

Paris, 14 April 2014

## **OECD DISCUSSION DRAFT ON BEPS ACTION 1: TAX CHALLENGES OF THE DIGITAL ECONOMY**

Submitted by email: [CTP.BEPS@oecd.org](mailto:CTP.BEPS@oecd.org)

Dear Jesse,

Please find below BIAC's comments on the OECD Discussion Draft on BEPS Action Item 1 – Address the Tax Challenges of the Digital Economy, issued on 24 March 2014 (the “Discussion Draft” or “paper”).

The Base Erosion and Profit Shifting (“BEPS”) project has a very ambitious timetable, so we thank the Task Force on the Digital Economy (“TF”) for being flexible in its contacts with stakeholders, and for issuing an early, non-consensus document to gather stakeholder input as soon as possible. In order to help the TF deliberations as it now seeks to reach a balanced and proportionate consensus, BIAC is submitting a consensus document that represent business views generally, rather than simply passing on views from our members. Given the complexity (and, in many cases, newness) of these issues, we present our comments in two parts: a summary, and a more detailed analysis. These parts should be read together.

### **General comments**

We do greatly welcome the statement by the TF that there should not be a separate tax regime for the “Digital Economy”. This is reinforced by the careful analysis in the Discussion Draft of the “Digital Economy” which shows that, broadly defined, all businesses are now “digital” in one way or another. Therefore, we also support the position taken in the paper that any issues raised by “digital” transactions should be dealt with under the other 14 relevant BEPS Action Items dealing with the many substantive areas of international tax rules.

We are, however, concerned that having said that, the Discussion Draft does appear to raise (and, potentially, make recommendations on) areas which do fall under other Action Items, or which are outside the BEPS project entirely.

We understand the political (and public) origins of the concerns about certain types of “digital” transactions, and we completely agree that these should be considered, and, if countries see fit, acted upon. However, in keeping with the publicly stated parameters of the project, we do not believe this paper is the place to consider “source” vs. “residence” issues. That is clearly an issue of concern to G20 and OECD members, but if that discussion is to happen, it needs to take place more broadly and more deliberatively than can be done in this paper. Furthermore, and as stated above, we believe that the Discussion Draft should not seek to prejudge discussions still to be held

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on other substantive Action Items, but leave those to be developed by the other Working Parties according to the structure of the BEPS Action Plan..

In our comments, we have only commented briefly on the sections of the Discussion Draft which deal with the two categories above. However, in relation to those proposals in Chapter VII relating specifically to the Digital Economy – which we completely understand represent only individual country suggestions, not a consensus view at this time – we provide more detailed analysis in order to help the TF consideration of these items.

I will not repeat here all our comments and suggestions that are contained in the attached summary and detailed analysis. However, I do think it is worth reiterating that the growth in the “Digital Economy”, broadly or narrowly defined, has been one of the great economic success stories of the past twenty years. Much of this success is down to decisions taken under OECD auspices in the late 1990’s which resulted in tax not becoming a barrier to digital expansion. The resulting growth in connectivity, technological leaps in developing countries, and new opportunities not just for large, but mid-sized and micro-businesses throughout the world, has been remarkable, and enriching (in many senses) for many people in many countries. It is entirely appropriate after twenty years, that we should look at this area again, and, where unacceptable, aggressive tax planning occurs, seek to counter that. But we should also be careful that in our efforts to end abuse, we do not also place growth-inhibiting tax burdens on a broad technology that has been so central to the OECD’s core mission of improving the lot of people around the world through increased cross-border trade and investment.

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We hope the TF finds our comments useful. As they consider changes, we hope that you and the members of the TF will not hesitate to call upon us for any help that we might be able to give in order for to reach a balanced and proportionate consensus report on this crucial area. We stand ready to respond.

