the use of digital technologies would violate the OECD's longstanding policy of neutrality on the means of delivery, agreed in the 1998 Ottawa Framework and reaffirmed in the Action 1 Report.<sup>5</sup> Such a tax would also compound the discriminatory effect of unilateral measures already being applied by some countries to impose a heavier tax burden on digital transactions than on their physical analogues. Neither, we submit, represents good tax policy.

It is not clear that there is even a revenue rationale for endorsing a digital special measure at this time. The Action 1 Report acknowledged that VAT/GST is the appropriate tax to impose by reference to the place of consumption, and widespread adoption of extraterritorial VAT/GST will result in large increases in VAT/GST collections around the world (except in the United States). As for direct tax, the BEPS Project already has had an effect on company behavior, in terms of sales structure reorganization, transfer pricing adjustments, and elimination of stateless income. Like companies generally, many digital enterprise companies are converting from a remote sales model to a commercial model in which revenue is recognized in local reseller entities established in major market jurisdictions. In any event, digital enterprises account for a small part of the total economy, and more data would be needed to evaluate their net revenue effect, if any.

In any event, it would seem imprudent for the OECD to endorse a tax policy that reallocates the corporate income tax base towards the country of consumption. Over time, that policy would shift the income tax base to major importing states globally and for all sectors, negatively affecting most OECD member countries. Any such change would require the development of an international consensus. In other words, a measure to change the direct taxation of digital transactions would need to be accompanied by an explicit agreement from residence jurisdictions (or production/development jurisdictions) to surrender part of their tax base to consumption jurisdictions. We applaud the TFDE and the OECD for opening and leading an explicit discussion of this divisive issue, which could otherwise cause double or multiple taxation that would impede or destroy digital innovation, to the detriment of the global economy.

Finally, proposing a ring-fenced option at this point would run counter to the agreement in the Action 1 Report that the effect of other BEPS measures should first be evaluated before any decision is taken on direct tax measures for the digital economy. That was a prudent judgment that, in our view, remains correct. There is no reason to accelerate this process, which is meant to critically review data when it becomes available and issue a fact-based recommendation in 2020. Departing from that mandate now would signal a lack of faith in the OECD and the G20 as data-driven analytical organizations that can create consensus and set global standards.

### **General Comments on Options**

A first principle for evaluating any proposed income tax on cross-border transactions is that it must honor tax treaty commitments. This was acknowledged in the Action 1 Report.<sup>6</sup> Therefore, all of the

---

<sup>5</sup> See, e.g., reference to *Ottawa Electronic Commerce: Taxation Framework Conditions* in the Action 1 2015 Final Report, Annex C, footnote 9 and accompanying text.

<sup>6</sup> Action 1 Final Report, page 148 (para. 383).

**SVTDG comment letter on TFDE Request for Input on Work  
Regarding the Tax Challenges of the Digitalised Economy**

options advanced for input should be discussed only in the context of modifications to Articles 5 (Permanent Establishment), 7 (Business Profits), and 12 (Royalties) of the OECD and UN Model Tax Conventions and the bilateral treaties based on those Models. Any measure that attempts to circumvent or override tax treaties for purposes of imposing corporate income tax on only one sector would be highly damaging to the integrity of the international tax treaty network. We assume that OECD and G20 member countries, as the guardians and beneficiaries of these treaties, continue to agree with this principle.

Any new tax also would need to be applied to income of all enterprises competing in a sector to avoid anti-competitive and discriminatory effects. Therefore, it would also need to apply to cross-border sales by enterprises not commonly described as “digital economy” enterprises. For example, would the measure apply to distance learning courses provided by a German university to students in remote locations in Africa where such training is not otherwise available? Or to travel services in France or Italy that are purchased online from the United States? Even if the scope of a measure is initially limited, endorsing a new tax only on digital sales or other digital transactions could cause other jurisdictions to regard the taxation of cross-border sales as an accepted international precedent and respond by imposing similar taxes on imports from other sectors.<sup>7</sup>

Even an initially targeted approach also would raise some obvious practical questions, such as how the scope of a targeted measure could be defined clearly enough to enable affected taxpayers to anticipate and comply with their tax liabilities under self-assessment systems. Certainty regarding the scope of any targeted measure would also be critical for tax administrations, which are called upon to administer tax laws in a consistent and equitable manner. These definitional challenges would be as serious for a tax targeting a subset of “highly digitalised” enterprises as for the digitalised economy generally.

We would add that the incidence of the taxes proposed by the current options would fall in many cases on local businesses or individual consumers, undermining any attempt to impose additional tax on foreign enterprises on a general “fairness” rationale.<sup>8</sup> They would also raise the cost of digital services (e.g., cloud services), which are critical to the future growth and competitiveness of the economy and businesses in every country. Such taxes could be particularly harmful for low-income countries and for smaller market jurisdictions generally.

For all of these reasons, we submit that none of the options should be endorsed without a thorough impact assessment.

---

<sup>7</sup> See, e.g., Central Board of Direct Taxes, Department of Revenue, Ministry of Finance, Government of India, *Proposal for equalization levy on specified transactions, Report of the Committee on Taxation of E-Commerce* (February 2016), available at [www.incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf](http://www.incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf), page 100 (citing UK DPT and Australian MAAL measures); 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 21.0.2017 COM(2017) 547, page 9 (citing adoption of unilateral measures by India and Israel).

<sup>8</sup> B. Smith-Meyer, N. Vinocur, & M. Scott, *10 EU Nations Back New Plan to Tax Digital Giants*, Politico (Sept. 21, 2017), available at <http://www.politico.eu/article/ten-eu-nations-back-new-plan-to-tax-digital-giants-google-amazon-facebook/>.

## SVTDG comment letter on TFDE Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy

Finally, the adoption of any new direct tax on digital transactions would need to be accompanied by an international commitment not to impose unilateral measures. The multiple taxation and administrative burdens created by inconsistent unilateral measures are very serious even for large global companies. They are apt to create real barriers to entry for start-ups or other small and medium enterprises (SMEs) and should be given great weight in evaluating potential options.<sup>9</sup> Unilateral measures harm cross-border trade and investment by undercutting the consistency and certainty that the treaty network is designed to provide.<sup>10</sup> This raises an increased threat of double or multiple taxation.

As discussed below, each of the three options offered for comment raises additional policy and practical concerns.

### **Specific Comments on Options**

#### **1. Significant Economic Presence**

We do not believe that there is any policy basis to support the allocation of more taxable income to a jurisdiction on the remote sale of a good or service than would be recognized through a limited risk distribution channel. Such allocations have already been encountered by SVTDG member countries in some jurisdictions, and they presumably would become commonplace under a Significant Economic Presence (SEP) approach unless appropriate safeguards were adopted.

The Request for Input asks an informative question, however: how can “meaningful income” be attributed to an SEP permanent establishment? This would not be possible under the arm’s length principle for a PE without physical presence. Accordingly, any profit attribution result would have to be based on formulary apportionment principles, which have heretofore been soundly rejected by the OECD and the G20 as well as in OECD and UN transfer pricing guidance.<sup>11</sup> The discussion of this option, and of the excessive taxation it could produce relative to other options, should be explicit on that point.

Conversely, any profit attribution approach adopted for SEPs would have to acknowledge that losses will be attributed to the SEP PE in cases where the transactions are not profitable. This is important because emerging digital enterprise businesses normally will be loss-making. In fact, many digitalized enterprises sustain losses for many years, as they seek to establish a stable market presence. There would need to be explicit guidance on the attribution of losses, including a transitional rule allowing the enterprise’s first SEP return to report all accumulated losses to date for prior years. Given the general reluctance of many tax administrations to allow PEs to realize losses, it is not clear how this requirement could otherwise be enforced as a practical matter.

Finally, we would note that compliance obligations under an SEP would be highly burdensome. Any such measure would need to be simple for tax authorities to administer, audit and enforce and also simple for non-residents to comply with, particularly given that they are non-residents and do not have

---

<sup>9</sup> See, e.g., <http://bfmbusiness.bfmtv.com/mediaplayer/video/l-etau-se-resserre-t-il-autour-des-gafa-1309-980599.html> (remarks of Pascal Saint-Amans).

<sup>10</sup> See, e.g., Stephanie Soong Johnston, *Saint-Amans Warns Against Unilateral Moves to Tax Digital Economy*, Tax Notes: Worldwide Tax Daily (Sept. 14, 2017).

## **SVTDG comment letter on TFDE Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy**

a local infrastructure, speak the local language, have local bank accounts, etc. Consideration should be given to how compliance could at least be handled through a local affiliate, if there is one, rather than trying to impose additional compliance options on a foreign entity.

### **2. Withholding Tax**

Gross basis taxation has many disadvantages from a tax policy perspective. As a general matter, any corporate income tax imposed on gross revenue is a poor tax policy decision. Tax imposed on gross revenue has no relationship to net income, which is the only proper base for a corporate income tax. It would, therefore, apply equally to companies regardless of profit margins or even loss positions. Economically, gross basis taxes can operate in a manner similar to tariffs and create the same barriers to cross-border trade and investment. This is why OECD member countries seek to eliminate or reduce withholding tax by treaty and why the EU has adopted directives for the same purpose.

The imposition of new gross basis taxes would presumably exceed tax treaty rate limitations or otherwise be inconsistent with treaty obligations, given that the amounts at issue are normal business profits that should be taxed only on a net basis and to the extent attributable to a PE.

In addition, a tax on gross revenue would disproportionately harm SMEs, many of whom have not yet achieved profitability. The most severe impact on SMEs would be on local digital economy companies, including those still in their start-up phases. This form of tax would damage their prospects for growth.

Any withholding tax imposed on a loss-making company will tend to drive that company out of the market. This would also disadvantage local businesses and consumers if the same goods and services are not otherwise locally available.

Finally, any gross-basis tax would need to be reviewed under international trade obligations, to ensure that it is not a prohibited tariff. Even if it were to pass muster under applicable trade agreements, however, a gross-basis tax would operate like a tariff in effect and have similar negative impacts on cross-border trade.

### **3. Equalization Levy**

An “equalization levy” would effectively operate in the same manner as a tax on gross revenue and apply without regard to profitability. Therefore, all of the above concerns regarding a gross-basis withholding would apply to an equalization levy as well.

If the equalization levy were in fact an excise tax, it would fall outside the scope of tax treaties. However, an excise tax also essentially is a tariff, and may be precluded by international trade obligations.

Excise taxes frequently are passed on to customers, as enterprises need to increase prices to compensate for the resulting erosion of gross profit margins. This could have the same negative effects as noted above.

### **Effects of BEPS Implementation**

The Action 1 Report expressed concern that digitalization had exacerbated direct tax BEPS risks, it anticipated that the implementation of BEPS measures, especially Actions 3, 6, 7, and 8-10, would substantially address those risks. As discussed below, there is already evidence in the public domain of

## SVTDG comment letter on TFDE Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy

widespread changes in response to the other BEPS measures, particularly the permanent establishment and transfer pricing provisions under BEPS Actions 7 and 8-10. Examples of this include the following:

- In July 2017, the OECD reported to the G20 that  
  
“While data that reflects the impact of the BEPS measures is still being collected, anecdotal evidence suggests that they are having an impact to end BEPS practices. In the business community there is a greater focus, at a more senior-level, on tax and reputational risks. Thus, there is less tolerance for arrangements such as the so-called “cash boxes” ...”<sup>12</sup>
- In 2015, Ireland saw a level shift of real GDP of 26%. The Report of Economic Statistics Review Group noted the increase was a consequence of IP onshoring, “with the effect that the net stock capital rose from EUR 479 billion in 2014 to EUR 760 billion in 2015.”<sup>13</sup>
- A recent KPMG study reported that BEPS implementation is forcing multinational enterprises to change their business structures and the location of their property: “BEPS is causing many multinationals to not just reevaluate tax planning, but also where and how they run their business operations.”<sup>14</sup> Indeed, “KPMG’s Global Transformation Study found that 96 percent of organizations are in some phase of transformation.”<sup>15</sup>

It would be premature, however, to try to quantify the revenue effects at this point, as the first post-BEPS tax returns generally will have been filed only this year and will not yet have been audited. In addition, the restructuring of operations and reexamination of global transfer pricing policies in response to BEPS could not commence until the BEPS Reports were released, and some large operations are still completing the required systems changes and other implementation steps. Therefore, although we appreciate that the TFDE must deliver an interim report, it would be prudent for that report to refrain from drawing conclusions on the effects of other BEPS measures and evaluate those effects in the 2020 report, as agreed in the Action 1 Report.

### VAT/GST Implementation

SVTDG members welcome the publication by the OECD in April of this year of International VAT/GST Guidelines.<sup>16</sup> Where extraterritorial VAT/GST is imposed, it is vital that the OECD continue to advocate and promote the adoption of uniform regimes. International compliance with VAT regimes becomes prohibitively expensive when there is a patchwork of regimes around the world. When the regime is straightforward, voluntary compliance is likely to be higher, which in turn results in more tax collected.

---

<sup>12</sup> OECD Secretary-General Tax Report to the G20 Finance Ministers, Hamburg, Germany (July 2017), page 13, available at <http://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-leaders-july-2017.pdf>.

<sup>13</sup> Seamus Coffey, *Review of Ireland’s Corporation Tax Code*, page 125 (June 2017).

<sup>14</sup> Brett Weaver and Jerry Thompson, KPMG, *The BEPS Ripple Effect*, page 2 (2017).

<sup>15</sup> *Id.* at 6.

<sup>16</sup> Available at <http://www.oecd.org/ctp/international-vat-gst-guidelines-9789264271401-en.htm>.

**SVTDG comment letter on TFDE Request for Input on Work  
Regarding the Tax Challenges of the Digitalised Economy**

Digital invoicing and record keeping can help keep VAT compliance costs down and thereby encourage voluntary VAT compliance.

It is imperative that the penalties for misreporting VAT registration numbers to document the transaction as a B2B sale be imposed on the reporting entity rather than the nonresident enterprise. This would incentivize the party with the best information—the VAT-registered company—to report correctly. This approach would be consistent with the extraterritorial Australian and New Zealand GST regimes.<sup>17</sup>

\* \* \*

Thank you again for the opportunity to provide these comments. We would be pleased to discuss these important issues with the TFDE as it continues its work.

Yours sincerely,

/signed/

Robert F. Johnson

Co-Chair, Silicon Valley Tax Directors Group

---

<sup>17</sup> See Taxation Administration Act 1953 § 284-75(4)(b); Goods and Services Tax Act 1985 § 8B.

## Appendix—SVTDG Membership

Accenture	Integrated Device Technology, Inc.
Activision Blizzard	Intel Corporation
Acxiom Corporation	Intuit, Inc.
Adobe Systems, Inc.	Intuitive Surgical
Advanced Micro Devices, Inc.	KLA-Tencor Corporation
Agilent Technologies, Inc.	Lam Research Corporation
Amazon.com	LinkedIn Corporation
Apple Inc.	Marvell Semiconductor, Inc.
Applied Materials, Inc.	Maxim Integrated
Autodesk	Mentor Graphics
Bio-Rad Laboratories, Inc.	Microsemi Corporation
BMC Software	Microsoft Corporation
Broadcom Limited	NetApp, Inc.
Brocade Communications Systems, Inc.	Netflix, Inc.
Cadence Design Systems, Inc.	Oracle Corporation
Chegg, Inc.	Palo Alto Networks, Inc.
Cisco Systems, Inc.	Pandora Media, Inc.
Dolby Laboratories, Inc.	PayPal Holdings, Inc.
Dropbox Inc.	Pivotal Software, Inc.
eBay, Inc.	Plantronics, Inc.
Electronic Arts	Pure Storage, Inc.
EMC Corporation	Qualcomm, Inc.
Expedia, Inc.	Rovi Corporation
Facebook, Inc.	salesforce.com
FireEye, Inc.	SanDisk Corporation
Fitbit, Inc.	Sanmina-SCI Corporation
Flextronics	SAP
Fortinet	Seagate Technology
GE Digital	ServiceNow, Inc.
Genentech, Inc.	Snapchat, Inc.
Genesys	Symantec Corporation
Genomic Health, Inc.	Synopsys, Inc.
Gilead Sciences, Inc.	Tesla Motors, Inc.
GitHub	The Cooper Companies
GLOBALFOUNDRIES	The Walt Disney Company
GlobalLogic, Inc.	Trimble Navigation Ltd.
Google, Inc.	Twitter, Inc.
GoPro, Inc.	Uber Technologies
Groupon	VMware Corporation
Harmonic	Xilinx, Inc.
Hewlett-Packard Enterprise	Yahoo!
Hewlett-Packard Company	Yelp, Inc.
Ingram Micro, Inc.	

S.J.D. Candidates  
Graduate Tax Program  
Levin College of Law  
University of Florida  
309 Village Drive  
Gainesville, FL 32611  
UNITED STATES OF AMERICA

13 October 2017

**VIA EMAIL**

The Organisation for Economic Co-operation and Development  
Task Force on the Digital Economy  
2, rue Andre Pascal  
75775 Paris Cedex 16  
France  
[TFDE@oecd.org](mailto:TFDE@oecd.org)

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

Dear Members of the Task Force on the Digital Economy,

This letter is submitted by and on behalf of the following Doctor of Juridical Science in Taxation Candidates at the University of Florida Levin College of Law Graduate Tax Program: Musaad F Alwohaibi, Debora S. Correa Talutto, Dalton Dallazem, Christine Davis, Bredan Fawzi, Aishwarya Krishna Iyer, Monica R. V. Oliveira and Abdullah A. Almudayhim (collectively the “S.J.D. Candidates”). We are a diverse group of students originating from a wide range of countries including Brazil, Libya, India, Saudi Arabia and the United States of America. However, we are similar in that our academic studies focus on International Tax Law. We appreciate the opportunity to respond to the OECD’s “Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy” (the “Request for Input”). Specifically, we are responding to the question set forth in Section 3.B.2.b) of the Request for Input, which states *“Digitalisation raises a number of challenges and opportunities for the current international tax system. In particular . . . [w]hat opportunities to improve tax administration services and compliance strategies are created by digital technologies?”*

Technology touches almost every aspect of our lives today. It can be our best friend and our worst enemy. When technology works it can save us massive amounts of time and money, completing tasks that can take weeks or months in a matter of minutes. On the other hand, few things utilize as much time and energy as trying to make technology work under adverse circumstances. In addition, for all of its good, technological change is “disruptive.”<sup>1</sup> Technology

---

<sup>1</sup> ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TECHNOLOGIES FOR BETTER TAX ADMINISTRATION: A PRACTICAL GUIDE FOR REVENUE BODIES 24 (2016) [hereinafter OECD TECHNOLOGIES],

creates new methods of conducting business and of operating in society, which can displace or replace “old-fashioned” methods when existing methods fail to adjust to the changed environment.<sup>2</sup> This type of disruption is not foreign to tax administrations.<sup>3</sup> Laws and regulations designed to tax the provision of physical goods and services developed during the past century just do not translate well to tax digital products, which do not rely on a physical place to provide goods and services.<sup>4</sup>

Yet, tax administrations can also benefit significantly from the use of digital technology. Digital technology has the potential to revolutionize how tax administrations operate and provide services to taxpayers.<sup>5</sup> The tax administrations of governments from around the world have used technology in numerous ways to improve the efficiency and quality of their operations.<sup>6</sup> These techniques include (a) allowing e-filing of tax returns; (b) providing citizens with pre-populated tax forms, which are tax returns completed by the government using data provided by 3rd parties, such as employers, banks and financial advisors; (c) requiring mandatory digital accounting and record keeping; (d) utilizing data analytics (a.k.a. “Big Data”), which allows governments to collect and analyze massive amounts of data from government and public sources on a real-time (or near real-time) basis, and target resources toward situations with the highest risk of compliance errors; (e) creating internet portals that provide links to other websites with information relevant to the taxpayer; (f) requiring electronic invoicing for specific types of business transactions, such as those necessary to implement a VAT system; and (g) creating automatic prompts to remind taxpayers to perform specific actions by the requisite deadline.<sup>7</sup> By using technology, the tax administrations hope to increase tax revenue and tax compliance, decrease tax avoidance and evasion, and reduce its operational costs.<sup>8</sup> The remainder of this paper will present some examples where governments have used technology to improve and innovate their tax administration. We hope our comments are helpful to you as you continue to research, analyze, develop and draft the interim report regarding tax challenges of the digitalised economy.

---

available at [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/technologies-for-better-tax-administration\\_9789264256439-en#\\_WdrxI0yZMcg#page13](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/technologies-for-better-tax-administration_9789264256439-en#_WdrxI0yZMcg#page13).

<sup>2</sup> OECD TECHNOLOGIES, *supra* note 1, at 23, 24-25.

<sup>3</sup> OECD TECHNOLOGIES, *supra* note 1, at 25.

<sup>4</sup> Jay Nibbe, Technology: A Taxing Exercise, 14 Ernst & Young Tax Insights for Business Leaders 3 (2015), available at [http://www.ey.com/Publication/vwLUAssets/EY-tax-insights-for-business-leaders-issue-14/\\$FILE/EY-tax-insights-for-business-leaders-issue-14.pdf](http://www.ey.com/Publication/vwLUAssets/EY-tax-insights-for-business-leaders-issue-14/$FILE/EY-tax-insights-for-business-leaders-issue-14.pdf).

<sup>5</sup> ICAEW INFORMATION TECHNOLOGY FACULTY, DIGITALISATION OF TAX: INTERNATIONAL PERSPECTIVES 3, 4 (2016) [hereinafter ICAEW DIGITALISATION OF TAX], available at <https://www.icaew.com/-/media/corporate/files/technical/digital-tax.ashx?la=en>; OECD TECHNOLOGIES, *supra* note 1, at 11, 25.

<sup>6</sup> ICAEW DIGITALISATION OF TAX, *supra* note 5, at 16-28; ERNST & YOUNG, TAX ADMINISTRATION IS GOING DIGITAL: UNDERSTANDING THE CHALLENGES AND OPPORTUNITIES 6-10 (2016) [hereinafter EY GOING DIGITAL], available at [http://www.ey.com/Publication/vwLUAssets/EY-tax-administration-is-going-digital-understanding-the-challenges/\\$FILE/EY-tax-administration-is-going-digital.pdf](http://www.ey.com/Publication/vwLUAssets/EY-tax-administration-is-going-digital-understanding-the-challenges/$FILE/EY-tax-administration-is-going-digital.pdf); Matt Mossman, Tax Administration Gets a Makeover, 14 Ernst & Young Tax Insights for Business Leaders 34-35 (2015), available at [http://www.ey.com/Publication/vwLUAssets/EY-tax-insights-for-business-leaders-issue-14/\\$FILE/EY-tax-insights-for-business-leaders-issue-14.pdf](http://www.ey.com/Publication/vwLUAssets/EY-tax-insights-for-business-leaders-issue-14/$FILE/EY-tax-insights-for-business-leaders-issue-14.pdf).

<sup>7</sup> ICAEW DIGITALISATION OF TAX, *supra* note 5, at 3, 7, 8-10; EY GOING DIGITAL, *supra* note 6, at 1-2.

<sup>8</sup> ICAEW DIGITALISATION OF TAX, *supra* note 5, at 3, 7; EY GOING DIGITAL, *supra* note 6, at 1-2.

## **1. The Gulf Cooperation Council (GCC) Countries**

The impending introduction of Value Added Tax (VAT) to the GCC governments which is expected to come into effect in the first quarter of 2018 will present a number of challenges for businesses operating in the region. Each member state of the GCC will establish its own separate national legislation concerning the VAT system and the detailed compliance requirements and set of rules will be outlined in the respective legislation of each country. Leaders in the region have recognized that digital can impact their nations as it contributes to economy growth and the society as a whole. The United Arab Emirates leads the GCC in digital adoption having implemented core digitization initiatives that matches the world's digital vanguard on several metrics. One of the main obstacles that encounters GCC countries and makes a VAT system hard to implement is the inadequate governance digital structure to achieve the desired change. However, in the meantime digital technologies are already transforming the GCC countries and they are spreading at an accelerated speed. To accelerate the adoption of digital across an entire nation there has to be strategic coordination of multiple stakeholders. Government, business, funding, and talent are four crucial players that can lead to a transferal change.

## **2. Latin America countries**

### **a. Mexico**

Since 2011, Mexico has introduced regulations requiring taxpayers to start using electronic invoices in their transactions. This legislation was updated in 2013<sup>9</sup> to require all companies with annual revenues above MXN 250,000 to transition to the government standardized e-invoicing system.

Mexico has been using automation to increase compliance and facilitate audits, which are now conducted electronically.<sup>10</sup> Taxpayers must maintain electronic accounting records,<sup>11</sup> and E-invoicing with validation from the tax authorities is mandatory. The so called "CFDI" (Comprobantes Fiscales Digitales por Internet) is the electronic billing schema defined by the Mexican federal tax code which has been mandated for companies doing business in Mexico since 2011.

Digital tax technology has improved significantly the Mexican self-assessment system whereby all companies are required to complete a tax return and compute their own liability. Mexican Tax authorities can reconcile digital tax receipts from electronic billing with accounting records, because they have created an environment in which everything is tied to an XML format and it must contain a stamp used to verify the origin of the e-invoice and its authenticity (called "Sello Digital Certificado").

---

<sup>9</sup> Segunda Resolución de Modificaciones a la Resolución Miscelánea Fiscal para 2013,

<sup>10</sup> The Mexican tax authority (SAT) published new Annex 20 of the Fiscal Miscellaneous Resolution for 2017, listing the specifications to be included in the online digital tax voucher effective 1 July 2017.

<sup>11</sup> Fraction III of article 28 of the FTC requires taxpayers to maintain electronic accounting records. According to rule I.2.8.6., taxpayers must maintain accounting records through electronic systems that can create XML format files.

## **b. Ecuador**

In Ecuador, all tax returns have to be filed electronically and submitted to the SRI through the Internet since 2013.

As from January 2015, the Ecuadorian tax authorities (called Servicio de Rentas Internas - “SRI”) issued special e-invoicing regulations requiring companies to sign their e-invoices using digital certificates issued by the tax authorities<sup>12</sup> and these e-invoices must be validated online through the SRI platform. Similarly to Mexico, the standard format of the e-invoice is XML.

On 17 August 2017, the SRI issued Resolution No. NAC-DGERCGC17-00000430 explaining the details regarding the new electronic invoice, which must be downloaded from the SRI website.

The new electronic invoice is applicable to a wider range of taxpayers, including individuals and companies whose revenue for the previous tax year is equal to or greater than the income threshold above which accounting records must be kept (USD 340,000 for 2017) and at least 50% of the income is derived from transactions carried on with exporters. Note that Public entities must comply with the provisions of the Resolution and require from their suppliers the electronic issuance of vouchers, receipts of taxes withheld and complementary documents.

## **c. Brazil**

Among the countries that are leading the digital revolution, Brazil is one example where a multilayered tax and accounting digital platform has demonstrated to be very beneficial for the tax administration. The 42nd Amendment to the Brazilian Constitution, approved in 2003, states that the tax administrations of the Union, the States, the Federal District and the Municipalities shall act in an integrated manner, including the sharing of records and tax information.

In January 2007 the Brazilian Government enacted Decree 6,022 establishing the Public System of Digital Bookkeeping. In Brazil, the public digital bookkeeping system (SPED)<sup>13</sup> allows the flow of information among different government authorities at the federal and state levels, granting the Brazilian tax authorities rapid access to a greater amount of taxpayer data. The system consists of an instrument that unifies the activities of reception, validation, storage and authentication of books and documents that compose the accounting and fiscal bookkeeping of business and legal entities, including exempt, through a single and digital information. Due to the Implementation of SPED, and the collaboration between the Brazilian Central Bank and the Brazilian Revenue Service, it is important to note that the number of audits and the amount of tax revenue has increased significantly since 2012. However, the digital tax revolution in Brazil might be frustrating to some taxpayers due to the complexities of the Brazilian tax system and the high compliance burden created by the enormous amount of forms to be submitted.

---

<sup>12</sup> Tax authorities or some authorized entities (called “Digital Certificate Entities”).

<sup>13</sup> Normative Ruling #787/07, created the so-called “SPED”—Public System of Digital Bookkeeping, which had the objective to integrate finance and tax information enabling the tax authorities to cross check tax returns and accounting records instantly.

The Brazilian Public Key Infrastructure (ICP-Brasil), also launched in 2001 by the Brazilian Government, is the digital platform that guarantees the authenticity, integrity and legal validity of documents in electronic form, as well as the realization of secure electronic transactions, through the use of digital certificates.

The users of the system are: (i) the Department of Federal Revenue; (ii) the tax administrations of the States, Federal District and Municipalities, through an agreement entered into with the Department of Federal Revenue; and (iii) the organs and entities of the direct and indirect federal public administration that have legal attribution of regulation, control and inspection of business and legal entities, including exempt.

Access to information stored in the digital system shall be shared with its users, within the limits of their respective competences and without prejudice to compliance with the legislation regarding commercial, fiscal and banking secrecy. The access will also be possible for business and legal entities, including exempt, in relation to the information transmitted by them to the system.

In 2017 the total of business and legal entities that have filed their fiscal and accounting documents reached 833,024. A large number of small business is not yet required to file through the system.

The system encompasses the following digital platforms: Digital Accounting Bookkeeping, Fiscal Accounting Bookkeeping, Digital Tax Bookkeeping, Electronic Invoice System and the so-called “eSocial” System.

### **c.1. Digital Accounting Bookkeeping**

The Digital Accounting Bookkeeping aims to replace the paper bookkeeping by the bookkeeping transmitted by file. In other words, it corresponds to the mandatory transmission, in digital version, of the following books: (i) transaction ledger and its auxiliaries, if any; (ii) general ledger and its auxiliaries, if any; (iii) daily summary balance sheets, balance sheet and vouchers of accounting entries.

### **c.2. Fiscal Accounting Bookkeeping**

The tax payer shall inform in the Fiscal Accounting Bookkeeping all the transactions that influence the composition of the taxable income for the purposes of Corporate Income Tax and the Corporate Income Social Contribution.

### **c.3. Digital Tax Bookkeeping**

The Digital Tax Bookkeeping is a digital file consisting of a set of tax documents and other information related to the consumption taxes and social contributions levied on the business entity gross revenue. It is of interest to the tax authorities of all levels, i.e., the Department of Federal Revenue and the tax administrations of the States, Federal District and Municipalities.

#### **c.4. Electronic Invoice System**

Perhaps the most important digital technology adopted by the Brazilian tax authorities, the electronic invoice has the purpose of implementing a national electronic tax document model to replace the paper issuance system. It covers the transactions with goods and services between companies and between companies and consumers, reducing costs, simplifying tax compliance and at the same time allowing real-time monitoring of business operations by the Treasury.

#### **c.5. “E-Social” System**

Decree 8373/2014 created the Digital Bookkeeping System for Tax, Social Security and Labor Obligations (eSocial). Through this system, employers will communicate to the Government, in a unified form, information related to workers, such social security contributions, payroll, and other tax relevant information.

The electronic transmission of such data aims to simplify the provision of information regarding tax, social security and labor obligations, in order to reduce bureaucracy for companies. The provision of information to “eSocial” will replace the completion and delivery of separate forms by each entity.

The implementation of “eSocial” will make it possible to guarantee the compliance with social security and labor rights, rationalize and simplify the fulfillment of obligations, eliminate redundancy in information provided by individuals and companies, and improve the quality of labor, social security and tax information. The legislation also provides for differentiated treatment of micro and small enterprises.

#### **c.6. Improvements to the Tax Administration**

The legislation, processes and new methods of the “SPED” system have brought companies and the Treasury a high degree of modernization, placing Brazil at the forefront of the world in technology applied to fiscal obligations and business processes of accounting and tax reporting at governmental levels. It helps to improve the business environment in Brazil through increasing competitiveness between companies because it reduces unfair competition by wrestling tax evasion. The result is an increasing in all of tax revenue levels.

Among others, the implementation of the “SPED” brought the following improvements to the Brazilian tax authorities, such as:

- 1) Artificial Intelligence: Member State will have to install the most up-to-date Artificial Intelligence software that will be able to ensure that all tax transactions that accrue in each Member State are legitimate;
- 2) Costs reductions with the print and storage of paper documents;
- 3) Homogenization of the information that the taxpayer provides to the various federated units;
- 4) Reduction of involuntary involvement in fraudulent practices;
- 5) Reduction of the time spent with the physical presence of tax auditors at the taxpayer's fiscal domicile;
- 6) Simplification of the procedures subject to the control of the tax administration (foreign trade, special regimes and transit between units of the federation);
- 7) Strengthening control and oversight through the exchange of information among tax administrations;
- 8) Speed in access to information;
- 9) Increase auditor productivity by eliminating the steps for collecting files;
- 10) Possibility of exchanging information among the taxpayers themselves from a standard layout;
- 11) Reduction of administrative costs;
- 12) Improvement of the quality of information;
- 13) Possibility of crossing between accounting and fiscal data;
- 14) Availability of authentic and valid copies of bookkeeping for different and concomitant uses; and
- 15) Improving the fight against tax evasion.

The development of the so-called “digital certification”, despite being an instrument to the performance of the “SPED” system, also resulted in improvements to the Brazilian Tax Administration. Since the electronic transactions require the adoption of security mechanisms able to guarantee authenticity, confidentiality and integrity of the information, digital certification is the technology that provides these mechanisms. At the heart of digital certification is the digital certificate, an electronic document that contains the name, a unique public number called the “public key”, and many others data, which show to people and to information systems who are the users of the certificate. The public key is employed to validate a signature made in electronic documents. Therefore, digital certification has brought countless benefits to institutions that adopt it. With the digital certification, it is possible to use the Internet as means of alternative communication for the provision of various services with a greater agility, easier access and substantial cost reduction.

## **Conclusion**

Digitalization is here to stay. On one hand, digitization not brings with itself opportunities to allow base erosion and profit shifting, they also bring challenges including automation and standardization. On the other hand, the same digital technology could be used to provide for “E-filing” and “E-accounting”, to allow tax authorities to match the digital data and produce electronic tax assessments. However, these technologies are the first tool to reduce base erosion and profit shifting, since they reduce the burden on the tax authorities and they facilitate the tax audit process.

The purpose of this letter is to showcase how various countries over the globe are using digital technology to help them assist with tax administration and compliance. The paper presents various tools implemented in other countries and how it can be applied to other G20 countries. The best example here could be how India, who is in the prime stages of implementing VAT, could borrow 'digital tool' from Gulf countries.

## Sony Responses to OECD Request for Input on “Tax Challenges of the Digitalised Economy”

### A. Digitalisation, Business Models and Value Creation

A.1 Our businesses (Music and PlayStation) are “content driven”. In other words, we develop unique content and distribute it globally. In the digitized economy, we distribute it directly to consumers and we also license it to third party digital service providers who distribute it to the consumers. The means and location of developing the content is not impacted by the move to a digital distribution model. The supply chains are different because when our content was distributed in a physical format, we needed production facilities for the CD/DVD/BluRay products, warehousing and logistics. We had risk of damage and obsolescence. All of these added to the cost structure. In the digital world we don’t have these costs. However, in the digital world, the consumer has the option to consume our products in smaller quantities. For example, they can download one song or listen to one song on a streaming channel rather than purchase an entire CD. Similar in the PlayStation business, there is a significant growth in simple low cost mobile games. This has meant that the pricing structure for the industry has also changed. This had a significant impact on the overall economics of the business and the industry as a whole has been impacted. Thus, the advantages of the cost savings largely went to the consumers in the form of lower pricing and more purchase options.

A.2 In our businesses, the IP value has historically and continues to be in the content itself. The digital portion of the business has largely changed the distribution of the content. In the PlayStation business, the content can be enjoyed differently over the internet and that involves some patent and IP development to create that functionality. But ultimately, the content itself is the main profit driver.

A.3 The digitalization has impacted the way we sell our product as noted above. However, our marketing efforts continue to be focused on the end consumer in much of the same way as the past through a variety of media and promotional outlets.

A.4 We receive data when we sell over the internet directly or through third party digital service providers. This data helps us to target our marketing and promotional efforts to the consumers most likely to be interested in buying our products. The data collected includes a whole host of information including, individual characteristics, past purchases, viewing patterns, etc.

A.5 We have used such architecture in our PlayStation business to allow online playing and competitions (with both participation and viewing opportunities). This allows our customers to expand how the Game business is enjoyed.

A.6 It is very hard to predict where these advances will take us. We see changes every day with new services and ways consumers can enjoy our content as a result of the digital economy.

### B. Challenges and Opportunities for Tax Systems

B.1 One of the major challenges we face is transfer pricing. Many countries do not understand that the economics of the business have changed (when you distribute content digitally) and

they don't understand that functions of our local distribution affiliates have changed. Historic benchmarking may no longer be comparable to the activity actually undertaken at the local level.

B.2 Current taxation frameworks can still be applied to digital businesses like ours but with a revised understanding of what functions are still being performed and at what location. Digitalization allows more functions to be centralized which provides economies of scale. This does NOT necessarily mean that profits have shifted. It may mean that prices to consumers have been reduced. This centralization may be necessary for the survival of the business. Governments should NOT equate revenues to profits.

C. Implementation of the BEPS package

C.1 It is still too early to assess the full impact. We believe that we are likely to see more tax disputes and the potential for more incidences of double taxation as a result. We believe that more countries will revert to "source based taxation" proposals as a way to counteract the changes in their economies as a result of the centralization of the functions described above. We think this will have a negative impact on the growth of these businesses.

C.2 We believe that these rules need to be clear and administrable. There should be common definitions for sales, license or services so that the appropriate rates are known and can be applied and multiple levels of taxation on the same end to end transaction should be avoided. Sourcing rules should also be clear with a presumption used for location of the end consumer, like a credit card billing address.

In addition, on the B2B elements of a content supply chain, we are seeing non-local entities being pulled into the local VAT net for what we would regard as non-local transactions. For example for 'Country X' content licensed to a US entity and included in the global licensing deal with a US digital service provider; to the extent an end sale is made online to a 'Country X' customer the 'Country X' rules require 'Country X' VAT to be applied to the entire supply chain drawing multiple international entities into the 'Country X' VAT scope. It is not realistic to expect legal entities to be VAT registered and to file VAT returns in countries all around the world when the net VAT collection might only apply on the subscription transaction with the customer.

D. Options to address the broader direct tax policy challenges

D.1 (a) Tax Nexus We believe that concepts like "significant economic nexus" should be avoided as they are open to interpretation. Because Tax Nexus creates a legal obligation to file a tax return in a country it should be a very clear test and should be tied to an economic transaction that occurs within the jurisdiction. The connection to the jurisdiction should be more than just online data collection and consumer marketing research.

(b) Withholding Tax If the withholding tax is creditable in another jurisdiction, then it becomes a division between source and residence taxation that can be agreed by the governments. However, without that, it becomes gross revenue taxation which is an

incremental burden that many of these businesses cannot absorb and it will ultimately increase prices to consumers.

Even where WHT is creditable in concept, practically there are many instances where full credibility is not achieved. For example, Sony distributes content digitally for which there are multiple IP rights holders and, therefore, the supply chains involve multiple parties/countries for valid commercial reasons. The margins retained by any particular entity from the collection of revenues may not be sufficient to claim a full WHT credit for the tax withheld on gross revenues. Leakages from WHT may be passed on to the IP owners through 'net of WHT' payments such that those IP owners themselves have no right to claim WHT credits (hidden WHT). All of this eventually is likely to lead to increased prices to consumers to cover the double tax burden.

(c) Digital Equalisation Levy Again, this will be a form of gross revenue taxation and will ultimately lead to an increase in prices to consumers.

In addition, any rules that are adopted should be clear and administrable.

D.2 We are very concerned about the proliferation of unilateral approaches in this area. This will lead to double taxation. In some cases these are designed to be punitive taxes, new transactional taxes or disallowances of deductions under local law that may not be eligible for competent authority relief under treaties. This is a great concern for us.

E. Other comments

We have none at this time.

## **Request for input**

*Spotify thank the TFDE for the opportunity to respond to the Request for Input of September 27 to further support the work of the TFDE. We request an opportunity to elaborate on the points made at the Public Consultation held November 1 in California.*

*Spotify is a member of the Digital Economy Group (DEG) who represented by Baker Mckenzie Palo Alto has submitted responses to this request. Spotify is fully aligned with and endorses the responses provided by the DEG, and the below are additional and supplemental response from Spotify.*

*Spotify was established to combat music piracy – offering a better alternative to consumers - while ensuring the artists got paid for their art/creations. On this background it is obvious that we do not endorse aggressive tax planning of the types that BEPS was created to combat and we have not engaged in such. Neither Spotify, nor many of the companies that would be subject to any special measure aimed at taxing a selected group of multinational enterprises engaged in so-called “highly digitalized business models” has engaged in the practice the special measures are intended to address. Never the less as currently proposed all off these measures would also cover Spotify and create substantial disruptions to our operations.*

*The developments and debates around taxation of “highly digitalized business models” is of substantial concern to us. Some governments appear to see “fair” taxation as working only one way – the “digital” enterprises that operate in many markets, should be paying tax without any substantiation in value creation and realized income.*

*Spotify does not agree that “digital” enterprises should be subject to special and differential tax rules. Today “digital” is part of all enterprises big or small. Local or international. “Digital” business cannot be separated from “other” business as they are one and same – in varying degrees yes but inseparable. The BEPS actions 2-15 have in our view created a very solid basis (not perfect but impressively good given the time to development and the extreme complexity of the matters addressed) which given time to take effect, will ensure that income generated by international business is taxed where the value giving rise to the income has been created.*

*Any departure from the fundamental – and internationally agreed – principle that income should be taxed where the value giving rise to the income has been created, and from the arm’s length principle, will create very serious issues for the global economy, growth, employment and welfare. This is most evident when taxation is based on anything other than realized profits. Withholding taxes and so-called “equalization” levies which are based on gross payments disregarding whether the transactions have given rise to any profit at all will cause serious damage.*

*Governments want multinational enterprises to pay their “fair” share of taxes and Spotify agrees with this goal. But it can only be achieved through the principle of taxation in line with value*

*creation. Many enterprises have already taken substantial steps to align with BEPS. For Spotify, we have taken the few additional steps necessary to fully align with BEPS proposed guidelines—without making any change in how income is allocated, because our practices of income allocation always has been aligned with where the value is being created.*

*Therefore Spotify urge all participating governments to refrain from taking immediate actions and wait for additional evidenced of the effects of BEPS. We are confident that given a few short years the effects of BEPS will be clear and show that the objective to substantially reduce/eliminate aggressive tax planning has been delivered.*

*—If all participating governments determine that short-term action is needed, we strongly recommend that any is based on taxing only realized income. Further any solution based on realized income should ensure this income is taxed only once. These requirements are only fair and reasonable – nobody should pay taxes without an income from which the tax can be paid.*

*Lastly we would like to stress that the effect of any taxation not based on realized income will have serious negative global effect on growth, employment and welfare. These negative effects will be incurred by both customers and businesses, and will be especially acute for start-up's, small and medium sized companies.*

## **A. Digitalization, Business Models and Value Creation**

A.1 The process of digitalization 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

*We have no additional comments to add to what has been provided to the OECD earlier by Spotify and many other stakeholders in written responses and/or in various face – to – face meetings.*

A.2 Highly digitalized business models are generally heavily reliant on intangible property (IP) to conduct their activities. 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.)?

*We agree that highly digitalized business models rely substantially on, intangible property (IP) – broadly defined. However, we do not believe highly digitalized business models fundamentally are more reliant on IP than less digitalized business models.*

*In the case of Spotify, different types of copyrights and our brand are most important to our business. These IP rights are relevant in three ways: 1. Technology/product/design (basically the app and its functionality) – IP being software copyright, 2. Content and data analytics – copyright and neighboring rights associated with the sound recordings, audio-visual works and images 3. Brand in its different forms.*

A.3 Digitalization 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 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?

A.4 Digitalization 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 digitalized business models, and what types of data are being collected and analyzed?

*Data certainly plays a role in all highly digitalized business models but exactly which role varies between the different highly digitalized business models. Data also plays important roles in less digitalized business models.*

*The value of data – regardless of whether your business model is highly digitalized or not – comes from;*

- *determining of which data points are relevant for the specific business to collect*
- *developing the systems/software to collect and store the data*
- *creation of the tools to analyze the data and the performing of the analysis*
- *the actual use of the analyzed data in combination with other relevant factors to make decisions adding value to the business*

*Data has no value whatsoever in its own right. It is collection, structure, analysis and its interpretation and business application that give value..*

*Spotify collects data to improve the user's experience. In every instance we collect, analyze and store the data in compliance with applicable laws and our terms of services agreements with our customers. The value for Spotify coming from data is created by our excellent data analysts and the management teams who base their decisions on the results of the collection and analysis of the data.*

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 digitalized business models, and what are the potential implications for value creation?

*We are not fully sure what is meant by this question but think it relates to “user engagement”.*

*For Spotify user engagement is a part of the complex value creation process of our business model(s). Learning about user engagement means that Spotify can learn more about the individual user and then improve the individualization of our service offers.*

A.6 The digitalization 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).

*We have no further to add to what has been provided to the OECD earlier by Spotify and many other stakeholders in written responses and/or in various face – to – face meetings.*

## **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 certainly agree with the OECD that this is a most relevant topic and that the issues with the current international taxation framework are many and big and many. We believe the discussion and analysis of these should be held separately from the topics under discussion here. Spotify is happy to engage in such separate analysis and discussion and share our experience and suggestions for improvement..*

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

a) What are the implications of highly digitalized 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?

*“Highly digitalized business” is run by same principles as less digitalized business models; The business who has the best product/service at the right time at the best price wins. It is really no more complicated that this – also true in “highly digitalized businesses”*

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

*The meaning of this question is unclear to us. If the question refers to taxation of profits qualified as business profits under Article 7 of the model treaty our comment is that digital services which clearly fall under the business profits definition often give rise to withholding tax issues although this should not be the case. We use substantial resources working with our partners globally to arrive at the correct treatment of payment for the Spotify service – namely that of business profit not subject to withholding tax.*

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

*We certainly believe that there are many opportunities to improve tax administration services and raise compliance through the use of digital technologies. However, also this topic should be the subject to separate analysis and discussions in which Spotify also is happy to participate.*

## **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 digitalization? 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?

*The impact of implementation of VAT/GST on supply of digital services by foreign suppliers varies from country to country (several countries had these taxes prior to the BEPS Action 1 recommendations).*

*Consumption taxes can be levied in ways that are very efficient and does not impose unreasonable and costly compliance burden on the foreign service provider. Examples of best practices are:*

- *EU – the MOSS*
- *Norway; Electronic filing, English, Electronic sign-off*

*The consumption taxes can also be levied in ways that do impose unreasonably cumbersome and costly compliance burdens. Examples of these practices include;*

- *Iceland; Mandatory legal representative, Physical filing, poor language customization*
- *Switzerland;*
- *Taiwan*

## **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 digitalization. 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?

*In our opinion it is not possible or meaningful to define only certain transactions to be included in the scope of significant economic presence (SEP)*

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

*We believe that the whole discussion about SEP simply is a discussion about whether value in addition to consumption is created simply by the presence of a “market”. We strongly believe that if the only value attributable to the “market” is consumption which then can be - and in almost all major countries is - taxed through consumption taxes (VAT, GAT & Sales Tax etc.).*

*We further believe that the current – after BEPS – definition of Permanent Establishment (PE) in Article 5 of the Model Convention is meaningful and together with economically sound principles of income allocation will ensure corporate tax being paid in accordance with the value created by the PE.*

(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?