Sincerely,



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Chair, BIAC Tax Committee

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Centre for Tax Policy and Administration  
OECD

CC: Mr. Pascal Saint-Amans,  
Director of the Centre for Tax Policy and Administration  
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## Summary comments

1. In the section 3 of this document we provide our detailed comments on all sections of the Discussion Draft. Given the wide-ranging nature of the Discussion Draft, and the need for detailed analysis of a number of the issues raised, we are also producing this very brief summary our key comments and concerns which are more fully developed in our entire submission.

## General comments

2. BIAC appreciates the opportunity to have input at this stage of the process, and we strongly support the OECD's conclusion that there should not be a separate taxation regime for the "digital economy". We strongly agree that the proposals to be developed under the other Actions of the BEPS Action Plan will address the challenges posed by the digital economy.
3. Parts of the Discussion Draft range far beyond the Digital Economy, with some aspects impacting other BEPS Action items and others touching upon issues explicitly excluded from the BEPS project. We believe that fundamental issues – such as source vs. residence taxation, which are beyond the scope of the BEPS project – should be addressed, if at all, directly and separately, rather than tangentially in this paper. With those BEPS issues beyond the Digital Economy we believe the best place to undertake that analysis is in work being undertaken on those substantive Action Items.
4. Arguments have been made that a market jurisdiction should have an entitlement to tax some part of the profits of sales into the jurisdiction, based on the demand created by the market place, even where an enterprise has no physical presence. We strongly believe that a combination of an origin-based income tax and a destination-based VAT appropriately divides the jurisdiction to tax between the countries where income producing activities occur and the countries where consumption of goods and services occur. We are also concerned that a number of proposals described in Chapter V, if adopted, would reflect a clear move a towards formulary apportionment. The development of a hybrid tax system would feed uncertainty, drive double taxation, and discourage investment. Deviations from well-established principles of taxation should therefore be very carefully considered before being acted upon. BIAC believes that this work should include an analysis of the purpose and economic burden of the corporate income tax versus the VAT.
5. We believe there are some potential contradictions in recent OECD proposals with respect to the importance of people functions and the location of business activities. For example, the Discussion Draft seems to consider tax nexus for enterprises delivering digital goods or services based on the place where those good and services are supplied to, rather than where functions are performed, risks are assumed and assets are used. These inconsistencies must be resolved to provide a stable tax system that encourages cross-border investment.
6. BIAC appreciates the extreme time pressure under which the OECD has been required to develop these proposals and we appreciate the opportunity to comment on what is explicitly identified as a non-consensus draft. We also understand the political imperative driving this project. Nevertheless, the proposals raised in this draft are complex issues which require time and care to work through the analysis and study the expected repercussions.

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## Specific Comments

### **Information and communication technology and its impact on the economy**

7. BIAC commends the Task Force for compiling a thorough and thoughtful analysis of the digital economy and BIAC agrees that the digital economy is characterized by rapid technological progress and shares the Task Force's view that the digital economy of tomorrow may look nothing like the digital economy of today.

### **The digital economy, its key features and the emergence of new business models**

8. BIAC strongly agrees with the Task Force that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. BIAC also notes that it is equally difficult to distinguish the digital economy from the larger economy. With the ever increasing digitalization of commercial activity, it is difficult to distinguish "pure play" digital/internet companies from other companies. The Discussion Draft implicitly acknowledges this point in its treatment of the internet of things, virtual currencies, and 3D printing, all of which create a business convergence between digital/internet service providers and providers of manufacturing, design, development, and financial services.
9. BIAC nevertheless acknowledges that digital/internet companies distinguish themselves from low-technology enterprises through the positive contributions that digital/internet companies make to the economies in which they are based. Academic studies demonstrate that an economy in which a high-technology enterprise, such as a digital/internet company, is based enjoys positive externalities in the form of increased employment in the local service sector that exceed those associated with the presence of a low-technology enterprise.