*No value is added by mere significant economic presence (SEP), in effect the mere act of providing services in a particular territory. Applying the well established and agreed principle of taxation of profits where value is created, no income should be attributed to mere “digital presence”.*

*Attributing income to mere a SEP would be a departure from the arm’s length principle. Attribution of income or loss (which also needs to be attributed) to a “digital presence” can only happen through formulary apportionment. In that situation, it would be necessary to develop new international agreements about how much of an enterprise’s consolidated income/loss should be allocated to SEP in a specific country. Such agreements would need to ensure the consolidated profit of the enterprise only is taxed once and that losses are treated similar. Any profit allocated to SEP’s” should thus give rise to proportional reduction in the income elsewhere. Further a fair solution needs to be agreed regarding the start-up losses incurred before any formulary apportionment take effect.*

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

*Any implementation would have to take place within the international tax treaty network. Administering such a regime would be very difficult, complex and cumbersome and likely give rise to further increase in the already heavy compliance burdens imposed on transnational enterprises. Furthermore, a substantial increase in international tax is likely to be a highly*

*controversial matter, putting further strain on enterprises engaged in international business. This should be seen in the context of already overburdened tax administrations and very long lead times for international tax dispute resolution.*

b) Withholding tax on certain types of digital transactions:

*There is substantial evidence that that taxes on revenue/gross payments have very negative economic effects. This is regardless of the type of transaction being subject to withholding taxation. The negative effects – mainly seriously hampering growth - are even larger when taxing productivity-improving technology on which the “digitalization” of the economy is based. The gross based taxation through withholding taxes will seriously negatively affect growth, employment and economic development and thus welfare.*

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

*None*

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

*There is no certain way to mitigate the many and seriously negative effect of gross basis taxation. Only by not applying any gross basis taxation can the negative impact be fully mitigated/avoided. Spotify strongly advise that the serious adverse consequences of taxes on revenue/gross payments are made clear in the 2018 interim report.*

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

*In theory could a full tax credit in the country of the recipient could mitigate the double taxation. However, obtaining a credit requires first and foremost positive taxable income which many start ups or even relatively large enterprises engaged in digital business do not have.*

*Many enterprises incur losses for several years, as is the case for Spotify. If there is no, or insufficient, domestic tax payment against which the withholding tax can be credited, the withholding tax would become a de-facto “cash cost”. This would remain the case for the enterprise even when there is possibility to carry forward the credit to future years. Furthermore, many countries have limitations of how many years withholding tax credits can be carried forward – in Sweden, for instance, it is 5 years. Imposing such cost on growing but not yet profitable businesses can have detrimental effect on its growth, ability to create jobs and tax revenues.*

*In addition, to the rules on calculating withholding tax credits are very complex, and the documentation and compliance requirements for obtaining a withholding tax credit, are very burdensome. Most young and growing companies do not have resources to comply with these requirements, and thus will be unable obtain a tax credit.*

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

*We do not believe any such measure can be efficiently and effectively implemented on an international level. We strongly advise against any application of withholding tax because it would have serious adverse consequences both for individual companies, as well as the growth of the digital economy.*

c) Digital equalization levy:

*The points mentioned above under withholding taxes applies equally for digital equalization levies or any other tax levied on gross payments – regardless of how the tax is labelled.*

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

*None as this would conflict directly conflict with the neutrality principle as established under the Ottawa Framework Conditions.*

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

*Please refer to our comments under withholding tax making the point that we do not see how paying such taxes will be subject to credits in other jurisdictions, thus such taxes would impose unfair and extreme burdens.*

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

*Because digital equalization levies are not addressed by the existing international treaty network, there is no available means to mitigate/eliminate double taxation. One possible solution would be for countries, in their national tax law to enact unilaterally rules giving tax credits for gross based taxes arbitrarily imposed by other countries on gross payments to their domestic businesses. But we do not believe is a realistic option.*

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

*What is particularly worrisome about gross based taxation on cross border payments for certain transactions (other than withholding taxes which has been discussed above) is that – at least outside the EU – they do not appear to be particularly difficult to implement. This is exemplified by India's implementation of the 6% "equalization levy" on revenue from sale of digital advertisement in India from non-resident seller. The Indian approach could be copied by other countries. The circumventing of the treaty network make this kind of taxes a very dangerous blunt instrument. For EU countries there is the additional complexity to address in an implementation that any gross based taxation must comply with the EU Treaty.*

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 digitalized 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.

*In our opinion there are no advantages to any of the unilateral measures mentioned. We have provide comments above on both withholding taxes and taxes on revenue/gross payments .*

*As for the diverted profits tax (DPT) type of measure we also do not see any advantages. Again we are looking at a unilateral measure which is not in line with the arm's length principle. Further the DPT measures are very complex and give rise to high degree of uncertainty and additional compliance burden and cost.*

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

*We believe the only meaningful way to mitigate the very serious adverse effects of the different approaches discussed is to abstain completely from using them.*

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

*The very negative effects on economic activity of unilateral and uncoordinated measures are evident. They would heighten uncertainty, increase compliance costs and almost certainly result in double taxation. The economic effect will be very counterproductive, discouraging cross border business and seriously hamper economic growth and employment.*

## **E. Other Comments**

E.1 Are there any other issues not mentioned above that you would like to see considered by the TFDE.

*Spotify believes that BEPS actions 2-15 in particular 3,6,7 and 8-10 have effectively addressed base erosion and profit shifting through aggressive tax planning which was the goal. The impact of these changes will take some time to become fully evident. We urge breathing room for these measures and restraint from taking additional actions.*

*We urge the TFDE in the interim report to recommend that the TFDE is given the full period through 2020 to do further analysis and gather data on the effects of the BEPS actions mentioned before. Further the TFDE should strongly recommend against any unilateral action by individual countries from which nothing good will come.*

**Final comment:**

*NERA Economic Consulting has been kind and provided Spotify with a copy of their submission in advance of the deadline. We would like to state our agreement with the analysis and conclusions reached in the submission. NERA's submission is another strong support for the arm's length principle full relevance for "digital business" and that any special/industry specific taxation of digital business will be counterproductive.*



# TAX EXECUTIVES INSTITUTE, INC.

## 2017-2018 OFFICERS

ROBERT L. HOWREN  
*President*  
BlueLinx Corporation  
Atlanta, GA

JAMES P. SILVESTRI  
*Sr. Vice President*  
PCS-Wireless  
Florham Park, NJ

KATRINA H. WELCH  
*Secretary*  
Texas Instruments Incorporated  
Dallas, TX

JAMES A. KENNEDY  
*Treasurer*  
OppenheimerFunds, Inc.  
Denver, CO

FRASER E. REID  
*Vice President, Region I*  
Teekay Shipping  
Vancouver, BC

JOHN P. ORR, JR.  
*Vice President, Region II*  
Equinox  
New York, NY

KAREN E. MILLER  
*Vice President, Region III*  
FusionStorm  
Franklin, MA

EVAN G. ERNEST  
*Vice President, Region IV*  
Toll Brothers, Inc.  
Horsham, PA

CRAIG SCHMIDTGESLING  
*Vice President, Region V*  
Givaudan Flavors Corporation  
Cincinnati, OH

DAVID D. GILLMAN  
*Vice President, Region VI*  
Telephone & Data Systems, Inc.  
Middleton, WI

MICHAEL F. ROACH  
*Vice President, Region VII*  
SM Energy Company  
Denver, CO

MITCHELL S. TRAGER  
*Vice President, Region VIII*  
Georgia-Pacific LLC  
Atlanta, GA

ERIC L. JOHNSON  
*Vice President, Region IX*  
Ross Stores, Inc.  
Dublin, CA

SILVA YEGHYAYAN  
*Vice President, Region X*  
Reliance Steel & Aluminum Co.  
Los Angeles, CA

TZI (SAM) Y. SIM  
*Vice President, Region XI*  
IBM Singapore  
Singapore

ELI J. DICKER  
*Executive Director*

W. PATRICK EVANS  
*Chief Tax Counsel*

12 October 2017

Task Force on the Digital Economy  
Centre for Tax Policy and Administration  
Organisation for Economic Co-Operation  
and Development  
Paris, France

Via email: [TFDE@oecd.org](mailto:TFDE@oecd.org)

## RE: Input on the Tax Challenges of the Digitalized Economy

Dear Sir or Madam:

The Organisation for Economic Co-Operation and Development (OECD) published final reports pursuant to its base erosion and profit shifting (BEPS) project on 5 October 2015. The reports were the culmination of the OECD's *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Plan) published in 2013. The Plan set forth 15 actions the OECD would undertake to address a series of issues that contribute to the perception of tax bases being eroded or profits shifted improperly. Included in the October 2015 final reports was the report under Action 1 of the Plan, *Addressing the Tax Challenges of the Digital Economy* (the Final Report).

On 22 September 2017, the OECD released a request for input from interested stakeholders regarding the OECD's work on the tax challenges of the digitalization of the economy (the Request), including the development of an interim report to be presented to the G20 Finance Ministers at their upcoming meeting. I am pleased to respond to the OECD's request for input on behalf of Tax Executives Institute, Inc. (TEI).

### TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all



levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies in the world.<sup>1</sup>

## TEI Comments

### General Comments

TEI commends the OECD for providing stakeholders the opportunity to comment on the important and often misunderstood area of the impact of digitalization and high technology on various business models and multi-national enterprises. As an initial matter, TEI agrees with the Final Report, which found 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.”<sup>2</sup> We also agree with the Final Report that “The collection of VAT/GST on cross-border transactions, particularly those between businesses and consumers, is an important issue. Countries are thus recommended to apply the principles of the International VAT/GST Guidelines and consider the introduction of the collection mechanisms included therein.”<sup>3</sup>

Before answering the specific questions posed in the Request, however, as a threshold matter, it is unclear to TEI what underlying fundamental tax issue or problem the OECD is addressing in the Request’s various proposed approaches to international taxation with respect to the digitalization of the economy. Is the issue that income from the changes wrought by digitalization is not taxed at all, or is the issue that the income is not taxed in the market country, *i.e.*, the country of the consumer? If the income is actually taxed somewhere, should the market country be able to tax that income in addition to, or instead of, the country where the functions, assets, and risks that create value are located? The solution to prevent double non-taxation is different than the solution to ameliorate non-taxation in the source country (if the latter is even an issue when the PE threshold is not met). Thus, TEI recommends further clarity on the problem the Request is intended to address, which will then inform the potential solutions.

### Responses to Questions

*Question 3.A.1* – This question concerns the impact of digitalization on business models. In TEI’s view, digitalization does not change the fundamental concepts of business models, it merely makes logistics cheaper and faster, enabling even start-up businesses to reach global markets to grow and prosper. A business still needs someone developing, identifying, procuring, storing, pricing, and shipping the goods and services to be sold or provided. Even in pure digital cloud businesses, an enterprise still needs to develop and write the software to provide the service, acquire servers and transmission capacity, accept the orders, handle

---

<sup>1</sup> TEI is a corporation organized in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

<sup>2</sup> Final Report at 11 & 54.

<sup>3</sup> *Id.* at 13.



customer complaints, *etc.* The servers, software developers, and warehouses all have locations. Thus, “internet scale” physically happens somewhere in the world that can be determined and then appropriately taxed.

*Question 3.A.2* – This question asks about the role intellectual property (IP) plays in highly digitalized business models and the important IP relevant to those models. IP includes copyrights, patents, brands, algorithms, business methods, and anything else that differentiates one seller from another, including brand loyalty generated from treating customers better than the competition. We note that all IP is created and developed somewhere by the activities of real people.

*Question 3.A.3* – This question enquires about the impact of digitalization on sales operations and activities. Digitalization does not materially change sales organizations in TEI’s opinion. If a particular business’ sales require face-to-face interaction, then the business will have a local sales and/or marketing organization. If sales are concluded because of name recognition or distance marketing, then there will not be a local sales and/or marketing organization.

*Question 3.A.4* – This question concerns the role of data collection and analysis in highly digitalized business models. Again, in TEI’s view, digitalization has not changed the role of data, it has simply increased the volume of data and the ability to analyze larger amounts of data at lower costs, benefiting both small and large businesses alike. Businesses have been analyzing purchasing trends for hundreds of years and this current business practice is no different.

*Question 3.A.5* – This question asks about the active participation of customers / users in a business via online platforms and whether this is a new phenomenon and specific to highly digitalized business models. TEI notes that automobile companies have had “fan clubs” for their products since they were first produced. So have fountain pen companies, football clubs, record companies and movie producers. Online platforms again merely make the logistics of the communications faster and easier, which drives higher volumes.

*Question 3.A.6* – This question asks stakeholders to describe how they view business models evolving in the future due to advances in information and communications. While obviously impossible to predict with any accuracy across the economy, in TEI’s view intermediation services will become easier and cheaper, continuing to reduce many of the frictional costs that presently make intermediation unsuitable for high volume, low value transactions. As noted above, digital resources will enable small businesses in developing countries to scale and compete globally.

*Question 3.D.1* – This question provides three potential options for addressing the broader direct tax challenges driven by digitalization: (i) a tax nexus concept of “significant economic presence”; (ii) a withholding tax on certain types of digital transactions; and (iii) a digital equalization levy. The question then asks for input on the advantages and disadvantages of the three options from an administrative and economic perspective.



These options were referenced in the Final Report, as well as a recent European Commission communication (the Communication).<sup>4</sup> In TEI's view, none of the three options are viable.<sup>5</sup> The withholding tax and equalization levy are each forms of a gross revenue levy and proposed as a proxy or substitute for a corporate income tax. The Request asks how the negative impacts of gross basis taxation and the threat of double taxation could be mitigated. In TEI's view, it is difficult to conceive of any system or process that (i) would be effective in mitigating the impact of gross basis taxation, and (ii) is capable of being efficiently and effectively implemented in practice while also being a viable substitute for a corporate income tax. Indeed, the Communication refers to these options as "quick fixes" and yet does not include any recommended practical solutions, merely stating that "further work is needed . . . ." Gross basis taxation will significantly increase costs for business, creating an additional barrier to entry into smaller markets, and for small to medium sized entities, as well as start-ups.

A recent paper from the European Presidency discussed at the ECOFIN meeting in Estonia in September 2017 reaches the same conclusion with respect to the withholding tax or equalization levy (the EU Paper).<sup>6</sup> The paper noted that

connecting the taxation of the digital economy with the source of income (e.g. online advertisements, digital services from non-residents) through 'quick fixes' may not be a reliable solution in the long-run . . . . The most likely outcome of such approach would be under-, over- or non-taxation. The latter deriving from an expectation that after enacting new rules, the tax base would cease to exist although the digital presence and value created in the jurisdiction would remain the same: the businesses would for instance abandon the sources of income that led to taxation and reorient to non-taxed sources (e.g. substituting advertisement revenue with client fees).

The EU Paper then suggests that a modification of the tax nexus concept, *i.e.*, changing the definition of a permanent establishment (PE), to address a digital presence, is the most appropriate way forward for a long-term solution. In TEI's view, changing PE thresholds so soon after the BEPS project creates even greater uncertainty for businesses. Moreover, in the absence of any useful guidance on the attribution of profits to a PE – the OECD still has not agreed on a profit attribution for the limited changes to the PE definition recommended in BEPS Action 7 – the concept of a digital tax nexus is problematic. In addition, it is difficult to contemplate how any extension of the PE definition can be limited to the digitalized economy, especially considering that the OECD and other bodies have not been able to describe, define, or explain what is meant by the phrase.

---

<sup>4</sup> The communication is available at [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/1\\_en\\_act\\_part1\\_v10\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/1_en_act_part1_v10_en.pdf).

<sup>5</sup> The OECD appears to agree as the Final Report stated it was not possible to ring-fence the digital economy for tax purposes.

<sup>6</sup> The EU Paper is available at [https://www.eu2017.ee/sites/default/files/2017-09/Ecofin%20Informal WS%20II\\_digital%20economy\\_15-16.Sept.\\_17.pdf](https://www.eu2017.ee/sites/default/files/2017-09/Ecofin%20Informal%20WS%20II_digital%20economy_15-16.Sept._17.pdf).



An equalization levy also appears similar to a VAT. If this analogy is correct, why not use a VAT rather than setting up a parallel tax system for “digital” transactions, as recommended in the Final Report? Most of the tax costs of these proposals will be passed on to local country customers. Thus, such proposals will have failed to generate tax revenue from non-resident suppliers to the extent that is the intended goal of the proposals. In addition, these proposals actually protect harm small and medium size businesses, as well as startups, who cannot afford to either absorb the costs or pass them on to customers. Further, increasing the cost of accessing non-resident cloud service providers via these proposals will negatively impact economic growth and hinder the development of local enterprises that utilize these cost efficient and empowering cloud based services in their business.

Fundamentally, what is needed is a way to tax net income. If the seller has a branch or local selling subsidiary in country, would that avoid the tax issue or will the country attempt to tax the income twice by imposing a digital economy tax (or withholding tax) on the intercompany transactions between the local selling entity and regional service suppliers? The approach of the proposal appears to be an attempt to change the focus of corporate income taxation in general from (i) where goods and services are produced (consuming government services in the production location) and/or (ii) where the IP was created, to where the goods and services are consumed. If this is correct, then the proposed solution seems to be replacing an income tax with a consumption tax, or worse an additional consumption tax regime layered over current income and/or consumption taxes. This goal could be achieved without increasing taxpayers’ compliance burden by increasing the rates of, or adapting, the current consumption tax regime as recommended by the Final Report.

To the extent countries (unwisely) attempt to develop a specialized tax system in this area, businesses that report all local customer revenue in the local jurisdiction should be exempt from such a special tax regime. In addition, it is critical to make it easy for non-resident businesses to comply, particularly considering language barriers, accounting differences, and lack of local resources for the non-resident sellers. Simplified reporting mechanisms should be established that do not require creating separate accounting systems and duplicate transaction reporting. Moreover and as noted above, these challenges are more difficult for small and medium sized businesses to overcome, which is a barrier to innovation in the marketplace. Further, care should be taken to ensure a specialized tax system does not discriminate against non-resident sellers and multi-national enterprises in favor of local businesses. Such discrimination would obviously raise trade issues that may run afoul of WTO rules and raise the specter of possible retaliation by countries who feel their taxpayers are targeted by such taxes.<sup>7</sup> Finally, taxes solely on imported goods would also increase prices for consumers purchasing such goods.

---

<sup>7</sup> For example, section 891 of the U.S. Internal Revenue Code authorizes the U.S. President to impose additional taxes on citizens and companies from nations that impose discriminatory or extraterritorial taxes on U.S. taxpayers.



*Question 3.D.2* – This question addresses the tax measures proposed or introduced by various countries to address the direct tax challenges of highly digitalized business models, including a digital profits tax and withholding tax. The question asks stakeholders to address the advantages and disadvantages of these approaches and how the latter may be mitigated through tax policy design. Taxpayer experience with the diverted profit tax (DPT) in the United Kingdom and its equivalent in Australia is that these taxes are not used in practice to address digitalized business models, so their discussion in the context of taxes to address the digitalized economy is inappropriate. The DPT in practice appears to be used as an opportunity to review an enterprise's global activities in greater depth and seems to proceed from the assumption that any activity within the country or sales made to customers within the country should be treated as constituting a PE, whether or not the business is digitalized or conventional. As in the past, tax authorities remain focused on transfer pricing. As noted above, such special measures should not apply to businesses reporting revenue in the local jurisdiction.

The other suggestions in D.2 are essentially the same as those referred to in D.1 b) and c), and have the same significant drawbacks, noted above.

### **Conclusion**

TEI appreciates the opportunity to comment on the Request regarding the tax challenges of the digital economy. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Giles Parsons. If you have any questions about the submission, please contact Mr. Parsons at +44 1455 826561, [parsons\\_giles@cat.com](mailto:parsons_giles@cat.com), or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, [bshreck@tei.org](mailto:bshreck@tei.org).

Sincerely yours,

TAX EXECUTIVES INSTITUTE, INC.

Robert L. Howren  
*International President*



October 12 2017

To  
Tax Force on the Digital Economy  
OECD  
[TFDE@oecd.org](mailto:TFDE@oecd.org)

Dear Madam/Sir,

Re: **Request for Input on the Work Regarding the Tax Challenges of the Digitalised Economy**

The response is submitted by Tax Justice Network Israel ([TJN IL](http://tjn.il)), a non for profit organisation, located at the College of Management Academic Studies in Israel. We wish to thank you for the opportunity to provide you with our input on your work regarding the tax challenges of the digitalised economy and to address some of the raised questions. Our comments will address the questions on p.4 of the Request for Input on Work Regarding the Tax Challenges of the Digitalised Economy.

According to the current international income tax laws, multinational corporations/entities (MNEs), especially Technological MNEs are taxed based on their profits in countries in which they operate (in addition to the country in which these entities are formed) to the extent that their business "create" a permanent establishment (PE) there.

However, the definition of a PE is rather archaic and mainly focuses on physical presence which has very little with the digitised economic reality of the 21<sup>st</sup> century. As a result, many of these MNEs manage to significantly reduce their overall income tax liability by not creating a "fixed place of business" from which their businesses are operated or by avoiding the employment (directly or indirectly through an engagement of a third party) of "dependent agents" in the countries they operate.

Moreover, in addition to the use of PEs, MNEs manage to reduce their effective income tax liability in countries that impose high income tax rates by shifting their profits to low income tax rates countries and/or by manipulating the current transfer pricing rules. These measures usually erode the MNEs' profits and enable them to pay a very low effective corporate income tax. Following the low corporate income tax (in comparison to the statutory tax rates that are imposed in countries where such MNEs operate) paid by many MNEs on their huge profits, several countries in Europe have started to partially adopt a different approach to tax MNEs. For example, the "turnover tax" or the "equalisation tax" was recently introduced in the United Kingdom and France has already declared it will



endorse such measures as well. Even more recently, this month the [EU has proposed](#) to re-launch the Common Consolidated Corporate Tax Base (CCCTB).

While it is unclear how these new approaches would interact with the current international tax rules (e.g. income tax laws and bilateral treaties), it is clear that the time has come to change the way MNEs are taxed. As we indicated previously, the principal problem in the current rules is that they fail to align the tax rights with the location of the real economic activities and where economic value is created. As such, MNEs invest significant resources in shifting profits to tax favorable jurisdictions even though these jurisdictions do not contribute to the creation of the MNEs' profits. In this respect, it is our opinion that the most efficient way to fix the existing flaws in the current tax regime relies mainly on a multilateral convention/cooperation such as the Multilateral Convention to Implement Tax Treaty Related Measure to Prevent BEPS (MLI). However, even though approximately 70 jurisdictions have already signed the MLI, as long as key jurisdictions – in which big MNEs are tax residents- choose not to sign it, the success of the MLI is uncertain.

**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?**

The 2015 Report recommend revising the "transfer pricing" guidance. It asserts that the legal ownership factor should not be the single factor in determining which entities should be taxed. Among others, the 2015 Report proposes to analyse the different functions that contribute to the production of profits (e.g. important assets and the controlling economical risks). The 2015 Report also proposes to issue specific guidance that would ensure that the transfer pricing analysis would not be weakened by information asymmetries between the tax administrations and the taxpayers in relation to hard-to-value intangibles, or by using special contractual relationships, such as a cost contribution arrangement.

In our opinion, such guidance will have minor impact in blocking aggressive tax planning or in significantly reducing the stateless income phenomenon that many of the developed countries face nowadays. Both the Authorised OECD Approach- which identifies the material factors that are responsible for producing the MNEs' profits and the identification of the significant assets/controlling economical risks, will enable the MNEs as well



as their advisors to continue manipulating their returns and reduce their overall income tax liabilities.

That is why we propose to alter the TFDE's recommendations. We recommend on strengthening the current rules by disallowing certain tax benefits which many MNEs currently receive: as a first step, to interpret PEs wider in a way that MNEs should be subject to reporting and tax liabilities in each country they operate and have significant clientele. Secondly, in our view, MNEs should be subject to stricter limitations regarding their ability to erode their corporate profits by disallowing certain deductions.

**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?**

(i) In our view, 'significant economic presence' should not include a list of specific transactions that would be subject to the new "treatment". This kind of list would be easily manipulated by taxpayers and might also lead to unnecessary litigation regarding the question of whether such transaction is covered or not by the "list".

In our opinion, the criteria listed in the 2015 Report (namely revenue based factor and user-based factors) are very helpful and generally are found in many MNEs that tend to be subject to low effective income tax rates globally (entities that are responsible for the undesirable stateless income phenomenon). We think that MNEs that meet certain criteria should disclose it in their returns as a flag for the income tax authorities to review their businesses more closely.

(ii) Even though the 2015 Report does not recommend adopting the "significant economic presence", we think that the adoption of such concept is indeed required. In our view, many MNEs indeed have a taxable presence in countries where their customers are located even though their entities do not necessarily rent offices there. We believe that the factors raised in the 2015 report are helpful and should be adopted, including: revenue



based factor and user-based factors to MNEs that operate globally with digitalised platforms.

Another criterion which we propose adopting is the overall effective income tax rate that the MNEs pay globally. This criterion should not be examined in comparison to the net income of a certain corporation within the MNE's group. Rather, such comparison should be made between the overall corporate group and the statutory corporate income tax rates in the countries in which the MNE operates.

(iii) In our view, the current transfer pricing rules are unsuccessful in preventing cross-border corporate base erosion and profit shifting. The traditional methodologies (Comparable Uncontrolled Price method, Cost Plus method and Resale Price method) are mainly irrelevant because it is very difficult to find genuine "comparables". The other two recent methodologies (Profit Split method and Transactional Net Margin method) often allocate such cross-border income arbitrarily by relying on assumptions that de-facto are easily manipulated by MNEs. We propose to use the profit split methodology with some changes that would make sure that the MNEs would be subject to a minimal effective corporate income tax rate. By making sure that the MNE is subject to a minimal corporate income tax rate, it would reduce the motivation of these entities to aggressively engage in profit shifting.

(iv) As we mention below, we propose adopting a new set of rules that would disallow MNEs with digital presence to deduct certain payments made to related parties and /or to set a ceiling (either a fixed ceiling amount or a fix percentage of the MNEs net operating profit as often adopted in thin capitalisation rules) on such deductions in order to limit the erosion of the corporate tax base. We also propose adding a concept of an Alternative Minimal Corporate Income Tax (AMCIT) that would make sure MNEs end up paying a minimal effective corporate income tax globally.

**(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?**

As mentioned above, the adoption of a withholding tax mechanism (to the extent adopted) should not be limited to a list of transactions. We propose setting a flexible criteria that apply to MNEs. In our view, a formal list of transactions would be much more easily



manipulated and will encourage undesired litigation as a result of the shenanigans to bypass the wording in the list. Furthermore, it would require to be amended from time to time as the new economic reality changes. Such an update is very problematic in the international tax regime and therefore a flexible criteria is preferable.

In our opinion, the introduction of a withholding mechanism will not suffice. For example, in case an MNE wishes to shift royalties between two jurisdictions that are parties to a treaty based on the OECD tax model convention, there will be a zero withholding tax. Imposing withholding tax on certain types of digital transactions is therefore relevant only between non contracting jurisdictions. Moreover, as long as the withholding liability does not apply to individual taxpayers, MNEs will continue to avoid effective withholding tax. Nevertheless, the risk of double taxation may be mitigated in circumstances in which the resident countries will allow foreign tax credit or in circumstances that source countries will allow the deduction. In any event, such withholding mechanism is far from being the optimal solution.

**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?**

In our view, a turnover tax or and equalisation levy are highly problematic. Such measures would have limited success in collecting tax revenues in the jurisdictions that choose to adopt them. Furthermore, it is likely that these jurisdictions that adopt them would not join the MLI or the desired multilateral measures and by opting out will weaken these measures. Moreover, these unilateral steps will increase the complexity under the current rules and may end up in perpetuating the current deficient regime. The imposition of such levies may also lead to double taxation that may be mitigated in circumstances in which the resident countries will allow foreign tax credit or in circumstances that source countries will allow the levies as a deduction. The main advantage we currently see in such levies is that different countries in which the MNEs operate in will have the opportunity to tax cross-border income. However, this end can also be achieved by using the existing rules without imposing more complexity and exposing the current tax regime to additional threats. In any event, it is our opinion that in order to prevent a “double dip” of a certain jurisdiction, such levies should not be imposed in circumstances where the MNE did not erode more than the set deductible ceiling (which is either a fix amount or a fix percentage of the net operating profits).



**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.**

In our view, the introduction of different levies or other mechanisms that are not covered by the current bilateral tax treaties might be highly problematic. As mentioned in the 2015 report, imposing new levies raises risks that the same income would be subject both to

corporate income tax and to these levies. Such "double taxation" could also arise in a situation in which a foreign entity is subject to the levy at source and to corporate income tax in its country of residence or in a situation in which an entity is subject both to corporate income tax and to the levies in the country of source.

As mentioned above, the main advantage we currently see in such levies is that different countries in which the entities operate in will have the opportunity to tax cross-border income. However, in our view, this end can also be achieved through the existing rules without imposing more pressure and exposing the current tax regime to more threats.

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

Instead of adding new taxing instruments, we think it is preferable that countries will adopt rules that disallow certain payments to **related** parties (directly or indirectly) including: interest payments, royalties, advertisement expenses, management fees and similar payments that are meant to erode the corporate taxable income. We also propose to disallow similar deductions to **third** parties if such deductions exceed 50% of the adjusted taxable income.

In addition, a new concept of AMCIT should be adopted. According to which, entities that are part of MNEs should not be viewed independently. Rather, the entire MNE should be viewed as a whole. In circumstances where MNEs pay less than the statutory corporate income tax rate in the specific country in which it operates, such MNE would be required to pay an AMCIT. The AMCIT will be determined according to the statutory corporate income tax rates that exist in the countries in which the MNE operates or has a "significant economic presence". Such tax payment will be collected and allocated among the relevant jurisdictions based on the profit split method and in doing so, a related party



transaction (e.g. royalties, interest payments) would be disregarded. In our view, under the AMCIIT method, MNEs would be less motivated to shift profits to tax havens because it would not reduce the overall effective corporate income tax significantly.

**(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, unilateral steps or uncoordinated measures would increase uncertainty and complexity in taxing cross border profits. It may also lead to double taxation, which might not be solved via the bilateral income tax treaties network given that some of the measures intended to be adopted are new tax instruments that are not covered by the current bilateral treaty network.

We think that reciprocal measures imposed both by OECD members as well as by developing countries would benefit all players. In order to incentivise more countries to adopt such new guidance, we recommend allowing foreign income tax credit or deductions on payments made by MNEs only to taxpayers (whether individuals or entities) that their country of residence adopted the new guidance/rules while disallowing such favorable tax treatment to taxpayers who are resident in countries that did not adopt the new guidance (as long as this approach does not conflict with bilateral or multilateral provisions included in the existing income tax treaties).

Accordingly, it makes sense to issue both a guidance of proposed rules that hopefully be adopted as well as a timeline for implementation of the changes. Such guidance should also strengthen the reporting liabilities MNEs have in jurisdictions in which they either operate or have significant economic presence.

Our recommendation is firstly, to extend the current definition of PEs to enable more jurisdictions - that allow MNEs to sell their products or render their services - to tax the MNEs' profits. Adopting a wider definition of PEs will provide the basis for changing the way PEs are taxed. In that context, it is our opinion that to prevent a complete erosion of the profits, setting a deduction ceiling would be much easier to enforce than adopting an AMCIIT regime that would require the calculation of the cumulative effective tax rate that the MNE should be subject to. Both measures are preferable to the imposition of new levies. In any event, the unilateral measures are undesirable and in our view, they should not be recommended.



Finally, we think that including Action 7 in the BEPS Inclusive Framework and making it part of the ‘minimum standard’ is likely to significantly increase the effectiveness of the above proposed solutions for the tax challenges of the Digitalised Economy.

**TFDE, Task Force Digital Economy**

[TFDE@oecd.org](mailto:TFDE@oecd.org)

Organisation for Economic Cooperation and Development

2 rue André-Pascal

75775, Paris, Cedex 16 France

**October 13<sup>th</sup>, 2017**

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

### **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**

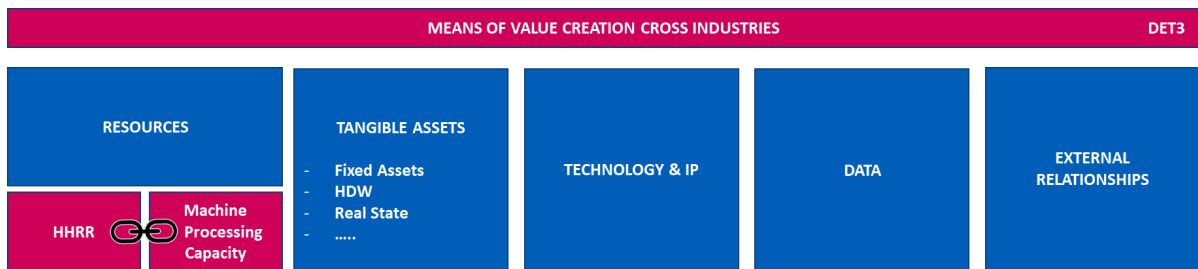
In the new design thinking era, the trend that will come is clearly that most MNEs will combine this enhanced evolution of their traditional business models, with try and fail controlled pilots of very disruptive digitally powered business model launches. The pure digital-play companies, either start-ups 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 process.

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, understanding 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?**

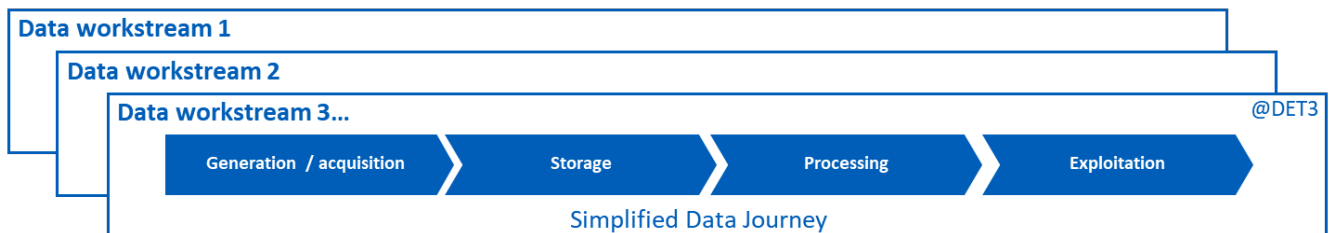
Unprecedented and scaling at a pace whose growing curve was not seen before in human history. This fact makes it necessary for most companies to invest efforts and resources (functions) in organizing and curating that vast amount of data collected as a first step, and second, to develop a culture that 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 stake-holders 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 the 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 unfair, 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 three 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.

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 being 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 it’s 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 works.

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 undeclared 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.



UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

October 13, 2017

**VIA EMAIL**

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](mailto:TFDE@oecd.org))

**Re: USCIB Comment Letter on the OECD's request for input on work regarding the tax challenges of the digitalized economy**

Dear Mr. Bradbury,

USCIB<sup>1</sup> appreciates the opportunity to comment of the OECD's request for input on work regarding the tax challenges of the digitalized economy (hereinafter "RFI"). USCIB requests the opportunity to present comments at the public consultation on November 1, 2017.

**General Comments**

USCIB is cognizant of the tremendous political pressure to move forward on taxing the digitalized economy. We recognize the concern that as remote sales activities increase, countries may consider re-evaluating the traditional rules splitting income between the so-called "source" and "residence" countries. It needs to be clearly understood that there is only one "pie" and if countries take a larger share of the "pie" on the basis of the market, they also must agree to relinquishing some of the "pie" previously allocated to other functions, assets and risks. The newly revised Transfer Pricing Guidelines<sup>2</sup> (hereinafter "2017 TPG's") continue to base transfer pricing between related parties on an analysis of functions, assets, and risks. If

---

<sup>1</sup> USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

<sup>2</sup> [OECD 2017 Transfer Pricing Guidelines](#)

anything, the 2017 TPGs emphasize the performance of people functions over other aspects of the FAR analysis. Chapter 6 of the 2017 TPGs provides:

This Section B confirms that the ultimate allocation of the returns derived by the MNE group from the exploitation of intangibles, and the ultimate allocation of costs and other burdens related to intangibles among members of the MNE group, is accomplished by compensating members of the MNE group for functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles according to the principles described in Chapters I - III.<sup>3</sup>

To the extent that any new method of allocating profits is inconsistent with the 2017 TPGs, countries that are negatively affected would need to agree that the new rules would be coordinated with the 2017 TPGs and how this coordination would occur.<sup>4</sup> This is why unilateral measures would be so destructive; the inconsistency would not to be resolved, some countries would be applying the 2017 TPGs with their emphasis on the place of performance of income producing activities while other countries – those adopting unilateral measures – would be using a different standard to determine tax nexus and returns for enterprises delivering digital goods or services.

Consistent with the OECD's conclusion that the digital economy is the economy, we understand that this re-evaluation will impact the total economy, not just the current digital economy. Some countries and trading blocks are already implementing or considering unilateral measures. In our view, unilateral measures will be extremely damaging and, because they will increase costs to supply those markets, may adversely impact economic development and increase costs to consumers. Unilateral measures would likely result in double taxation, decreased trade, and reduced global growth. If a new global consensus is to be reached on the general allocation of taxing rights, it will require sustained effort over a number of years to balance the interests of both countries and businesses. In our view, it is also likely to require considerable additional thinking on taxation principles since the proposals that have been considered previously (as discussed in detail below) are deeply flawed.

As the Action 1 Final Report (hereinafter "Final Report") points out, the broader tax challenges of the digital economy intersect with several other BEPS action items.<sup>5</sup> The Final Report<sup>6</sup> further points out "it is expected that the implementation of the BEPS measures will substantially address the BEPS issues previously identified with respect to the digital economy." The Final Report identifies specific aspects of other BEPS measures that may have an impact on the digital economy, including changes to the definition of a permanent establishment, and

---

<sup>3</sup> IBID, Chapter VI.B.6.32, page 258.

<sup>4</sup> The guidance on intangibles is so important because the goal of this re-evaluation of the split between so-called "source" and "residence" countries is to allow a country a claim to tax the excess rents generated by MNEs.

<sup>5</sup> [Action 1 Final Report](#), Chapter 9.4, paragraph 352, page 135.

<sup>6</sup> IBID, at Chapter 9.4, paragraph 353, page 135.

concludes that: “As a result, the expected impact of the tax BEPS measures needs to be taken into account when evaluating the extent of the broader tax challenges and the options to address them.”<sup>7</sup>

The multilateral instrument that would implement key portions of the BEPS package – including all the PE measures -- has only just been signed and is not yet in effect. Although the Transfer Pricing Guidelines have been updated, there remain important pieces of that work that are still being debated. Countries and companies are changing their tax laws and tax reporting as a result of the other BEPS action items. Therefore, it is not now possible to take into account the impact of the BEPS measures in evaluating the broader tax challenges and the options to address them.

Further, the Final Report<sup>8</sup> recommended improvements to the collection of VAT as an important part of addressing tax challenges of the digital economy. Working Party 9, in conjunction with the technical advisory group (hereinafter the “VAT/TAG”), has been addressing these challenges and is beginning to address the practical difficulties associated with the collection of VAT in the context of digital platforms. This work is likely to substantially increase collection of VAT that is due under current law. Many countries have enacted or are considering extra-territorial VAT registration and collection obligations for nonresidents and business is making the significant investments required to comply with these obligations. Many of the VAT issues, including the platform issues, may be replicated by a tax – whether a turnover tax, a withholding tax or an equalization levy – that imposes a gross basis tax.<sup>9</sup> Beginning a separate process to evaluate the same issues is not likely to speed up the work and may result in inconsistent outcomes, which would only create multiple levels of taxation, additional costs and complexity.

While RFI cites the G7 and G20’s support for the work of the TFDE, the RFI does not point out that the primary economic goal of the G7 and G20 is encouraging global growth.<sup>10</sup> USCIB is concerned that the proposals -- particularly those that impose gross basis taxes and therefore do not account for significant costs that may be imposed in the absence of any profits – may have a significant negative impact on growth. This would particularly be the case if the gross basis taxes did not provide credit refunds similar to VAT and, therefore, would actually be cascading at every level. Significant unilateral shifts in net basis taxation will also increase controversy, require more resources devoted to dispute resolution, and increase double tax costs (if disputes cannot be resolved due to the lack of agreed upon standards), resulting in a

---

<sup>7</sup> IBID, at Chapter 9.4, paragraph 355, page 136.

<sup>8</sup> IBID at Chapter 8.2, paragraph 321, page 122.

<sup>9</sup> USCIB believes that proposals that are designed to impose a gross basis tax in lieu of a corporate income tax look like VATs with a different name. We understand that in theory the VAT is supposed to be a final tax on household consumption and therefore is it politically extremely difficult to simply increase the VAT. Nevertheless, gross basis taxes, regardless of the name, may be passed onto the final consumer (and if they are not, they may reduce the trade and global growth).

<sup>10</sup> [G20 Leaders Declaration](#), third paragraph.

profound negative impact on growth. Smaller markets will suffer most because the additional costs will be a higher percentage of the revenue opportunity. The imposition of taxes in a manner inconsistent with the existing international framework, in the absence of a new broad-based consensus, will result in double taxation and reduced trade and investment.

### Detailed comments

Section D of the RFI requests comments on the potential options outlined in the Final Report.<sup>11</sup> These options are: imposing net taxation based on a tax nexus that relies on a significant economic presence rather than the traditional concept of permanent establishment; a withholding tax on certain digital transactions; and an equalization levy on certain digital transactions. The questions in this section presume that each of these taxes can be made to work in a principled manner – which would require significant additional changes to all the options or to the historical tax policy principles. We believe that the principles enunciated in the Final Report ought to be applied to determine whether such an approach is appropriate.

The Final Report set forth an agreed upon framework starting from the basic tax principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, and proportionality. These are the longstanding (from 1998) Ottawa principles with the addition of sustainability and proportionality. We do not repeat the definitions of these terms here, they can be found in the Action 1 Final Report Chapter 9.3 Framework to Evaluate the Options, paragraph 351, page 134.

USCIB believes that each of the enumerated options should be analyzed under these principles to determine whether taxation under these options meets these principles. In our view, the identified options do not satisfy these principles and therefore should not be adopted, particularly since the impact of the BEPS measures cannot yet be effectively measured.

### Neutrality

As the Final Report points out “attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not.”<sup>12</sup> The questions with respect to each of the options starts with a question asking where this line should be drawn. USCIB agrees with the Final Report; wherever the line is drawn will be arbitrary and that arbitrary line will create different results for similarly situated taxpayers. Thus, the neutrality principle will be violated for all the options because of the necessity of drawing arbitrary lines. The significant economic presence option starts with a revenue factor that would apply the new nexus test to taxpayers above a certain revenue threshold. This

---

<sup>11</sup> Chapter 7.6 of the Final Report lays out the three different options. The EU is apparently considering a turnover tax, which is not one of the options set forth in the Final Report. So far, no details are available with respect to the EU proposal, so we do not analyze it here.

<sup>12</sup> Chapter 10.1 paragraph 364, page 42. This is also consistent with the fundamental conclusion of the Final Report, that the digital economy cannot be ring-fenced. USCIB strongly supports this conclusion.

would effectively function as a cliff, with very different results for those just below or above the threshold (which would itself be arbitrary) and therefore not neutral.

A new nexus test that determines significant economic presence test based on factors other than the location of functions, assets and risks of the taxpayer will require a new model for attributing income. Such a new model would also violate the neutrality principle unless the new factors were also applied broadly to all businesses and not just digitalized businesses. As more companies become digitalized the new model would will expand to eventually cover the entire economy, which may reduce the neutrality issue but effect a complete change in the taxation of all multinational corporations.

### Efficiency

Under the efficiency factor, the benefits of the proposal should outweigh the costs of its adoption including transitional and implementation costs.<sup>13</sup> It is difficult to evaluate the efficiency factor with respect to the significant economic presence and equalization levy given the high-level nature of the proposals and the lack of a definition of the benefits of the proposal. Presumably the “benefit” of the proposal is the increased tax collected by the market jurisdiction. Can this be considered a “benefit” if the tax is imposed unilaterally such that the transaction is potentially subject to double taxation? On the cost side, it is difficult to estimate even the cost of designing new systems to comply with new obligations when there is so little detail. Using current transfer pricing principles, it is difficult to understand how tax nexus based solely on revenue will significantly increase tax collections, resulting in little benefit from a significant disruption in the current tax system.

With respect to the withholding tax, the efficiency principle is likely to be violated. In many cases, the withholding tax might be imposed on business to consumer transactions. Collection would be unlikely at best and if individuals did withhold these taxes the cost of collection could easily exceed the amount of tax due.

### Certainty and Simplicity

As to certainty and simplicity factors, again there is very little detail, so these factors are difficult to evaluate under the circumstances. However, under the significant economic presence option there would probably need to be either some form of formulary apportionment that includes a sales factor or another deemed profit measure. These are unlikely to be simple and without agreement among countries on how profits would be apportioned, there is likely to be both double taxation and gaps. For example, a country that has a small market and wishes to attract manufacturing might give sales a disproportionate weight to shift income away from the manufacturing activities that it hopes to attract. Without agreement among its trading partners, this might result in untaxed income. Conversely, a country with a large market might also disproportionately weigh sales in a way that might

---

<sup>13</sup> Final Report, Chapter 9.3, paragraph 351, page 134.

double tax manufacturing that is occurring outside of its borders. This might be a disguised restraint on trade, that is an attempt to require manufacturers to manufacture locally goods for the local market to avoid double taxation of the company's manufacturing income. Current formulary apportionment systems illustrate the issues with consistent and fair application of the general apportionment framework, often resulting in double taxation.

Deemed profit measures would also be likely to require detailed analysis of the activities of a particular industry and agreement among countries to achieve results that avoid double taxation and double non-taxation. This is unlikely to produce either certainty or simplicity.

With respect to withholding taxes, the Final Report<sup>14</sup> does a good job of identifying some of the difficulties associated with imposing a withholding tax. The transactions to which it applies must be clear and the scope defined as simply as possible (multiple rates for different types of transactions should be avoided). The Final Report<sup>15</sup>, however, suggests that because of the possibility of imposing the tax when there is no income that withholding rates might be determined based on typical profit margins in domestic industries and the withholding rate could be adjusted to reflect those profit margins. This would likely lead to varying rates and perhaps the need to change rates over time – not a prescription for either certainty or simplicity.

The most difficult issue with a withholding tax – particularly one which is intended to address direct sales to consumers by non-residents of the market jurisdiction – is the absence of an appropriate person on which to impose the withholding and remittance obligation. Consumers are unlikely to be able or willing to comply, so tax collection would be very uncertain. It would also be very difficult to require a financial intermediary to withhold because the intermediary is unlikely to have the information available to determine whether withholding is required. Therefore, imposing a withholding tax on an intermediary would likely violate the certainty principle.

These questions are being addressed in the context of the work of Working Party 9 and the VAT/TAG, which is considering how platforms operate and whether a combination of information reporting and simplified registration and payment of the tax due can achieve the desired outcome of correct imposition of destination based VAT without overpayments and negative impacts on cross-border trade.

With respect to the equalization levy, the Final Report<sup>16</sup> suggests that a significant business presence would be necessary before the equalization levy would apply and further suggests different additional tests that could be adopted depending on the policy goals of the country implementing the equalization levy. Two additional tests that are mentioned are one based on monthly active users and the volume of data collected. The Final Report acknowledges that the

---

<sup>14</sup> Chapter 7.6.3, paragraph 292 et seq., page 113.

<sup>15</sup> Chapter 7.6.4.1 paragraph 303 et seq., page 116.

<sup>16</sup> Chapter 7.6.4, paragraph 302 et seq., page 115.

suggested additional tests would be difficult to apply in practice because measuring either of these items may be challenging. Thus, the equalization levy is unlikely to be certain or simple in its application.

### Effectiveness and Fairness

The standard for effectiveness and fairness provides that “taxes imposed should produce the right amount of tax at the right time.” That “who may bear the ultimate burden of the tax and in what proportion” is important in assessing fairness. An ineffective tax (one that is difficult to enforce) “is unlikely to be either equitable or neutral and may undermine the public perceptions of the whole system in the long term.”<sup>17</sup>

Unilateral changes to fundamental tax principles are unlikely to produce the “right amount of tax at the right time”. Rather such unilateral taxes are likely to produce inconsistent results that will be damaging to trade among countries. Annex E of the Final Report (which analyzes the incidence of taxation) “assumes that a significant number of countries impose these changes in a global coordinated step.”<sup>18</sup> Incidence might be more difficult to determine if countries act unilaterally. Thus, it might be very difficult to determine who bears the ultimate liability for the tax and whether that burden is fair or proportionate.

The difficulties associated with the proposed taxes have been discussed in the efficiency section of this letter.

### Flexibility and Sustainability

USCIB believes that to the extent that the changes rely on defining a significant business presence (which both the changes to the PE rules and the equalization levy do), the changes may become obsolete. The evolution of the permanent establishment rules is evidence that business is constantly changing. Designing a new standard for business presence based on the way business is done today may similarly become obsolete in the relatively short term.

The withholding tax is less subject to obsolescence, but the difficulties with imposing tax when there is no profit and collecting tax on sales to consumers would remain substantial obstacles.

### Proportionality

USCIB strongly agrees with the conclusion of the Final Report that the digital economy cannot be ring-fenced. As a corollary, any rules designed to address the tax challenges of the digitalized economy should apply broadly.

The BEPS project was intended to align taxation with value creation. USCIB believes that, although information and communications technology has allowed all businesses to become more efficient and has provided enormous benefits to society, the fundamental aspects of

---

<sup>17</sup> These quotations are from Chapter 9.3, paragraph 351, page 134.

<sup>18</sup> Annex E.4.1.1, paragraph 15, page 278.

running a business have not changed. Most businesses fail. Businesses that do succeed do so because they do certain things well. They identify a business opportunity, develop (including R&D and manufacturing) a product or service that fills that need, market that product or service, and deliver it to customers.

A retailer of LPs once shipped LPs to consumers using the postal service. An online provider of song downloads now uses ICT to deliver songs to consumers over the internet. The fundamental business model of finding and developing artistic talent, marketing, and delivering musical content to consumers remains the same. Similarly, a software developer and manufacturer once shipped software on disk or CD directly to consumers or retailers. This same developer and manufacturer may now provide access to this software online. The fundamental business model of developing, delivering and supporting software for use by consumers remains the same. While the “Cloud” may sound intangible, Cloud services are supported by tens of \$billions in annual physical investments by Cloud businesses in network infrastructure, datacenters, servers and all the support requirements. These investments are funded by business and provide incredible low-cost economic development opportunities to developing economies, small business, start-ups and governments.

### Conclusion

USCIB understands concerns about eroding tax bases and the political pressure to address those concerns. We believe, however, as explained above, that the measures proposed in the Final Report are all deeply flawed, which was why none of the proposals was recommended by the Task Force on the Digital Economy. As the economy becomes more digitalized, enabling more small business and start-ups to compete in the global market, these proposals will effectively represent fundamental changes in all business taxation and create significant impediments to growth for companies unable to afford the related administrative and tax costs. If the Task Force is to move forward with a proposal, we believe that it must start fresh with new ideas for comprehensive reform.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business (USCIB)

#### **Washington Office**

1400 K Street, N.W., Suite 525  
Washington, DC 20005  
202.371.1316 tel  
202.371.8249 fax  
[www.uscib.org](http://www.uscib.org)

Global Business Leadership as the U.S. Affiliate of:  
International Chamber of Commerce (ICC)  
International Organization of Employers (IOE)  
Business and Industry Advisory Committee (BIAC) to the OECD  
ATA Carnet System

**SATURNINA MORENO GONZÁLEZ**

**Full Professor of Financial and Tax Law, Castilla-La Mancha University, Spain**

**Researcher at International Centre for Tax Studies**

**Saturnina.Moreno@uclm.es**

**JOSÉ ÁNGEL GÓMEZ REQUENA**

**PhD Candidate, Castilla-La Mancha University, Spain**

**Researcher at International Centre for Tax Studies**

**Guest Researcher at Institute for Austrian and International Tax Law, Austria**

**JoseAngel.Gomez@uclm.es**

**10/12/2017**

**To: Members of the Task Force on the Digital Economy, OECD**

**RE: Public input on the tax challenges of digitalisation**

Dear members of the OECD Task Force on the Digital Economy,

First of all, we would like to thank for the opportunity to share our views about the tax challenges of the digitalised economy. We are convinced that initiatives like this one will enhance the quick accomplishment of the desired international consensus so that those issues are addressed. This comment is done within a research project granted by Spanish Ministry of Economy, “Taxation and new commerce and information technologies. Proposals for the adaptation of the tax system to the demands of the digital economy and society”, DER2014-55677-R, whose main researcher (IP) is Professor Ms. Saturnina Moreno (<http://fiscalidaddigital.net/>).

We found that all questions propounded in the questionnaire are correct and very valuable for the next step in the so-called “Post-BEPS era”. Specifically, we are focusing on offering our view to question in an overarching way. The exacerbated problem by the digital economy is the mismatch between the taxation place of incomes and the value-creation place. This results in loss of revenue from the source states due to the lack of adequacy of international taxation’s traditional concepts to the current digital context as, for example, occurs with permanent establishment concept. Therefore, the aim to solve this problem is to create new tax nexus to these digital revenues in the source country, being respectful with the principles of neutrality, efficiency, certainty, simplicity, effectiveness, justice, flexibility, sustainability and proportionality.

The nexus problem is one of the three broader tax challenges of digital economy detected in the Action 1 of the BEPS Plan. This commentary is going to analyse two proposals to increase the source States' taxation power when a purely electronic commercial transaction take place. In this way, we will issue a first approach on a new permanent establishment concept for the OECD Model Tax Convention (OECD MC) and its Commentaries and, collaterally, a second approach on the creation of new type of income in the OECD MC for e-commerce operations or, alternatively, an update of the Commentaries to art. 12 OECD MC so as to include the tax regime for new digital business models such as cloud computing or 3D printing.

### **A NEW PERMANENT ESTABLISHMENT CONCEPT BASED ON BOTH SIGNIFICANT DIGITAL AND ECONOMIC PRESENCE**

The permanent establishment concept embedded in double tax conventions is based on physical presence. The new IT encourage the dematerialisation of the legal-commercial relationship so that a non-resident enterprise in a jurisdiction may be generating a high volume of incomes through a website without any taxation in this source country. We appreciate the reforms introduced in the permanent establishment concept from Action 7 of BEPS Plan, but these have been focused only in external aspects to the digitalisation phenomenon, such as the reformulation of the dependent/commissionaire clause or preventing the fragmentation of both industrial and commercial activities. The real problem with the nexus remains unresolved.

A concept of permanent establishment that combines both the significant digital and economic presence is an idea which begins to be defended in the tax law academic environment. Such a presence should be made clear in the focus of optimal factors that create legal certainty for non-resident taxpayers. In short, it should ensure the recovery of source states' tax power thanks to adequate control mechanisms that may be able to measure exactly such factors. These factors may include amount of data that the non-resident company collects from residence customers in the source marketplace; the monthly active users who contract each month products or services with the non-resident company through a virtual platform; or, the use of a domain name registered in the source country. These substantive factors would determine the existence of a significant digital presence. They could be required individually or cumulatively. They could even be helped by factors less virtual and closer to fixity requirement, such as the existence of marketing campaigns, post-sales support or customer services in the source state where customers reside.

A mere significant digital presence would not symbolise the existence of a permanent establishment at source State if it is not accompanied by another quantitative element such as non-resident's volume of incomes that exceeds specific ratios or thresholds. This is a key factor to achieve the compliance with neutrality and proportionality tax principles, so that it would be desirable to apply thresholds that distinguish between a more notable economic presence, which are subject to taxation in

the source country, compared to other less important ones that would mean higher compliance (administrative) burdens for enterprises. Hence, it is necessary as well to combine clauses that mitigate abusive practices, such as the potential fragmentation of e-commerce operations through some affiliates or branches of the group in order to avoid the quantitative thresholds.

## **EITHER A NEW KIND OF INCOME IN THE OECD MODEL TAX TREATY OR AN UPDATING OF ART. 12 OECD MODEL TAX TREATY COMMENTARIES**

In case a new permanent establishment is not introduced finally, given the pitfalls of achieving a new international consensus about such an important aspect as we noted above, we proposed two alternatives that can partially solve the problem of revenue loss by sources countries due to the digital economy.

Firstly, the creation of a new kind of specific income for the operations exclusively operated through electronic commerce. It would be a special rule over the generic rule established in the art. 7 OECD MC. Its speciality would be the taxing right to tax these types of digital incomes that would correspond to residence and source country, but to the latter in a limited way. Incomes paid by residents of a contracting state to a non-resident company would be subject to a withhold in the source, which is the jurisdiction where the product or services (physical or digital) is going to be used. In the framework of business-to-business e-commerce (B2B) the withholding tax could be practised by the resident company and pay the amount withheld to the national tax Administration. Nonetheless, in business-to-consumers transactions (B2C) it would be disproportionate to make compulsory that customers do it. Thus, this liability could be imposed to the company responsible for the management of electronic payment system that would be responsible for entering that amount to the tax authority of the source State and deliver the net amount to the non-resident company. The withholding tax on Internet provisions introduced by Buenos Aires city in 2014 (Resolution No. 593/2014) shares the idea that issuers of debit and credit cards with which residents make their payments to the non-resident for accessing to movies, TV series, music and similar multimedia contents are those that must be the withholding agents.

Secondly, taking advantage of the fact that quite a few of tax treaties provide limited taxation at source country when the incomes arisen are royalties, an update of the Commentaries on art. 12 OECD MC concerning the taxation of digital products (par. 17 and ff.) could help to ensure that these transactions are taxed at source. The update should include new business models arisen from digital economy advances, for instance cloud computing or 3D printing. In short, to make clear when payments made to cloud-based services or 3D printing licences providers who reside in a third country are made as a consideration for the acquisition of any intellectual property right. In this vein, it should be taken into account some factors as the control level over the cloud

infrastructure that the customer has or the rights that has been granted in the license agreement to print in 3D a product purchased in the STL digital format.

In conclusion, the unilateral actions of some tax jurisdictions are beginning to proliferate in the post-BEPS environment in order to solve the initial problem of the loss of tax revenue of source states over incomes originated inside their boundaries. It is highlighted the British Diverted Profit Tax, conceived as an anti-abuse rule, the Indian Equalisation Levy, the recent Italian Web Tax, conceived as a voluntary disclosure process, and the recent joint proposal of France, Germany, Italy and Spain to the European Commission for the study of the implementation of a digital equalisation levy in the European countries. While all these tax measures solve the problem partially and locally, we consider necessary to move forward a global and homogenous solution. Once implemented in several Double Tax Conventions the anti-BEPS measures proposed in 2015, now it is the time to trigger new measures to solve the three broader tax challenges that arise due to digitalisation, being one of them the lack of nexus binding to digital incomes. We regard more in line with the current international taxation framework to choose, as a first choice, updating the permanent establishment concept, anchored in an old fixity, towards an international taxation concept based on both significant digital and economic presence to fight against the noted problem. Secondly, the creation of a new kind of *sui generis* income for e-commerce revenues, distributing a limited tax power to the source country, or the widening of royalty concept to embed new digital business models like cloud computing or 3D printing could be partially effective measures if they are adopted multilaterally and co-ordinately.

Yours sincerely,

Saturnina Moreno and José Ángel Gómez

Lausanne, Amsterdam, Leuven, 13 October 2017

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

*Input Statement by the International Observatory on the Taxation of the Digital Economy  
(University of Lausanne, International Bureau of Fiscal Documentation, KU Leuven)*

### **Contributors (in alphabetical order)**

**Prof. Dr. Niels Bammens** (Professor of Tax Law, KU Leuven)

**Prof. Dr. Yariv Brauner** (Professor of Law, Hugh Culverhouse Eminent Scholar Chair in Taxation, University of Florida – Levin College of Law; Former Professor in Residence IBFD)

**Dr. Vikram Chand** (Executive Director of the MAS in International Taxation and of the Executive Program in Transfer Pricing, University of Lausanne – Tax Policy Center)

**Prof. Dr. Robert J. Danon** (Ordinary Professor of Swiss and International Tax Law, Director of the Tax Policy Center - University of Lausanne)

**Prof. Dr. Luc De Broe** (Professor, Chair of Tax Law, KU Leuven)

**Prof. Dr. Pasquale Pistone** (Academic Chairman, IBFD; Jean Monnet ad personam Chair in European Tax Law and Policy, WU Vienna; Associate Professor of Tax Law, University of Salerno)

**Ms Lisa Spinosa** (Doctoral Candidate, University of Lausanne – Tax Policy Center)

**Dr. Alessandro Turina** (Post-Doctoral Research Fellow, University of Lausanne – Tax Policy Center/IBFD)

## Table of Contents

<b>I</b>	<b>Introductory remarks and scope of the input statement .....</b>	<b>3</b>
<b>II</b>	<b>Implementation of the current BEPS package .....</b>	<b>3</b>
<b>III</b>	<b>Options to address the broader direct tax policy challenges.....</b>	<b>6</b>
	<b>III.1 Significant Economic Presence test (SEP) .....</b>	<b>6</b>
	<b>III.1.1 In general.....</b>	<b>6</b>
	<b>III.1.2 Compatibility issues .....</b>	<b>7</b>
	<b>III.2 Withholding Tax on Certain Digital Transactions and Equalization levy .....</b>	<b>10</b>
	<b>III.2.1 Scope of the analysis .....</b>	<b>10</b>
	<b>III.2.2 Compatibility issues .....</b>	<b>12</b>
	<b>III.2.3 Synthesis .....</b>	<b>18</b>
	<b>References .....</b>	<b>20</b>

## I Introductory remarks and scope of the input statement

The present input statement is prepared by the International Observatory on the Taxation of the Digital Economy. The Observatory is a joint initiative put in place by the Tax Policy Center of the University of Lausanne ([www.unil.ch/taxpolicy](http://www.unil.ch/taxpolicy)) and the International Bureau of Fiscal Documentation ([www.ibfd.org](http://www.ibfd.org)) as part of a research project “Taxation and Digital Innovation” (<https://goo.gl/5MWCKZ>). The Observatory is a neutral academic platform aiming at contributing to fiscal policy challenges raised by the digital economy. In addition to its founding members, the Observatory also includes other research partners, in particular the Institute for Tax Law of KU Leuven (<https://www.law.kuleuven.be/fisc/>). The contributors who prepared this input are listed in the cover page of this document in alphabetical order.

The input statement concentrates on the following issues raised by the OECD request for input on work regarding the tax challenges of the digitalized economy (“the request for input”):

- The implementation of the current BEPS package (section II hereafter).
- Options to address the broader direct tax policy challenges (section III hereafter). Our comments thus focus on (i) the concept of “*significant presence test*” (SEP), (ii) a withholding tax on certain types of digital transactions and (iii) a digital equalization levy. We in particular look at the compatibility of these measures with international obligations, namely tax treaties, EU law and WTO law (section III hereafter).

Needless to say, however, that our comments ought to be considered as a **preliminary and high level analysis** and would of course need to be refined/revisited once the details of a particular policy option are known.

## II Implementation of the current BEPS package

1. Although the final report on Action 1 report<sup>1</sup> has not led to a conclusive output shared by all States on a possible adaptation of the international tax law framework to the new business models, it is, on the other hand, quite clear that some of the items of the BEPS package were

---

<sup>1</sup> 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 (cited Action 1 Final Report hereafter).

designed to also tackle the tax policy challenges raised by the digital economy. Conceptually, the most promising item in this respect is **BEPS Action 7**<sup>2</sup> which aims at reducing the Permanent Establishment (“PE”) threshold by amending paragraphs 4, 5 and 6 of art. 5 of the OECD Model Tax Convention. Pursuant to these amendments, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a permanent establishment for that seller under the new standard<sup>3</sup>. Further, BEPS Action 7 also modifies the agency PE definition to address circumstances in which artificial arrangements relating to the sales of goods or services of one company in a multinational group effectively result in the conclusion of contracts, such that the sales should be treated as if they had been made by that company. The Action 7 Final Report notes for example that an online provider of advertising services habitually plays the principal role in the conclusion of contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modifications by the parent company, this activity would result in a permanent establishment for the parent company<sup>4</sup>. From this perspective, BEPS Action 7 introduces a change of policy as compared to the existing agency PE concept under tax treaties, especially in jurisdictions favoring a formal interpretation of this concept.

2. This being said, BEPS Action 7 has at least two main shortcomings. First of all, BEPS Action 7 does not represent a minimum standard and several signing jurisdictions to the Multilateral Instrument (MLI) have reserved the right not to include the revised PE definition in their treaty practice. Moreover, under the MLI the modifications to the PE definition would come into effect only when both parties to the Covered Tax Agreement (CTA) agree to adopt the provision. Secondly, it is well known that a number of jurisdictions have not adopted the changes recommended by BEPS Action 7 because of concerns regarding how profit attribution should take place under this revised PE definition. This latter debate is of course still ongoing.

---

<sup>2</sup> OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (cited Action 7 Final Report hereafter).

<sup>3</sup> See Action 1 Final Report, p. 12 and Action 7 Final Report, Para. 13 (commentary to new Art. 5(4) in Para. 22).

<sup>4</sup> See OECD, Action 7 Final Report, Para. 32.6.

In its input to the 22 June 2017 Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments, the Tax Policy Center of the University Lausanne has discussed the challenges raised in this area<sup>5</sup>. For instance, with respect to the warehouse PE, the taxable profit in market jurisdiction will be restricted to the limited functions performed by the PE i.e. warehousing activities<sup>6</sup>. Similarly, in the case of the agency PE, once the intermediary is compensated on an arm's length basis, the input statement argues that no further profit should be attributed to the PE<sup>7</sup>. For these reasons, it is therefore fair to say that **the implementation of BEPS Action 7 by jurisdictions is rather heterogeneous**<sup>8</sup>. Accordingly, some of us advocate in favor a stronger coordination between the tax treaty aspects (lowering or rethinking the permanent establishment definition) and transfer pricing issues (attribution of profits to permanent establishments), on the other hand<sup>9</sup>.

3. We feel that the tax policy challenges raised by the digital economy underscore the need for an **increased coordination between tax treaty and transfer pricing aspects**. Therefore, some of us feel that if future work is to be carried in this area with a view to revisit, once again, the permanent establishment threshold it would be desirable to (i) first resolve the controversy surrounding the attribution of profits under BEPS Action 7 and (ii) simultaneously address

---

<sup>5</sup> University of Lausanne, Tax Policy Center, DANON R./CHAND V., Comments on the 22 June 2017 Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments (cited Comments on the Discussion Draft hereafter), Example 4, Paras. 45-49.

<sup>6</sup> *Ibidem*

<sup>7</sup> University of Lausanne, Tax Policy Center, DANON R./CHAND V., Comments on the Discussion Draft, Example 2, Paras. 28-35. The analysis under the foregoing situations is premised on the assumption that the tax treaty at stake follows the Authorized OECD Approach (AOA), see OECD (2010), 2010 Report on the Attribution of profits to permanent establishments, Paris (cited Attribution Report hereafter), Part I: General Considerations, Para. 10.) However, if the tax treaty at stake provides for a non-AOA methodology (a formulary approach), then the profits attributable to the PE could be significantly higher (for instance, the market jurisdiction may allocate a percentage of the sales to the PE). Therefore, attribution of profits to the PE in a market jurisdiction would depend on the exact wording of the treaty. Consequently, uniform attribution rules do not exist and each State may adopt its own approach.

<sup>8</sup> See thereupon DANON R. / SALOMÉ H., The BEPS Multilateral Instrument – General overview and focus on treaty abuse, in IFF Forum für Steuerrecht, 3, 2017, p. 197

<sup>9</sup> See DANON R., The Permanent Establishment Concept in the Post BEPS world – Selected thoughts on future challenges, forthcoming; CHAND, V./SPINOSA, L., Shortcomings of BEPS Action 7 with Respect to Taxing Digital Business Models, Section 6, forthcoming.

whether a consensus and a feasible solution could be found under transfer pricing rules for the digital economy<sup>10</sup>. Otherwise, the entire exercise would in our view yield little practical results.

4. Finally, the lack of agreed coordinated framework under BEPS Action 1 has, meanwhile, led several jurisdictions to adopt **unilateral measures**. Experience shows that these measures may have **distortive effects and lead to new international double taxations situations**.

### III Options to address the broader direct tax policy challenges

#### III.1 Significant Economic Presence test (SEP)

##### III.1.1 In general

5. Turning to options aiming at addressing the broader direct tax policy challenges of the digital economy, we begin with the tax nexus concept of “*significant economic presence*” (SEP). Specifically, an input is requested on the following questions: 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? and (iv) how could such a measure be efficiently and effectively implemented in practice?
6. The objective of any business is to sell goods or provide services or do both. Goods can either be physical products or digital products. Physical products could either be sold through brick/mortar models or through online mediums. On the other hand, digital products are mostly sold online. Likewise, services can either be provided physically through brick and mortar models or through online mediums. The question arises as to whether the SEP concept should apply to “all enterprises” that commercialize their activities through brick and mortar models and/or online mediums or should the concept capture only “*digital enterprises*” that commercialize their activities mainly through online mediums? In order to avoid the issue of “*ring-fencing*” the digital economy (i.e. applicability of the rules only to “digital enterprises”), the SEP concept should, from a subjective standpoint, be applicable to “all enterprises”<sup>11</sup>; at the

---

<sup>10</sup> Ibidem.

<sup>11</sup> On this issue, see also COMMITTEE OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS, Report E/C.18/2017/CRP.22 on Tax challenges in the digitalized economy: Selected issues for possible consideration,

same time, as far as the objective scope is concerned, the test should not be overly broad. Of course, the SEP test would apply to non-resident enterprises that have a purposeful and sustained interaction with the economy of the market jurisdiction.

### III.1.2 Compatibility issues

#### III.1.2.a Relation with tax treaties and transfer pricing

7. The Action 1 report proposes several factors<sup>12</sup> (such as revenue based, digital based and user based factors) to determine whether or not a SEP exists in the market jurisdiction. The adoption of the SEP threshold would of course require **an amendment to the tax treaty definition of permanent establishment**<sup>13</sup>, so to allow this concept to operate as nexus for taxing rights on profits also for the new business models connected with the digital economy. Yet, as discussed above, this option would yield little practical result if the possibility of making changes to the **attribution guidelines**<sup>14</sup> and **the transfer pricing guidelines**<sup>15</sup> is not explored simultaneously. Indeed, if the existing AOA is applied, profit attribution will depend on the significant people functions performed at the level of the PE. If significant people functions are not performed in the market jurisdiction then the income attributable to the PE will be negligible<sup>16</sup>. Therefore, significant changes will need to be made to the current profit allocation framework, which will require thorough studies of the possible reform options.
8. Some of the contributors of this input argue that it would be desirable to ascertain whether the application of a specific method for allocation of taxing rights (such as for instance the profit-

---

Fifteenth session (17-20 October 2017) (cited Report on Tax Challenges in the digitalized economy hereafter), Para. 8 – 12.

<sup>12</sup> With reference to the potential factors that could further be considered to that effect, see HONGLER, P./PISTONE, P., Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy (January 1, 2015). Available at SSRN: <https://ssrn.com/abstract=2586196>.

<sup>13</sup> Art. 5 of the OECD Model (see OECD (2014), Model Convention with Respect to Taxes on Income and on Capital (cited OECD Model hereafter)).

<sup>14</sup> Art. 7 of the OECD Model; OECD (2010), 2010 Report on the Attribution of Profits to Permanent Establishments, Paris.

<sup>15</sup> OECD (2017), OECD Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administrations 2017, OECD Publishing, Paris.

<sup>16</sup> CHAND, V./SPINOSA, L., Shortcomings of BEPS Action 7, Section 6.

split method) could reach satisfactory results for the new business models connected with the digital economy and the current framework be reformed accordingly. In this regard, it should be determined whether the concept of assets for the purpose of attribution of income to the permanent establishment could also include intangibles that are connected with the involvement of users in the market jurisdiction<sup>17</sup>.

9. Some of the other contributors feel by contrast that another possible alternative may be to implement the SEP test through a shared taxing rights mechanism (for instance, see Art. 10 and 11 of the OECD Model or Article 12 of the UN Model). The Tax Policy Center of the University of Lausanne is currently exploring whether and how this option or other similar options that move in the same direction could concretely be implemented and how the policy and legal issues such an option may raise could be addressed.

### III.1.2.b Relation with EU Law

10. The EU Law implications of a SEP-based approach would refer to the two planes of EU primary and secondary law. In particular, EU primary law issues would refer to the interaction with the EU fundamental freedoms and with the prohibition of State Aid enshrined in the Treaty on the Functioning of the European Union (TFEU). Secondary law would mainly refer in this context to the interaction of the proposed measures with the existing framework of Directives in the area of direct taxation<sup>18</sup>.
11. From an EU primary law perspective, it is settled case law that under the case law of the Court of Justice of the European Union (CJEU) Member States' retain the power to define, by treaty or unilaterally, the criteria for allocating their powers on taxation<sup>19</sup>. Therefore, the introduction of the SEP threshold for purposes of allocating taxing powers should in principle not be incompatible with the **EU non-discrimination concept**. It may also be envisaged that the SEP be coupled with a non-final withholding tax acting as a supplementary collection mechanism and enforcement tool, as outlined in section III.2.1 of this note. Under such a scenario, it should

---

<sup>17</sup> See in this regard HONGLER, P./PISTONE, P., Blueprints for a New PE Nexus and BRAUNER, Y./PISTONE, P., Adapting Current International Taxation to New Business Models: Two Proposals for the European Union, Bulletin for International Taxation, 12, 2017, in particular Section 3.

<sup>18</sup> With reference to the compatibility of the SEP with EU Law further considerations are carried out in BRAUNER, Y./PISTONE, P., Adapting Current International Taxation, in particular Section 3.

<sup>19</sup> See CJEU, 21 September 1999, C-307/97, Saint-Gobain, Para. 56-58.

be explored whether any concern could be raised from a primary EU Law viewpoint with regard to the different treatment (essentially in terms of cash-flow disadvantage and supplementary administrative burden) of different “categories” of non-residents, assuming that non-resident taxpayers with a “traditional” PE would not be subject in the PE State to a withholding tax while non-resident taxpayers with a “digital” SEP would be subject to a withholding tax, albeit non-final<sup>20</sup>.

12. **State aid law** (art. 107 et seq. TFUE) should however also be borne in mind. State aid rules could indeed become potentially applicable if a Member State unilaterally introduces rules on profit allocation that result in a different (higher) tax burden for certain undertakings, as compared to other undertakings that are legally and factually comparable, adopting as a reference framework the tax regime ordinarily applicable to undertakings<sup>21</sup>. From the perspective of State Aid rules, therefore, it would be important to ensure that the new rules do not ring-fence a specific sector of activity, such as for instance the digital economy. Accordingly, any tax bias between the regime applicable to traditional and new business models can potentially generate a ring-fencing effect and become a selective tax advantage that distorts or threatens to distort competition within the internal market.
13. On the other hand, the SEP concept does not seem problematic from the perspective of **secondary EU law**<sup>22</sup>.

---

<sup>20</sup> This circumstance also raises a new form of market equality problem between two different ways of exercising the secondary right of establishment that trigger the liability to tax in the host state at different standards, i.e. between the “traditional” PE and the SEP. See in this regard, CJEU, 21 September 1999, C-307/97, Saint-Gobain, Para. 47 – 53, where the Court concludes that two forms of exercise of the secondary right of establishment are equivalent whenever the host State exercises its taxing jurisdiction on them.

<sup>21</sup> See in this regard, CJEU, 21 December 2016, Case C-20/15 P, World Duty Free and CJEU, 15 November 2011, Joined Cases C-106/09 P and C-107/09 P, Gibraltar with regard to the assessment of the presence of legal and factual selective advantages.

<sup>22</sup> For the sake of coherence, however, it may be worthwhile to consider whether PE definitions in secondary EU law (e.g. in article 2(b) of the Parent-Subsidiary-Directive) would benefit from an interpretation and application that is consistent with those proposed solutions.

## III.2 Withholding Tax on Certain Digital Transactions and Equalization levy

### III.2.1 Scope of the analysis

14. The BEPS Action 1 Report mentions that a **withholding tax**<sup>23</sup> could, in theory, be imposed alternatively<sup>24</sup>: (i) as a **standalone gross-basis final withholding tax** on certain payments made to non-resident providers of goods and services ordered online; or (ii) as a **primary collection mechanism and enforcement tool** to support the application of the nexus option based on SEP.
15. The first configuration of the concerned withholding tax could be applied to transactions for goods or services ordered online (i.e. digital sales transactions) or to all sales operations concluded remotely with non-residents. Under the second configuration, the withholding tax would be non-final and would be used as a tool to support net-basis taxation. In this scenario, a broad scope of application covering all remote supplies could be foreseen, the tax so withheld could be claimed against any outstanding tax liability resulting from the detection of SEP or, shall no SEP be detected, be claimed back by the affected taxpayer.
16. Based on the wording of the “Request for inputs”, it would be our understanding, based on reference to potential instances of “international double taxation”, that, for the purposes of the consultation, the focus would be placed on the first configuration of a withholding tax approach. At the same time, it would seem to us that it would be hard to distinguish between such a “standalone gross-basis final withholding tax on certain payments made to non-resident providers of goods and services ordered online” and an “equalization levy” as currently understood in the current international tax policy debate. For this reason, we have brought these two options under a single heading, provided that they would raise analogous issues in terms of compatibility with EU and international trade law obligations<sup>25</sup>. It should also be noted that this

---

<sup>23</sup> A further implementation model of withholding-based approach that would not be limited only to specified “digital transactions” may be found in BRAUNER, Y./BÁEZ MORENO, A., Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy (February 2, 2015). WU International Taxation Research Paper Series No. 2015 - 14. Available at SSRN: <https://ssrn.com/abstract=2591830>.

<sup>24</sup> See Action 1, Para. 7.6.3.

<sup>25</sup> On the other hand, the second configuration of the withholding tax would have to be placed with the broader framework of the SEP and would only function as a collection mechanism and enforcement tool. For this reason, for the broader implications of such an option, a reference could be made to the considerations carried out in relation to the SEP in Section III.1.

approach seems justified by the circumstance that questions raised with regard to the “withholding tax” approach and the “*equalization levy*” approach are the same in the “Request for inputs”, namely:

- (i) What transactions should be included within [the] scope [of the tax]?
- (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?

17. As acknowledged also by the BEPS Action 1 Report, an equalization levy could be structured in a variety of ways depending on its ultimate policy objective<sup>26</sup>. The policy rationale of an equalization levy as purported by the Action 1 Report would be intended to serve as a way to tax non-resident enterprises where it is perceived that the latter would have a SEP in a jurisdiction.
18. In this regard, even though no detailed draft has been circulated, the **Communication** recently released by the **European Commission** briefly refers to an equalization levy as a “[a] tax on all untaxed or insufficiently taxed income generated from all internet-based business activities, including business-to-business and business-to-consumer, creditable against the corporate income tax or as a separate tax.”<sup>27</sup> At the same time, no public draft has been circulated to date.
19. In the light of the above, we shall consider an equalization levy on the digital economy as a tax charged on the turnover of enterprises operating in this sector, i.e. the turnover derived from their global business. Moreover, we shall assume that this levy pursues the goal of allowing the country of value creation to exercise its taxing sovereignty over business connected with the digital economy and to equalize the tax burden applicable to business in the traditional scenario of the physical economy. For such reason, we shall also assume that the equalization levy applies neither to traditional business activities, nor to the ones that operate under the sole sovereignty of that state (so-called purely domestic business activities). Finally, we shall assume in such scenario that the state of residence of all business will continue levying taxes on all

---

<sup>26</sup> See Action 1, Para. 7.6.4.

<sup>27</sup> 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, Brussels 21.9.2017, at 10.

business income, thus both the ones connected with the digital and physical economy, giving relief for foreign taxes levied on income under the applicable domestic and treaty rules.

### III.2.2 Compatibility issues

#### III.2.2.a Relation with tax treaties

20. Although the characterization of an equalization levy is debatable, it seems however outside the scope of tax treaties (art. 2 OECD Model Tax Convention)<sup>28</sup>. Therefore, the introduction of an equalization levy by market jurisdictions on a unilateral basis may **entail a risk of international double taxation** as the State of residence would not be obliged to provide relief under the applicable tax treaty and/or, as the case may be, under its domestic double taxation relief rules<sup>29</sup>.

#### III.2.2.b Relation with EU Law

21. The EU Law implications of an equalization levy would refer to the two planes of EU primary and secondary law. In particular, EU primary law issues would refer to the interaction with the **EU fundamental freedoms and with the prohibition of State Aid enshrined in the TFEU**. Secondary law would mainly refer in this context to the interaction of the proposed measures with the existing framework of Directives in the area of taxation and, in particular, due to the circumstance that the equalization levy may be characterized as tax on turnover, with secondary EU law in the area of VAT.

---

<sup>28</sup> In the Indian experience, the equalisation levy has been expressly carved out of the income tax. It may however always be argued that the Indian Equalisation Levy may more correctly be characterised as a withholding tax rather than a “pure” equalisation levy in the sense purported by the BEPS Action 1 Report.

<sup>29</sup> It may be noted that the US allows the interpretation of its tax treaties in a way that foreign tax relief is given for taxes levied “in lieu of income tax”, including in such context especially withholding taxes. Yet, it is doubtful whether such an interpretation could allow to reach satisfactory results in respect of relief for taxes levied on turnover, as it would be the case for an equalisation levy, provided that the latter ones are substantially different from the ones levied on income. Therefore, this situation could lead to polarise taxation of income in the country of residence of the enterprise and taxation of turnover in that of the market, generating a potential negative tax bias that could severely undermine cross-border economic relations connected with the new business models and the digital economy.

22. Under the case law of the CJEU,<sup>30</sup> any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favorable treatment in tax matters given to recipients of services established in the latter State. Since the object and purpose of equalization levies would be to allow for an exercise of taxing powers in the State of the recipient of digital services, thus systematically compensating taxes charged by the State of the supplier in conformity with a different nexus, such levies would clearly constitute a tax obstacle on the free circulation of services within the European Union. Accordingly, insofar as digital services are effectively supplied from an EU Member State to another EU Member State, any compensatory effect produced by the equalization levy charged by the latter State in respect of a more favorable tax treatment applicable in the former State, may be incompatible with Article 56 of the Treaty on the Functioning of the European Union. The likely non-credibility of such a tax under tax treaties may further exacerbate the different treatment across the borders as compared to the one applicable to traditional business models, which can further dissuade persons from supply digital services in another Member State.
23. In summary, the very concept of equalization levies, as described in the previous section, would be at odds with the principles and foundational legal values of the EU internal market, to the extent that the levying of tax on business activities connected with the digital economy may potentially harm level-playing field in the European Union. This may occur insofar as such levies apply to the revenue derived from cross-border digital situations only, and a give rise to different tax treatment from the one that applies to income generated from traditional business activities. In fact, this situation may therefore generate a different treatment across the borders as compared to the one applicable to traditional business models, which can further dissuade persons from supplying their services digitally.
24. In concrete terms, the equalization levy would be implemented in the form of a final withholding tax on certain transactions. Such an approach would be compatible with the EU fundamental freedoms only insofar as it would apply identically to comparable residents and non-residents or, more generally, to comparable cross-border situations and purely domestic situations. This yardstick would preclude different rates, but also – given the case law of the CJEU – taxation on a gross basis in cross-border situations and on a net basis in comparable domestic situations.

---

<sup>30</sup> See in particular, CJEU, 26 October 1999, case C-294/97, *Eurowings Luftverkehr*, especially Para. 44 – 45.

25. **From an EU primary law viewpoint**, a domestic measure that distinguishes between residents and non-residents (assuming that the withholding tax be applied only to non-residents) appears to be problematic from the perspective of the fundamental freedoms.
26. Any domestic measure that imposes a higher tax on either of these categories would only be compatible with EU law if justified by an overriding reason relating to the public interest. A likely justification on which Member State may tend to rely would be the need to prevent tax avoidance and evasion. In this regard, the CJEU's traditional response to this type of justification has been that domestic measures in that area ought to specifically target wholly artificial arrangements<sup>31</sup>. Measures that go beyond this standard, and also cover arrangements that are not 'wholly artificial', such as the one hereby under scrutiny, would be difficult to maintain in the light of the CJEU's consistent case law.
27. It may also be observed in more specific terms that, provided that, the BEPS Action 1 Report traces the idea of an "equalization levy" to the taxation of the insurance industry<sup>32</sup>, it may be useful to refer to the CJEU decision in the *Safir* case<sup>33</sup>. That case concerned a Swedish rule requiring residents that took a life insurance policy with a non-resident insurer to pay an insurance premium tax in Sweden (leading to burdensome procedural requirements for policy-takers choosing a non-resident insurer). The Swedish measure was intended "to ensure competitive neutrality" between domestic and foreign policies. The CJEU held that, due to its dissuasive effect on cross-border insurance services, the measure was contrary to the freedom to provide services. Given the express reference in the Final Report of BEPS Action 1 to such levies on insurance premiums as an inspiration for the suggested equalization levy (as well as its objective of "ensuring equal treatment of foreign and domestic suppliers"), the *Safir* case serves as a useful illustration of the possible restraints imposed by European law in this context.
28. Moreover, **EU State Aid law** could apply if an EU Member State unilaterally introduces a withholding on (certain) digital transactions in such a way that the conditions of application

---

<sup>31</sup> CJEU, 12 September 2006, Case C-196/04, *Cadbury Schweppes*, Para. 55.

<sup>32</sup> Namely, in the area of insurance, some countries have adopted equalisation levies in the form of excise taxes based on the amount of gross premiums paid to offshore suppliers. Such taxes are intended to address a disparity in tax treatment between domestic corporations engaged in insurance activities and wholly taxable on the related profits, and foreign corporations that are able to sell insurance without being subject to income tax on those profits, neither in the state from where the premiums are collected nor in state of residence. See Action 1, Para. 7.6.4.

<sup>33</sup> See CJEU, 28 April 1998, case C-118/98, *Safir*.

thereof (*de iure* or *de facto*) result in a different (higher) burden for certain undertakings, as compared to other undertakings that are legally and factually comparable, adopting as a reference framework the tax regime ordinarily applicable to undertakings<sup>34</sup>. Asymmetric tax burdens may arise, for instance, where a specific sector of activities is treated more favorably than other sectors. The design of a withholding tax should thus carefully consider the limits imposed by EU State Aid law and avoid creating asymmetric burdens.

29. Finally, EU law precludes EU Member States from introducing ‘turnover taxes’ in addition to VAT<sup>35</sup>. The CJEU has held this to be the case for turnover taxes that display the essential characteristics of VAT even if they are not identical to it in every way<sup>36</sup>; at the same time such a test would foresee that all the four characteristics of VAT would have to be met to that effect<sup>37</sup>. The qualifying characteristics would in particular be the following: (i) the tax applies generally to transactions relating to goods or services; (ii) it is proportional to the price charged by the taxable person in return for the goods and services which he has supplied, (iii) it is charged at each stage of the production and distribution process, irrespective of the number of transactions which have previously taken place, (iv) the amounts paid during the preceding stages of the process are deducted from the tax payable by a taxable person, with the result that the tax applies, at any given stage, only to the value added at that stage and the final burden of the tax rests ultimately on the consumer. Since the taxable basis of an “equalisation levy” would most likely be the sales price charged to the customer, these characteristics should be borne in mind in order to ensure that the withholding tax cannot be considered as a turnover tax in the sense of EU law.

---

<sup>34</sup> See in this regard, CJEU, 21 December 2016, Case C-20/15 P, *World Duty Free* and CJEU, 15 November 2011, Joined Cases C-106/09 P and C-107/09 P, *Gibraltar* with regard to the assessment of the presence of legal and factual selective advantages.

<sup>35</sup> See Art. 401 of Council Directive 2006/112/EC of 28 November 2006.

<sup>36</sup> CJEU, 31 March 1992, Case C-200/90, *Dansk Denkvit and Poulsen Trading*, in particular Para. 11 – 14 and CJEU, 29 April 2004, Case C-308/01, *GIL Insurance and Others*, Para. 32.

<sup>37</sup> See in this regard CJEU, 8 June 1999, Case C-338/97, *Pelzl and Others* and CJEU, 3 October 2006, Case C-475/03, *Banca Popolare di Cremona*, Para. 28 – 38 where the “test” and the underlying reasoning is applied to a tax such as IRAP. At the same time, a more literal interpretation of the prohibition to introduce turnover taxes has recently been set forth by Advocate General Kokott in her Opinion of 5 September 2013 delivered in relation to the case C-385/12 on the special Hungarian retail tax. For the time being, however, the Court of Justice would appear to have upheld its narrower test.

30. An additional issue of compatibility with EU law could arise insofar as the equalization levies were introduced **by means of enhanced cooperation**, i.e. by a number of EU Member States representing at least one third of the total EU Member States<sup>38</sup>. In particular, Article 326 TFEU indicates that such cooperation shall neither undermine the internal market, nor constitute a barrier to trade between Member States or distort competition between them. Article 327 adds that it should respect the sovereignty of States not participating to enhanced cooperation. Because of its compensatory effects, the equalisation levies may in our view undermine the sovereignty of EU Member States that have opted not to participate to it.

### III.2.2.c Relation with International Trade Law

31. The most obvious part of the WTO umbrella of agreements that is at odds with the equalization levy is the GATS, since it is likely that the majority of the equalization levy's base is likely to be viewed as receipts from the provision of services. The classification of the tax base is important for the WTO analysis since the different agreements protect different sorts of trades differently, the GATS applying to the provision of services only.
32. A precise and detailed analysis of compatibility of an equalization levy with the GATS would require a detailed legal rule as well as a particular national context, since different countries submit in the GATS specific and differing obligations, and such obligations were based on a classification method that had been devised prior to the ascent of the digital economy, so the analysis of the specific countries obligations under the GATS is not straightforward when it comes to the digital economy<sup>39</sup>. Yet, basic treaty interpretation rules and common practice must lead one to conclude that arguing that the later evolution of the digital economy cannot be used to fully exempt it from GATS scrutiny.
33. In fact, at a broader level, it may be argued that there is a general agreement that the digital economy should not be ring-fenced and hence it should be treated as "the economy" for the purposes of its taxation. In more specific terms, it should be observed that many countries have

---

<sup>38</sup> For further considerations on the potential implications of an introduction of this measure by means of enhanced co-operation, see BRAUNER Y./ PISTONE, P., Adapting Current International Taxation, in particular Section 2.

<sup>39</sup> The case of India is a peculiar one, in fact, the scope of application of the equalization levy would cover digital advertisement. This circumstance would provide India with some significant leeway given that, in its Schedule of Commitment to National Treatment under GATS, India has not included advertisement services. The Schedule of Commitments for each economy may be retrieved at the following link: [https://www.wto.org/english/tratop\\_e/serv\\_e/serv\\_commitments\\_e.htm](https://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm)

made GATS commitments in sectors that clearly include digitalization, such as advertising, telecommunication and software. For the purposes of our compatibility analysis we assume therefore that the equalization levy will impact trade in services subject to GATS obligations in many if not most cases<sup>40</sup>.

34. The GATS include two primary rules: national treatment (“NT”) and most-favored-nation (“MFN”). The application of the former concerns discrimination among foreigners, and therefore it applies in cases of different treatment of residents of different countries. We are unable to predict whether such practice is likely to occur in this context and hence we shall focus on the NT norm. GATS Art. XVII prohibits a less favorable treatment of foreign service providers compared to domestic service providers (in the covered industries).
35. There is little doubt that the equalization levy provides an additional burden on foreign service providers, especially if we assume that the levy is unlikely to be creditable by the state of residence of the service provider.
36. GATS includes an exception in Art. XIV(d) for “difference in treatment ... aimed at ensuring the equitable or effective imposition or collection of direct taxes,” direct taxes defined as “all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.”<sup>41</sup> Even if the equalization levy were argued to operate as an “equalizer” it would not pass this exception on point since it is levied on the turnover of corporations.<sup>42</sup>
37. In any event, GATS Art. XIV’s chapeau<sup>43</sup> provides that carve-outs are not absolute, and may still be challenged under GATS if they constitute arbitrary or unjustifiable discrimination or disguised restrictions on trade in services. There is little law on the interpretation of this

---

<sup>40</sup> The Indian equalisation levy is a notable exception because it would apply to (online) advertisement and India has not committed to National Treatment under GATS with regard to advertisement services. Shall the scope of application of the levy be broadened – as it was originally proposed – significant international trade law issues may arise also for India.

<sup>41</sup> See Art. XXVIII (o) GATS.

<sup>42</sup> This provision includes a footnote with illustration of measures that may be acceptable, yet since the levy cannot qualify for the exception, one cannot analyse it in light of this footnote.

<sup>43</sup> That reads: “Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services ...”

chapeau, yet it obviously may be used as a basis for litigation against the equalization levy in front of the WTO.

38. It should be noted that the application of the GATS may be just part of the WTO law compatibility of the equalization levy. The GATT also includes NT and MFN provisions. Assuming irrelevance of the MFN norm (see above assumption), the NT rule in the GATT, Art. III:2 prohibits discrimination against imported goods by the means of internal (nontariff) taxes. Discrimination is measured by comparison between the treatment of the imported goods and “like” domestic products. The likeness test may be complex in this case, yet if the equalization levy is imposed on the turnover it may very well be viewed as applying separately to each and every product imported, especially if it is a simple flat tax as it seems to be under the currently floated proposal. Moreover, there is no reason to argue that products in this case do not include digitized products. Many digitized products compete against very similar digitized domestic products, and therefore one must anticipate exposure of the equalization levy to the GATT NT with respect to these products.<sup>44</sup>

39. **In conclusion, an equalisation levy substantially displaying the features of a turnover tax is likely to be incompatible with WTO obligations of many countries, primarily pursuant to the GATS, but also pursuant to the GATT.** The exact exposure depends on the exact articulation of the levy and the countries applying it, yet, in any event the incompatibility is likely to be very meaningful. A non-universal levy, applying differently to different countries, may require even further caution due to the potential application of the MFN clauses in addition to the NT provisions discussed above.

### III.2.3 Synthesis

40. An “equalization levy” implemented in the way it is generally purported in the current international tax policy debate on the basis of the Indian experience would appear to be hard to distinguish from a turnover tax. This characterization would evidently not raise issues of compatibility with income tax treaties as such tax would fall outside of their scope. At the same

---

<sup>44</sup> As earlier mentioned, Art. III.2 is traditionally understood as applying only to indirect taxes, and not to income (or other direct) taxes because these cannot be qualified as taxes on products. Nevertheless, there is no clear language necessitating this interpretation. In our opinion even direct taxes may be qualified under Art. III, para. 2 as “other internal charges of any kind”. The equalization levy is even more vulnerable than income taxes when applied to the turnover as explained above.

time, this would imply that said levy would typically not be creditable in the State of residence of the affected taxpayer thus giving rise to instances of international double taxation.

41. On the other hand, such a levy would be susceptible to raise varied and not easy to resolve compatibility issues with European law and international trade law obligation. The latter potential issues have most likely not been raised with regard to the Indian equalization levy simply because such levy would fundamentally apply to online advertising and, for the time being, India has not committed to National Treatment for this type of services under the GATS.
42. In a way, the equalization levy may actually be considered as “a solution in search of a problem”, provided that the trigger behind the whole digital taxation policy debate was offered by the perception that MNEs were not paying their “fair share” of (income) taxes. By introducing a solution outside of the scope of the income tax we would be moving in uncharted territory and potentially encourage a proliferation of “alternative levies” that are likely to undermine not only the international tax regime but the very reliance on the income tax as a pillar of the international tax regime.

\*\*\*

## REFERENCES

### Literature

BRAUNER Yariv / BÁEZ MORENO Andrés, Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy (February 2, 2015). WU International Taxation Research Paper Series No. 2015 - 14. Available at SSRN: <https://ssrn.com/abstract=2591830>.

BRAUNER Yariv / PISTONE Pasquale., Adapting Current International Taxation to New Business Models: Two Proposals for the European Union, forthcoming on Bulletin for International Taxation, 12, 2017.

CHAND, V./SPINOSA, L., Shortcomings of BEPS Action 7 with Respect to Taxing Digital Business Models, forthcoming

DANON Robert, The Permanent Establishment Concept in the Post BEPS world – Selected Thoughts on Future Challenges, forthcoming.

DANON Robert / SALOMÉ Hugues, The BEPS Multilateral Instrument – General overview and focus on treaty abuse, in IFF Forum für Steuerrecht 2017/3, pp. 197-247.

HONGLER, P./PISTONE, P., Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy (January 1, 2015). Available at SSRN: <https://ssrn.com/abstract=2586196>.

### Policy documents

COMMITTEE OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS, Report E/C.18/2017/CRP.22 on Tax challenges in the digitalized economy: Selected issues for possible consideration, Fifteenth session (17-20 October 2017).

EUROPEAN COMMISSION, DIRECTORATE-GENERAL FOR TAXATION AND CUSTOMS UNION, 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, Brussels 21.9.2017.

OECD (2017), OECD Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administrations 2017, OECD Publishing, Paris

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.

OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

OECD (2014), Model Convention with Respect to Taxes on Income and on Capital.

OECD (2010), 2010 Report on the Attribution of profits to permanent establishments, Paris.

## **Public comments**

University of Lausanne, Tax Policy Center, DANON R./CHAND V., Comments on the 22 June 2017 Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments.

## **Case law**

CJEU, 21 December 2016, Case C-20/15 P, European Commission v. World Duty Free Group SA.

CJEU, 5 September 2013, Case C-385/12, Hervis Sport- és Divatkereskedelmi Kft. v. Nemzeti Adó- és Vámhivatal Közép-dunántúli Regionális Adó Főigazgatósága, Opinion of Advocate General Kokott.

CJEU, 15 November 2011, Cases C-106/09 P and C-107/09 P, European Commission v. Government of Gibraltar.

CJEU, 3 October 2006, Case C-475/03, Banca popolare di Cremona Soc. coop. arl v Agenzia Entrate Ufficio Cremona.

CJEU, 12 September 2006, Case C-196/04, Cadbury Schweppes plc v. Commissioners of Inland Revenue.

CJEU, 29 April 2004, Case C-308/01, Gil Insurance and others v. Commissioners of Customs and Excise.

CJEU, 26 October 1999, Case C-294/97, Eurowings LuftverkehrsAG v. Finanzamt Dortmund-Unna.

CJEU, 21 September 1999, Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt.

CJEU, 28 April 1998, Case C-118/98, Jessica Safir v. Skattemyndigheten i Dalarnas Län.

CJEU, 8 June 1997, Case C-338/97, Pelzl and Others v. Steiermärkische Landesregierung.

CJEU, 31 March 1992, Case C-200/90, Dansk Denavit and P. Poulsen Trading v. Skatteministeriet.

Tribunal administratif de Paris, 12 July 2017, Case 1505113/1-1, Google Ireland Limited v. Administration générale des finances publiques.

## **APPENDIX - List of Contributors**

Professor **Niels Bammens** is Professor of Tax Law at the Catholic University of Leuven (KU Leuven) and of counsel to EY Belgium FSO Tax. In 2012 he received the Mitchell B. Carroll Prize for his doctoral thesis, defended at KU Leuven, titled "The principle of non-discrimination in international and European tax law" (published in the IBFD Doctoral Series). In addition, he is the author of various contributions in Belgian and foreign journals and books. His research concerns the application and interpretation of double tax treaties, the evolution of European direct taxation, the interaction between international and European tax law, the economic efficiency of double tax treaties and the history of double tax treaties.

Professor **Yariv Brauner** holds the Hugh Culverhouse Eminent Scholar Chair in Taxation at the University of Florida Levin College of Law where he is also Alumni Research Scholar and Research Foundation Professor. He joined the Florida faculty in 2006, after teaching at NYU, Northwestern and ASU. He has been a Visiting Professor or a guest speaker in various universities in the U.S. and abroad. He is an author of articles published in professional journals and law reviews, and a co-author of U.S. International Taxation – Cases and Materials (with Reuven S. Avi-Yonah and Diane M. Ring), now in its third edition. He taught multiple courses in the fields of Taxation, Corporate Taxation, International Taxation, International Trade Law, and the Law of Multinational Corporations. He has held visiting professorships at WU Vienna and at Carlos III University (Chair of Excellence Program) and was the second “Professor in Residence” at IBFD in 2014. Prior to joining the Academe, he has practiced international tax law in New York City, and business law in Israel.

Dr. **Vikram Chand** is the Executive Director, International Tax Education, Tax Policy Center of the University of Lausanne (UNIL) wherein he manages the Master of Advanced Studies in International Taxation (MASIT) Program and the Executive Program in Transfer Pricing (EPTP). Dr. Chand lectures/has lectured on different international tax topics in Universities such as the University of Lausanne, Neuchatel, Zurich, Liechtenstein, Leiden, Maastricht, Leuven, Lisbon, Copenhagen, Moscow. Recently, Dr. Chand has been appointed as an “external expert” for the OECD (Global relation’s platform) pursuant to which he trained hundred and twenty Russian tax

officials in Moscow and fifty Chinese tax officials in Vienna on international tax policy, tax treaties and transfer pricing related matters. Dr. Chand holds a PhD (with distinction) in International tax law, which focuses on the interaction of domestic anti-abuse rules (GAARs and SAARs) with tax treaties. Dr. Chand's currently researches and publishes on topics related to International Tax Policy, Transfer Pricing, Tax Treaties, Taxation of Multinational Groups, Comparative Tax Law and Indian Tax Law.

Professor **Robert J. Danon** is Ordinary Professor of International Tax Law at the University of Lausanne, where he is a Director of its Tax Policy Center, of the LLM in International Taxation and of the Executive Program in Transfer Pricing. Robert Danon, who is founding Partner of the independent tax firm Danon & Salomé, also renders opinions on complex international tax matters. He is a member of several leading tax organizations and currently serves as the Chairman of the Permanent Scientific Committee (PSC) of the International Fiscal Association (IFA). Robert Danon's recent research interests include the implementation of Base Erosion and Profit Shifting (BEPS) initiative around the globe - a topic on which he acted as the chair of main topic 1 at the 2017 IFA Congress in Rio - as well as taxation of the digital economy, treaty abuse and dispute resolution. Professor Danon is the author and editor of numerous leading publications, including the co-editor of a French commentary to the OECD Model Tax Convention.

Professor **Luc De Broe** holds the Chair of Tax Law at the Catholic University of Leuven (KU Leuven), Belgium and heads the tax litigation team of LAGA law firm in Brussels. He has been a member of the Brussels Bar since 1982 and was a member of the executive committee of the International Fiscal Association in 2007-2012. Professor De Broe is the author of numerous articles on Belgian, international and European tax law. He was awarded the Mitchell B. Carroll Prize of the International Fiscal Association (IFA) in 1988 for his manual on cross-border leasing between Belgium and the United States. In 2008 he published the book "International Tax Planning and Prevention of Abuse" (IBFD, Doctoral Series).

Prof. **Pasquale Pistone** is the Academic Chairman of IBFD. He holds a Jean Monnet ad personam Chair in European Tax Law and Policy at WU Vienna University of Economics and Business (Austria) and is Associate Professor of Tax Law at the University of Salerno (Italy). He has been

invited to present his views in meetings organized by the European Commission, the CJEU and the OECD. Prof. Pistone has been visiting professor of European and/or International Tax Law at various universities, including Florida, Lisbon, Louvain UCL, Melbourne (UM and Monash), Paris (I and II) and São Paulo. In his IBFD capacity he is a member of the Executive Board of the EATLP (European Association of Tax Law Professors) and of the Permanent Scientific Committee of the IFA (International Fiscal Association). Prof. Pistone is the editor-in-chief of the World Tax Journal (IBFD), a fully peer-reviewed interdisciplinary international tax journal. He was a founding member of the GREIT (Group for Research on European International Tax Law), of ILADT's research project on a Model Tax Convention for Latin-America, of WU Vienna's research project on International Tax Coordination (funded by the Austrian Science Fund) and of the DeSTaT project on global fiscal transparency and developing countries (funded by the Norwegian Research Council). Among other prizes and distinctions, he was presented with the EURYI Award of the ERF (European Science Foundation) in 2005.

**Lisa Spinosa** is a PhD candidate at the University of Lausanne in the field of international taxation with a particular interest in the field of the digital economy and hospitality. Graduated from HEC Lausanne with a Master of Sciences in Accounting, Control and Finance and from Ecole hôtelière de Lausanne with a Bachelor in Hospitality Management with a Finance major.

Dr. **Alessandro Turina** is a Post-Doctoral Fellow at the Tax Policy Center of the University of Lausanne, at the International Bureau of Fiscal Documentation (Amsterdam) and a Lecturer at Bocconi University (Milan), researching and teaching mostly in the area of International Taxation (especially on implications for emerging Countries and on the interaction with other areas of International Economic Law), EU Tax Law and Comparative Tax Law. He holds a Ph.D. in International Economic Law from Bocconi University and an LL.M. (international tax, "Grotius" Scholar and "Italian Alumni" Scholar) from the University of Michigan Law School (Ann Arbor, USA). He has spent terms as a visiting researcher ("Ernst Mach Fellow") at the WU - Institute for Austrian and International Tax Law in Vienna as well as at Georgetown University Law Center. He has served on multiple occasions as a visiting lecturer (introduction to tax treaties) at the Financial University under the Government of the Russian Federation (Moscow) and in 2017 he was invited as a visiting lecturer by the Graduate Tax Program of the University of Florida Levin College of Law, where he has taught an introductory course to EU Tax Law. He is a contributing member of

the DeSTaT (Norwegian Research Council) and EUDisCoop (Spanish Ministry of Economy) research projects. His current research focuses on the interface of taxation and digital innovation, on international tax policy issues affecting developing countries, on the EU external strategy for effective taxation and, more broadly, on administrative co-operation in tax matters from a global governance perspective.

By email: [TFDE@oecd.org](mailto:TFDE@oecd.org)

Organisation for Economic Cooperation and Development  
Centre for Tax Policy and Administration  
Pascal Saint-Amans



**Authors:**

Prof. Dr. Christoph Spengel  
*University of Mannheim, Research Associate at the ZEW and Director of the  
MannheimTaxation (MaTax) ScienceCampus*  
Ann-Catherin Werner  
Marcel Olbert  
*both University of Mannheim*

Mannheim, 12 October 2017

**Public input on the tax challenges of digitalisation**

Dear members of the Task Force on the Digital Economy (TFDE),

Dear Mr. Saint-Amans,

We appreciate the opportunity to deliver our views on the tax challenges of digitalization as a response to your request for input. We believe that major shortcomings in the ongoing debate still exist. We further believe that uncoordinated action is dangerous and hampers future investment within the OECD-Area. Therefore, we propose a well sounded plan for future action and we believe that OECD-Standards might be enhanced to tackle business models in the digitalized world. Above all, no new tax order for digitalized businesses is recommended.

The digitalization of the economy is considered as a key driver of innovation, economic growth and societal change, and is a major challenge for the international tax system. However, respective tax reform proposals are still premature. We thus welcome the OECD's approach to discuss the matter with all kinds of stakeholders in order to develop solutions on common ground. In our opinion, one major reason for the difficulties to precisely define the tax challenges of the digital economy and to develop appropriate reform options is – above all – the lack of a common understanding of what the digital economy consists of. In our believe, major traditional business models will turn to digitalized business models very soon.

A major difficulty for policy makers with respect to the taxation in the digital economy is the lack of scientific evidence on the tax challenges as well as profound academic work on the potential merits and drawbacks of the reform options under review. The novelty of the subject to the academic world in business taxation as well as the need for action motivated us to initiate several research projects on taxation in the digital economy at the University of Mannheim and the Centre for European Economic Research (ZEW).<sup>1</sup> We thus seize the opportunity to comment on several of the questions in your request for input based on our early findings and ongoing work as well as insights from other academic work.

### **A. Digitalization, Business Models and Value Creation**

In general, we consider the understanding of digital business models in the international tax community still incomplete. We argue that business model analyses based on economic characteristics that are identified relying on interdisciplinary knowledge are helpful to reach a more profound understanding to develop solutions for tax policy. Based on insights from literature in the fields of industrial economics, management and information technology we have qualitatively analyzed three stylized types of digital business models: Business models in the B2C and B2B sectors as well as the digital transformation of (formerly) traditional, physical business models.<sup>2</sup> We summarize our findings in the following (A1-A5) and also relate our comments on the tax challenges to this work.

#### **A1. Impact of digitalization on business models**

A business creates value if the revenues exceed the corresponding costs. In traditional management science, information technology was seen as a supporting element of the process of differentiation. In the digital economy, the increasing relevance and strategic use of information requires a modern value chain analysis within digital markets to take into account the combination and integration of resources, innovative technologies and information. A digital business model “depicts the content, structure, and governance of transactions

---

<sup>1</sup> In particular, we have conducted the following studies: A qualitative analysis of digital business models and the respective tax challenges in an article published in the World Tax Journal, see Olbert/Spengel, International Taxation in the Digital Economy: Challenge Accepted?, World Tax Journal, 2017, pp.3-46, available at [https://online.ibfd.org/kbase/#topic=doc&url=/collections/wtj/html/wtj\\_2017\\_01\\_int\\_4.html](https://online.ibfd.org/kbase/#topic=doc&url=/collections/wtj/html/wtj_2017_01_int_4.html); The derivation and quantification of Effective Average Tax Rates (EATR), Effective Marginal Tax Rates (EMTRs) and the Cost of Capital for digital business models depending on the location of investment for 33 countries, see PWC/ZEW, Steuerliche Standortattraktivität digitaler Geschäftsmodelle: steuerlicher Digitalisierungsindex 2017, 2017, Frankfurt/Mannheim, (“Digital Tax Index 2017”) available at [http://ftp.zew.de/pub/zew-docs/gutachten/Studie\\_Digitale\\_Geschaeftsmodelle\\_2017.pdf](http://ftp.zew.de/pub/zew-docs/gutachten/Studie_Digitale_Geschaeftsmodelle_2017.pdf); An explorative study in cooperation with ICT experts from the ZEW on the German market for digital services with an evaluation of the relevance of digital service providers from third countries to detect critical market segments in need for support (“Structure and Volume of the Market for Digital Services with a Focus on Companies from third Countries”, initiated and funded by the German Ministry of Finance), see <http://www.zew.de/de/forschung/struktur-und-volumen-des-marktes-von-internetdienstleistungen-mit-fokus-auf-drittlandsunternehmen/?cHash=5adc68515f54ce8b47094cb3bd7b3480>.

Currently, we are working on a qualitative analysis of the tax treatment of cross-border cloud computing transactions; on a survey-based study on the challenges for transfer pricing of digital business models; and on an empirical investigation on the response to tax incentives from value-added taxes and corporate income taxes by multinational companies in the digital economy.

<sup>2</sup> See Olbert/Spengel, International Taxation in the Digital Economy: Challenge Accepted?, World Tax Journal, 2017. Our results were summarized in several other outlets such as Austaxpolicy (<http://www.austaxpolicy.com/international-taxation-digital-economy-challenge-accepted/>), Public Finance International (<http://www.publicfinanceinternational.org/feature/2017/09/tax-and-mend>). A Chinese translation is available in the Shenzhen-based Taxation Translation Journal.

designed so as to create value through the exploitation of business opportunities”.<sup>3</sup> In practical terms, the value creation of a digital business model can be defined as the way of generating revenue (exploitation of business opportunities) by using data and information (content) in a specific form of products or services (structure). This process has to be implemented by skilled personnel acting in strategic management and operations and using appropriate assets within their organization (governance). We suggest to rely on the concept of economic value added (EVA) to quantify the value creation. It captures both sales and related current costs, as well as the opportunity cost of the employed assets within a business model. As a result, one should analyze at what point in time (and for international tax purposes in which location) revenue is generated by sales on the market, costs are incurred through relevant activities (performed anywhere) and assets are employed within digital business models.

## A2. Role of IP and types of IP in business models

Intangible assets are key value drivers of digital business models. Yet, for understanding value creation of digital business models, it is important to note that they can take on new forms other than patents or copyrights, i.e. other than traditional IP that has been intensively discussed in the past. For instance, a lot of R&D is never formalized as IP but still adds substantial value to businesses. Also, hardly measurable categories, such as organizational capital, user-generated content, and human capital related to digital capabilities are large parts of intangibles in digital businesses.<sup>4</sup>

We consider it particularly critical to distinguish between assets of ordinary character that involve only little risk and those assets with a larger contribution to value creation. According to the OECD’s current work on transfer pricing of intangibles, an ordinary asset involving low risk would be, e.g., an assembled workforce (if qualifying as intangible) or only internally used software. However, a detailed analysis of digital business models might reveal that these assets are more crucial for generating profits. In particular, most parts of the IT infrastructure are very important tangible and intangible assets of digital business models because products and services have embedded digital technologies that cannot be disentangled from the underlying IT infrastructure. For instance, empirical studies confirm that investment in IT is positively associated with sales growth and profitability.<sup>5</sup> Not only inherently digital firms, such as cloud software or online platform providers but also traditional businesses make strategic investments to foster the digitalization of their value chain. Therefore, the work on the OECD guidelines on intangibles should be extended with regards to the development and management of the IT infrastructure as well as the strategic location of IT investments and the people influencing the respective business processes.

As a specific type of IP, software is a crucial asset of any digital business model. The tax treatment of the investment in software as well as on its development and use is thus a key pressure area. Today’s software business models are not always formalized in the form of copyrights. The generation of revenue from software is dependent on ongoing maintenance and development. As revenue is further based on service-oriented cloud transactions, protecting software from unauthorized copying through copyrights becomes (partly) obsolete.

---

<sup>3</sup> Amit/Zott, Value Creation in E-Business, Strategic Management Journal 6/7, 2001, p.496.

<sup>4</sup> See Brynjolfsson/McAfee, The Second Machine Age, 2014, p. 119 et sequ. (“Intangibles”).

<sup>5</sup> Cardona/Kretschmer/Strobel, The Contribution of ICT to Productivity: Key Conclusions from Surveying the Empirical Literature, Information Economics and Policy, 25(3), 2013, pp. 109-125.

As a practical example, the traditional German automotive supplier Bosch is transforming its business model from a purely physical product-driven approach towards the supply of a cloud through which industrial and private customers are offered software-related services.<sup>6</sup> Tax policy should carefully analyse new forms of software provision, the underlying ownership structure and related business transactions so as to clearly define taxing rights and the nature of underlying income as well as to avoid double taxation.

### A3. Sales operations in digital business models

The sales function is decisive for any company's profitability and should thus be appropriately reflected when aligning taxation (and, in particular, transfer prices) with value creation. While the sales function in many traditional physical product-oriented companies is considered to perform routine activities, it might be of much more strategic nature for certain digital business models due to the reliance on market penetration (user base, network effects). Yet, this notion is hard to capture within the traditional tax framework since digital business models expand internationally via slim organizational structures. Under current tax law, digitalization leads to a convergence of core activities and thus taxable nexus at the location of the parent company or regional hubs. While the sales function is performed locally, the underlying legal and tax structure often takes on the form of commissionaire arrangements. As a result, little profit stemming from digital business models of foreign companies is attributed to market jurisdictions for tax purposes.

We stress that this specific form of sales operations is not necessarily tax-driven but rather represents the outcomes of the technological development. Yet, providing high-quality digital services to end-users requires a certain degree of infrastructure in proximity to the customer market. Also, customer orientation and all related activities are crucial for the success of digital business models. Thus, activities performed by local staff, such as customer support or the technical adaptation of digital products and services to the particularities of local markets (e.g. language features, legal requirements, customer characteristics, etc.), might not be best interpreted as routine tasks from a tax perspective.

Potentially new forms of the sales function of digital business models should be analyzed in more depth as to develop criteria that distinguish between important activities that contribute to customer-centric value creation and rather supportive activities.

In our study on the German market for digital services, we investigated where providers of digital services that are delivered to private consumers are located and to which market segments they belong.<sup>7</sup> Given the size of the market segments and the relevance of B2C-services in that category, we identified eight relevant segments: Gambling, Digital Games, Education, Pornographic Content, Digital Video, Digital Music, Classifieds and Dating.<sup>8</sup> These first market analyses show that providers of digital services can operate from everywhere in the world no matter where the consumers are located. Multiple third-country service providers are active in the German market, as is probably true for many other

---

<sup>6</sup> See <https://www.bosch-si.com/iot-platform/bosch-iot-suite/homepage-bosch-iot-suite.html>.

<sup>7</sup> We analysed the data traffic (over a period of roughly 9 months) of relevant websites using data from the Amazon Alexa Web Services, available at <https://aws.amazon.com/de/awis/>.

<sup>8</sup> Listed here according to the sales volume with final consumers in Germany in 2016.

consumer markets.<sup>9</sup> Consequently, different issues concerning indirect taxation arise. On the one hand, tax authorities are in need to identify the providers of these remote online sales for consumption tax purposes. On the other hand, the providers themselves are burdened with identifying the location and status of their customers in order to adequately declare and remit tax.

#### A4. Types and roles of data

In the ongoing discussion, data is considered a new type of intangible asset for which the tax treatment is crucial but unresolved. We do not share the apparently common perception that the mere process of collecting data substantially adds to value creation. One should rather acknowledge that increased computing power, proprietary software and database management tools have to be managed and strategically used by people in order to facilitate the processing and analyzing of data. Only this sophisticated use of data then is a success factor for digital businesses.

Further, it is important to examine in which functions the data is exploited in order to create value. Additionally, different business models rely on different types of data. While biographic data on private users is crucial for personalized advertising, such data is less relevant for an automotive supplier aiming to digitally optimize maintenance. Due to the dynamic development as well as the individual nature of business models, it is impossible to distinguish how much value for the business is associated with the data of a specific platform user or any other type of data. In the digital age, not only the IT or operations departments exploit data but other functions too. Marketing, customer support and sales may also engage in data collection, processing and analysis depending on the business model. Particularly market-related activities, such as marketing or sales, make extensive use of data and digital technologies.

To arrive at solutions for taxing businesses that make use of data, these phenomena should be accounted for in the functional analysis for transfer pricing purposes. Taxing corporate profits based on the functional analysis will be a less complicated and a more efficient way of taking the value of data into account for tax purposes than any attempt to tax the use of data separately. Theoretical studies show that taxing profits will not influence the amount of data collected by platform providers.<sup>10</sup> In contrast, transaction-based taxes on data are expected to create economic distortions.

In order to exploit data within a business model, database systems are a key asset that combine hardware and software features. The nature and relevance of databases has dramatically changed due to the uptake of online services and cloud computing applications. Guidance on the nature of related payments for the use of database systems (often involving cloud computing transactions) is needed, as it is unclear how the existing principles should be applied for this growing business segment.

---

<sup>9</sup> Further insights on the relevance of third-country service providers, next to domestic or EU-based providers, in the respective segments can only be discussed after the official release of the report by the German Federal Ministry of Finance.

<sup>10</sup> Bloch/Demange, Taxation and Privacy Protection on Internet Platforms, France Stratégie, 2016, pp. 3-4.

#### A5. Platforms for value creation

Digital business models running an online platform usually rely on a well-performing IT landscape without necessarily owning any tangible or intangible assets when accessing foreign markets. Instead, hosting services allow for the same activities to be conducted as when the infrastructure was owned.

Several theoretical studies and practical reports highlight the importance of a meaningful user base for the success of digital business models.<sup>11</sup> The reason is that major (financial) benefits arise for digital businesses relying on the use of platforms due to network externalities. Theory suggests that taxing network externalities can directly increase overall efficiency. Yet, such an approach would clearly depart from existing tax principles. Similarly, it would be difficult to enforce regulation that defines and measures the user base as separate intangibles since not all users are customers that contribute in the same (financial) manner to a platform's value (see our comments in A.4).

When a digital business runs a platform business in foreign markets, the functions of the local subsidiary in the country of the platform users and customers are certainly of high relevance since platforms depend on local usage and customization (see our comments in A.3). E.g., the business model depends on a platform tailored to the local language and regulation as well as to customer-specific configurations. As a result, subsidiaries in countries where users and customers are located might deserve a closer analysis even if their assets and functions are limited from a traditional perspective. Such analyses would be in line with the OECD's idea to consider that the user base might serve as an indicator for value contribution as well as the OECD's statement that the value of consumer-related data is indirectly reflected in financial outcomes such as advertising revenue.

### **B. Challenges and Opportunities for Tax Systems**

Based on the OECD's work on BEPS Action 1 and our qualitative analysis of digital business models, we have initiated several research projects that focus on analyzing and quantifying the tax challenges. We have analyzed the tax rules of 33 countries that are relevant for investments in digital business models in order to compute effective tax burdens for such investments measured as Effective Average Tax Rates and the Cost of Capital. The results offer insights on the implications for the taxation of digital business models (B.1.ii). When commenting on the tax challenges, we further refer to other ongoing work on transfer pricing, cloud computing as well as sales reporting and profit shifting.

#### B1. Issues with the current framework

The OECD aims to overcome this primarily legal view and tax businesses according to value creation and economic activity. However, current tax law attributes taxing rights and, in particular, taxable profits primarily to the jurisdiction where parent companies or regional operating centers of multinational digital businesses are located and important intangible assets are legally owned. The market side of digital business models is largely neglected for tax purposes under existing rules since the slim organizational structures for international

---

<sup>11</sup> See France Stratégie, Taxation and the digital economy: A survey of theoretical models, 2015.

expansion, in particular with regard to sales and marketing, circumvent the establishment of (significant) taxable nexus.

We acknowledge that there is a certain political will to assign more taxing rights to market countries in the digital economy.<sup>12</sup> However, we advocate to act with caution since activity in the market country measured by proxies leading to a virtual or digital presence might lead to uncertainty and economic distortions. As highlighted above, different digital business models act differently in their markets. In other words, data and activities in the country where customers are located do not necessarily attribute the same value to a business.

Further, there is no empirical evidence for the alleged excessive profit shifting activities of digital companies. In a current research project based on a large dataset of European affiliates of multinational companies, we find no differential income tax sensitivity of reported pre-tax profits for firms in the digital sector. While prior studies do not focus on the digital economy, they show that profit shifting behavior is relatively steady across industries. Despite the lack of empirical evidence, the anecdotal cases of Google and Amazon suggest that digital companies engage more aggressively in profit shifting. Yet, the anecdotal evidence also extends to firms relying on sales of physical products such as Apple<sup>13</sup> or Caterpillar<sup>14</sup>. We thus promote rationality when it comes to discussing anti-avoidance measures to combat BEPS in the digital economy.

In a recent survey among German transfer pricing managers and consultants we find that there is no common understanding of the appropriate methods and documentation to price intercompany transactions relating to digital business models. For instance, issues arise when one affiliate offers cloud computing services to other group members or when data mining is performed by one affiliate and respective results are exploited by other group members. While great uncertainty exists with regard to the current tax treatment, the majority of tax managers expect disputes in transfer pricing audits as well as severe risks of double taxation in the future due to the lack of clearly defined transfer pricing guidelines based on an internationally harmonized approach. Most practitioners therefore advocate for a revision of the existing transfer pricing guidelines and favor “safe havens” for non-strategic but dynamic and frequent transaction types in the digital economy. In our view, transfer pricing guidance should be developed with priority since such work would ensure certainty for transactions that are already becoming predominant and will be major topics in tax assessments and tax audits in the near future.

---

<sup>12</sup> E.g. <https://www.eu2017.ee/news/press-releases/eu-finance-ministers-agreed-develop-new-digital-taxation-rules>.

<sup>13</sup> See <http://www.nytimes.com/2013/05/03/business/how-apple-and-other-corporations-move-profit-to-avoid-taxes.html>.

<sup>14</sup> See <https://www.ft.com/content/8b68af3a-b8ed-11e3-a189-00144feabdc0?mhq5j=e7>.

## B2. Implications of digital business models on taxation policy

### i. Existing tax bases, structures, distribution of tax bases

Regarding the indirect taxation of businesses via consumption taxes such as the VAT, distortions of competition have been identified since digital services are treated differently than non-digital services.<sup>15</sup> Similar issues exist in the U.S. context of the sales tax where sellers only need to collect sales taxes on shipments to states where they have a physical presence (nexus).<sup>16</sup> The fact that online sellers delivering to consumers in a state where they have no nexus do not have to collect sales taxes serves as an argument for online sellers' location decisions being affected by sales taxes.<sup>17</sup> The enforcement and collection of consumption taxes is thus one of the major issues for tax authorities. Only since 2015, digital service suppliers in the EU need to comply with the VAT legislation of the Member States where their customers are located (destination principle). This means they need to identify the customers' location in order to apply the correct VAT rate.<sup>18</sup> For the supply of digital services, these pieces of information may not be available<sup>19</sup>, leading to compliance costs and enforcement issues on the one hand and potential loopholes for VAT avoidance on the other hand. We advocate to examine in detail which issues exist regarding the enforcement of the destination principle for digital services (as enacted from 2015) within the EU in order to design a VAT system that is fit for the digital age. Collecting consumption taxes consistently across all segments of the economy is an integral part of fair competition and crucial for generating tax revenue.

Regarding direct taxes, we conclude that profit taxation of digital business models is being "centralized" under current tax law. Abstracting from any tax planning considerations, foreign markets can be accessed without a significant taxable nexus, which leads to taxable profits accruing at the location where a digital business model's people perform the strategic investments and the relevant activities. As a result, we observe two opposing strategies for tax policy. On the one hand, competitive tax incentives are offered to attract investments in digital business models (doubtlessly involving employment) in order to promote a country's

---

<sup>15</sup> The value-added taxation according to the origin principle in place until 2014 provided an incentive to locate in countries with a low VAT rate. Exploiting respective tax rate differentials granted a competitive advantage for supplying digital services to consumers in a high VAT rate country compared to service providers located in such a high VAT rate country and compared to non-digital service providers. On the one hand, final prices for consumers could be set lower while still generating the same net revenue. On the other hand, equal prices could be charged while generating higher net revenues. Considering the highly flexible, i.e. delivered electronically or online, distribution of digital services to private consumers, distortions of competition favouring low-tax countries were a problem for the single EU market.

<sup>16</sup> See e.g. Agrawal/Fox, Taxes in an E-Commerce Generation, *International Tax and Public Finance*, forthcoming; Fox/Luna/Schaur, Destination taxation and evasion: Evidence from US inter-state commodity flows, *Journal of Accounting and Economics* 57, 2014, pp.43-57.

<sup>17</sup> Hoopes/Thornock/Williams, Does use tax evasion provide a competitive advantage to e-tailers?, *National Tax Journal* 69 (1), March 2016, p. 133-168; Bruce/Fox/Luna, E-tailer sales tax nexus and state tax policies, *National Tax Journal* 68 (3S), September 2015, p. 735-766.

<sup>18</sup> If this information is not available, the location of the customer is based on two items of non-contradictory evidence. These are either the billing address, bank details, IP address or any other commercially relevant information (VAT Implementing Regulation (1042/2013)).

<sup>19</sup> A billing address is typically not necessary, the bank account of the receiving customer may be set up in another country than the country of the customer's usual residence and the IP address identified the location of the computer but not necessarily the customer. See Bal, EU VAT: New Rules on B2C Supplies of Digital Services from 2015, *European Taxation*, 2014, p. 303.

attractiveness as a locational hub in the digital economy. On the other hand, defensive tax policy includes specific tax legislation targeted at foreign digital companies.

Tax policy should consider both, indirect and direct taxation simultaneously when reforming tax law in the digital economy since income and non-income taxes are interrelated with respect to the tax bases (and thus tax revenue) as well as firms' tax planning considerations. In our ongoing work, empirical results suggest that firms react to both, lower value-added tax rates via sales reporting and lower corporate income tax rates via profit reporting. We further find particularly strong value-added tax rate sensitivities for digital businesses. Also, there is robust evidence that the reaction to low corporate income taxes is dependent on the applicable value-added tax rate in the same country (and vice versa). Again, this interrelation seems to be particularly strong for firms in the digital sector.

## ii. Implication for the taxation of business profits

Due to the “centralized” nature of assets and functions for digital businesses under current tax law, the effective tax burden primarily depends on the location of these assets and functions even if sales are largely generated abroad. Thus, investment decisions with regard to digital business models might be particularly contingent on the tax environment. We have quantitatively shown that the tax attractiveness for digital businesses varies considerably across Europe and other developed countries. Further, digital business models face significantly lower effective tax burdens (and lower costs of capital) due to special tax incentives available for innovative activities as well as the weaker reliance on long-term capital assets. For further results with regard to tax burdens of digital vs. traditional business models, we refer to our joint study with PWC “Digital Tax Index 2017”.<sup>20</sup>

---

<sup>20</sup> Executive Summary in English available at <https://www.pwc.de/de/industrielle-produktion/executive-summary-digitalisierungsindex-en.pdf>. Full version (only in German) available at <http://www.zew.de/en/das-zew/aktuelles/steuerlicher-digitalisierungsindex-2017-deutschland-hat-nachholbedarf-im-internationalen-vergleich/>. Online appendix available at <https://www.pwc.de/de/technologie-medien-und-telekommunikation/assets/anhang-steuerlicher-digitalisierungsindex-2017.pdf>.

Tab. 1 Main results of the 2017 digital tax index

Country	EATR					CoC				
	Rank	Ø	Δ Rank	Δ in percentage points		Rank	Ø	Δ Rank	Δ in percentage points	
Ireland	1	-10.32%	↗ 3	-24.44		4	0.24%	↗ 6	-5.46	
Italy	2	-8.84%	↑ 20	-32.43		1	-4.09%	→ 1	-9.28	
Hungary	3	-6.85%	↑ 11	-26.18		3	-0.15%	↑ 16	-6.15	
Latvia	4	0.33%	→ 1	-13.94		8	2.25%	↗ 4	-3.46	
Lithuania	5	0.44%	↘ -2	-13.18		9	2.27%	↘ -3	-3.29	
Belgium	6	2.28%	↑ 22	-26.07		5	1.29%	↑ 11	-4.57	
Croatia	7	5.19%	↗ 2	-11.28		12	2.49%	↘ -7	-2.88	
Romania	8	6.62%	↘ -2	-8.11		16	3.55%	↘ -8	-2.10	
Czech Republic	9	7.48%	→ 1	-9.18		14	3.23%	↘ -7	-2.36	
Norway	10	8.02%	↑ 11	-15.27		7	2.22%	↑ 16	-3.99	
Switzerland (Zurich)	11	8.39%	→ 1	-10.25		13	3.09%	↘ -2	-2.61	
Cyprus	12	8.73%	↓ -10	-4.38		26	4.64%	↓ -23	-0.69	
Slovenia	13	9.51%	↘ -6	-5.96		19	4.08%	↓ -10	-1.58	
Bulgaria	14	9.52%	↓ -13	0.52		30	5.18%	↓ -26	-0.15	
Luxembourg	15	10.76%	↑ 9	-14.76		27	4.82%	↘ -6	-1.20	
United Kingdom	16	11.11%	↗ 2	-10.44		22	4.45%	↗ 4	-2.18	
Portugal	17	11.63%	↗ 8	-14.99		11	2.47%	↑ 13	-3.80	
France	18	12.39%	↑ 15	-25.96		2	-0.72%	↑ 28	-8.14	
Poland	19	12.63%	↘ -8	-4.86		23	4.53%	↓ -9	-1.27	
Spain	20	12.85%	↑ 9	-17.43		10	2.39%	↑ 22	-5.48	
Malta	21	13.12%	↑ 9	-19.12		6	1.45%	↑ 23	-5.39	
Netherlands	22	13.61%	↘ -3	-8.93		18	3.84%	↗ 2	-2.17	
Denmark	23	14.61%	↘ -6	-5.23		24	4.58%	↘ -7	-1.33	
Slovakia	24	15.09%	↘ -8	-4.48		25	4.62%	↓ -12	-1.16	
Austria	25	15.16%	↘ -5	-7.93		20	4.14%	↗ 2	-2.02	
Finland	26	15.86%	↓ -13	-3.04		29	5.18%	↓ -11	-0.80	
Canada (Ontario)	27	16.05%	↘ -4	-9.07		21	4.29%	↗ 7	-2.35	
Estonia	28	16.27%	↓ -20	0.57		32	5.27%	↓ -31	0.10	
Greece	29	16.73%	↘ -3	-10.84		17	3.76%	↑ 10	-2.88	
Sweden	30	16.93%	↓ -15	-2.50		31	5.22%	↓ -16	-0.63	
Germany	31	22.81%	↘ -4	-5.41		28	5.13%	↘ -3	-1.32	
USA (California)	32	22.82%	→ 0	-13.70		15	3.32%	↑ 16	-4.30	
Japan	33	25.46%	↘ -2	-8.79		33	5.76%	→ 0	-2.34	
Average		10.20%		-11.73			3.18%		-2.95	

Germany is ranked 31<sup>st</sup> based on its EATR. In comparison to traditional business models Germany even loses 4 places. In other words: The EATR for digital business models is 5.41 percentage points lower than for traditional ones. Regarding capital costs Germany ranks 28<sup>th</sup> with a CoC of 5.13%. This means Germany ranks three positions worse compared to the CoC of traditional business models.

### **C. Implementation of the BEPS Package**

#### **C1. Did BEPS Actions 3, 6, 7, 8-10 address BEPS risks and broader challenges, examples**

The OECD as well as its members have worked on implementing new tax regulation and anti-avoidance measures to combat BEPS at high pace. The content and pace of this work is unprecedented and has remarkably changed the tax landscape while it has certainly closed loopholes for aggressive tax planning. However, existing concepts of international taxation and their potential adoptions are discussed separately in the corresponding action points and are not specifically analyzed with regard to the tax challenges of the digital economy. In particular, with regard to Actions 8-10, an opportunity was missed to include guidance on assets, activities and transactions of digital business models. Further, the implementation of specific BEPS action points in national or supranational law faces obstacles of compatibility with EU law, and proposals regarding transaction and withholding taxes for the digital economy might collide with international trade law.

Certainly, the question of defining a source and allocating taxing rights arises and is therefore thoroughly discussed in Action 1. However, even if the threshold for PEs is lowered, the profit allocation via transfer pricing cannot be circumvented in a second step. Several scholars highlight that the key question for taxing businesses in the digital economy is how to allocate profits generated by the underlying new types of business models. Currently, we see no sustainable guidance with respect to transfer pricing for digital business models that would account for the new forms of value creation and thus allocate profits accordingly. As a result, the OECD's preferred proposal to amend the exception of auxiliary and preparatory activities from the PE status will not remarkably affect income allocation in the digital economy.

Rather, we anticipate that taxpayers will face higher compliance costs and higher risks of double taxation in case their business model implies more PEs after the BEPS reform. One example is the case of cloud computing. If the distribution of cloud services through formerly commissionaire arrangements now leads to PEs in foreign markets, not only primary software companies will be faced with a surge in PEs in their organizational structure but also traditional businesses that now offer cloud-based services alongside their physical products<sup>21</sup> will be confronted with additional complexity. Yet, it is unclear how profit allocation and the tax proceedings will work after establishing additional taxable nexus.

Against this backdrop, we encourage the OECD to further work on the development of a guidance on profit splits (PS). As the magnitude of comments received and recently published on 04 October 2017 suggests, arriving at a globally coordinated application is ambitious since both, criteria when to apply the PS method and how to allocate profits, depends on numerous factors and the specificities of the underlying business model. In our qualitative analysis, we conclude that the profit split method might be best suited to determine transfer prices (and thus profit allocation) for international and vertically integrated business models in the digital economy. As many practitioners have noted in their comments, vague wording and a rather

---

<sup>21</sup> E.g. the aforementioned automotive supplier offering a cloud for additional „internet of things“ services after selling physical products, pharmaceutical companies, digital health applications (<https://www.ft.com/content/d7a60642-0361-11e7-ace0-1ce02ef0def9?mhq5j=e7>) or software applications for additional B2B services in the chemical industry (<https://www.basf.com/en/company/about-us/digitalization-at-basf/digital-business-models.html>).

conceptual nature of PS guidance creates uncertainty and implies the potential for transfer pricing disputes between taxpayers and the respective tax authorities across the globe. We anticipate that this scenario is particularly probable for digital business models since the underlying value chains are neither well understood nor commonly defined. We thus recommend to include a specific section on digital business models in the guidance on transfer pricing in general and profit splits in particular including practical examples (e.g. in the Annex).

## C2.Experience from new VAT/GST collection models

Digital service providers typically run highly mobile business models such that they do not necessarily have a physical presence in the country of their consumers. While firms have no discretion over where to remit VAT due when generating revenues from digital services since the regulatory changes in 2015, the OECD still identifies major difficulties in the collection of consumption taxes on digital transactions between companies and consumers (see also our comments in B.2.i.).<sup>22</sup> For the cross-border supply of digital services, a major challenge is to identify the country of the consumption (the consumer's place of residence or the place of final consumption) as well as the country of the service provider's establishment.<sup>23</sup> This problem is especially pronounced due to the numerous low-value transactions in the digital services sectors. Many transactions at very low prices are being closed across borders aggravating the amount of information that needs to be collected. An evaluation of the effectiveness of the regulatory changes in 2015 together with the introduction of the MOSS, which should simplify registration, declaration and tax remittance, has still to be conducted. First statistics, however, have shown that registration numbers have been relatively low compared to actual market growth in the digital services sector.<sup>24</sup> This suggests that there are further issues to tackle since potentially not all providers active in the EU market registered in at least one Member State and even the registration does not necessarily mean that revenues are declared adequately. The enforcement of the new regulation and hence the collection of the VAT is still difficult and puts pressure on national governments to develop control systems and new enforcement strategies. In ongoing work, we identify an incentive for digital service providers to report sales where VAT rates are low (also see our comments in B.2.i). We will examine whether the introduction of the destination principle in 2015 has altered these forms of behavior once sufficient data is available for the period after 2015.

## D. Options to Address the Broader Challenges

### D1.Proposals of the 2015 Report

Your request also asks for comments on the following reform proposals that were mentioned in the 2015 report on Action 1:

- a) Nexus concept of significant economic presence

---

<sup>22</sup> OECD (2015), Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report.

<sup>23</sup> See Bal, EU VAT: New Rules on B2C Supplies of Digital Services from 2015, European Taxation, 2014, p. 303; also Basu, To Tax or Not to Tax? That is the Question? Overview of Options in Consumption Taxation of E-Commerce, Journal of Information, Law and Technology 1, 2004, pp. 1-25.

<sup>24</sup> European Commission, VAT Aspects of cross-border e-commerce - Options for modernization Final report – Lot 3, November 2016, available at [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/vat\\_aspects\\_cross-border\\_e-commerce\\_final\\_report\\_lot3.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/vat_aspects_cross-border_e-commerce_final_report_lot3.pdf), p.14.

- b) Withholding tax on certain types of digital transactions
- c) Digital equalization levy

In our qualitative analysis on the tax challenges and respective reform options, we have concluded that none of these proposed concepts represents a feasible option that would enhance profit taxation in line with value creation and consistently complement the existing tax framework.<sup>25</sup>

In the other sections of our comments, we encourage to analyze the specifics of digital business models in order to develop further the existing principles based on a global coordination. Such an approach takes into account longstanding practices and would ensure the highest level of certainty and feasibility.

Regarding the proposed options in the 2015 report we again stress our following view. We do not consider the identification of a taxable nexus in the digital economy a major issue. Tax policy should rather focus on how to allocate profits once a digital business model has a taxable nexus. If there is no nexus under prevailing tax rules, this fact should be accepted since cross-border trade without creating a nexus is also possible within the “old” economy (e.g. in the form of export/direct businesses).

Further, we consider the concept of withholding taxes an effective mechanism to collect/remit taxes. Yet, we do not recommend to further expand the concept to digital transactions since already existing problems of gross taxation, uncertainty and double taxation might aggravate. Further, expanding source taxation through withholding tax mechanisms is a politically delicate approach since particularly developed countries with large economies relying on export would lose substantial tax revenue.<sup>26</sup>

Finally, we do not consider an equalization levy as a suitable way forward. Such a levy on turnover of digital companies results in double taxation for cross-border cases since the “equalization tax” will most probably not be credited against income taxes in the residence country.<sup>27</sup> It is important to note that the equalization tax is not levied on foreign source income but on turnover and thus does not fit into the current framework of taxing business income. Moreover, the idea of an equalization tax restricted to companies currently accessing foreign markets and avoiding taxes is flawed. Also traditional businesses tend to have more and more income from digital services and would thus be harmfully affected by such special taxes in the future.

## D2. Unilateral developments

While not recommending any of the considered options discussed in the BEPS report on Action 1, the OECD has left the unilateral or bilateral implementation of such options to countries wishing to proactively limit perceived tax challenges of the digital economy. We

---

<sup>25</sup> Olbert/Spengel, International Taxation in the Digital Economy: Challenge Accepted?, World Tax Journal, 2017, pp. 12 et sequ.

<sup>26</sup> Finke/Fuest/Nusser/Spengel, Extending Taxation of Interest and Royalty Income at Source – an Option to Limit Base Erosion and Profit Shifting?, ZEW Discussion Paper No. 14-073, September 2014.

<sup>27</sup> For the Indian case, see Wagh, The Taxation of Digital Transactions in India: The New Equalization Levy, Bulletin for International Taxation, 2016, pp. 538-552.

have mentioned that such unilateral approaches are problematic since they cause uncertainty for internationally acting digital business models and might lead to economic distortions.<sup>28</sup> Further, countries considering unilateral (anti-avoidance) measures need to weigh the benefit of potential revenue gains and the cost of foregone investment if adverse tax legislation affects corporate decision making as suggested by our quantitative results on effective tax burdens.

We thus strongly recommend to pursue a globally coordinated approach when working on new tax principles or (transfer pricing) guidelines for digital business models instead of encouraging unilateral approaches. Tax policy should bear in mind that digitalization is seen as a major driver of innovation and economic growth. Tax systems in general, but particularly concerning digitalization's potential for innovation, should promote growth and investment (besides other political goals).<sup>29</sup> Due to the globalized nature of most digital business models, such policy is best pursued in an internationally coordinated way.

## **E. Other Comments**

### **E1. Issues we would like to see considered by the TFDE**

As with other issues and debates on tax reform, we recommend to evaluate reform options and base political decisions on a broad range of input, in particular from the academic as well as practitioner's community. So far, there is no empirical evidence on the tax challenges of the digital economy. Apart from anecdotal evidence, it is particularly unclear whether digital business models are structured in order to minimize taxes. Interdisciplinary research efforts can help to shed light on the issue with the aim to support political decision making.

Further, we highly recommend to broaden the scope of the understanding of digitalization and the respective tax challenges towards the transformation that traditional business models are experiencing. While it is tempting to initiate tax legislation targeted at inherently digital firms that are assumed to exploit customer markets in high tax jurisdictions without paying "a fair share" of taxes, such legislation might affect a broad range of industrial companies without anticipation. Besides ensuring a fair taxation "in line with value creation", the overall objective should be to establish an investment-friendly environment through international cooperation and avoiding double taxation. In our opinion, a first and necessary step is to arrive at a common understanding of value creation in the digital economy and develop respective guidelines within the existing tax framework.

A first step in ensuring the indirect taxation of digital transactions at destination is the regular and consistent exchange of information between countries (especially since there are often no control mechanisms at the frontiers). While one such tool exists in the EU, the VAT Information Exchange System (VIES), services provided by non-EU companies or transactions involving only non-EU countries cannot be tracked in a similar way. Potential solutions have been discussed such as including the financial intermediaries in the process<sup>30</sup>

---

<sup>28</sup> See Olbert/Spengel, International Taxation in the Digital Economy: Challenge Accepted?, World Tax Journal, 2017, p. 19.

<sup>29</sup> See Olbert/Spengel, International Taxation in the Digital Economy: Challenge Accepted?, World Tax Journal, 2017, p. 42 for a more detailed discussion.

<sup>30</sup> See also discussions by the OECD, Consumption Tax Aspects of Electronic Commerce, A Report from Working Party No. 9 on consumption taxes to the Committee on Fiscal Affairs, February 2001.

or obliging service providers themselves to provide information to tax authorities on their customers<sup>31</sup>. So far, none of these suggestions (and there may be even more of this kind) imply a successful solution to the problem; neither for the tax authorities nor for the taxpayers. We recommend tackling these issues further given that the potential VAT or sales tax foregone is large.<sup>32</sup> Alternatively, one has to find an integrated solution taking into account the interests of the tax authorities as well as the structure of the service transactions.

We hope that our comments will contribute to the discussions. We look forward to receiving critical remarks with the aim to deliver reliable input for the ongoing work on the tax challenges of digitalization.

Yours sincerely,

Prof. Dr. Christoph Spengel

Marcel Olbert

Ann-Catherin Werner



**ZEW**

Zentrum für Europäische  
Wirtschaftsforschung GmbH  
Centre for European  
Economic Research

**MaTax** MannheimTaxation  
Science Campus

---

<sup>31</sup> See Ligthart, Consumption Taxation in a Digital World: A Primer, Center Discussion Paper No. 2004-102, 2004.

<sup>32</sup> The unbalanced value-added taxation contributed to an estimated VAT gap of EUR 170 billion in 2013, European Parliament, Tax Challenges in the Digital Economy, 2016, available online at [http://www.europarl.europa.eu/RegData/etudes/STUD/2016/579002/IPOL\\_STU\(2016\)579002\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2016/579002/IPOL_STU(2016)579002_EN.pdf), p. 67.