### **Identifying opportunities for BEPS in the digital economy**

10. The Discussion Draft acknowledges that the nature of the strategies used to achieve BEPS in digital businesses is similar to the nature of strategies used to achieve BEPS in more traditional businesses.
11. Detailed comments are provided in section 3 on opportunities for BEPS with respect to VAT, avoiding withholding tax and eliminating or reducing tax in the market country.

### **Tackling BEPS in the digital economy**

12. BIAC strongly agrees with the view expressed by the Discussion Draft that other Action Plan items will have an impact on BEPS in the digital economy. We also strongly agree with the statement that it is necessary to evaluate the impact of those other changes before considering unique rules for the taxation of the digital economy that may turn out to be unnecessary. The Discussion Draft provides insight into where some of the future action items may be headed. It is worth noting that with all the proposed changes, there is no evidence in the Discussion Draft that the countries see improved dispute resolution as part of the package of items necessary to tackle BEPS in the digital economy. As business has repeatedly made clear, improved dispute resolution is critical to implementing any fundamental restructuring of the international tax principles. The interpretation of these new rules will generate disputes and improving dispute resolution must be addressed.

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## Broader tax challenges raised by the digital economy

13. The Discussion Draft states that the evolution of business models in general and the growth of the digital economy in particular have resulted in non-resident companies operating in market jurisdictions in a fundamentally different manner today than at the time that international tax rules were designed. The draft also asserts that the traditional model of doing business in market economies is obsolete. BIAC believes that these assertions significantly overstate the impact of digital methods of doing business on market economies. Companies still require people, assets and functions which will create a tax presence in significant jurisdictions.

## Potential options to address broader tax challenges raised by the digital economy (Ch. VII).

14. BIAC strongly supports the Discussion Draft's reference to the Ottawa Taxation Framework (from 1998) principles – neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. We endorse the view that these principles are still relevant and, supplemented as necessary; can constitute the basis to evaluate both direct and indirect tax options to address the tax challenges of the digital economy.
15. We also believe that options should not contradict the sovereign choice of jurisdictions to determine how tax is imposed on properly attributable income. With the exception of appropriate CFC rules, countries should not be able to assert a claim to tax another's income.

### *Modifications to the exemptions from permanent establishment status*

16. Business prefers bright line rules that provide certainty, so objectivity and clarity in the application of any new rules would be welcomed. However, the OECD/G20 should not make broad changes without careful consideration of the consequences.

### *A new nexus based on significant digital presence*

17. This proposal seems to directly contradict that statement that ring-fencing the digital economy is neither appropriate nor feasible. We note that the proposals in the Discussion Draft do not seem to focus on whether payments made in relation to goods and services are deductible for tax purposes, and rather largely focuses on B2C transactions. Without this key element, it is difficult to see how this proposal targets base erosion. BEPS is intended to address **artificial** profit shifting. If the income is attributable to actual activities that have moved out of the jurisdiction, then the profit shifting is not artificial and there is no BEPS issue. We also believe that this option is inconsistent with the emphasis on people functions in the draft Chapter VI TPG revisions and violates the Ottawa principles.
18. This option would result in significant controversy and double taxation and would discourage the expansion of digital goods and services into remote economies, which will adversely affect economic growth.

### *Virtual permanent establishment options*

19. BIAC opposes the adoption of any of these virtual PE options because adoption would violate the Ottawa Principles. Such options would create compliance difficulties and would add uncertainty in many ways.

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### *Creation of a withholding tax on digital transactions*

20. This option seems to reflect a concern where goods or services are provided into a jurisdiction where there is no taxable nexus. This option raises questions with respect to consistency with trade obligations and the practicability of imposing WHT on B2C transactions. In this regard, a huge burden could be imposed on financial institutions to act as tax collector. Imposing a gross tax without the need to determine profits may seem attractive at face value, but we note that revenue is a poor proxy for net income and digital goods and services may never generate a profit on a net basis. The administrative issues associated with this option would be similar to those faced when imposing VAT on cross-border digital transactions.

### *Consumption Tax Issues and options*

21. VAT issues should be addressed by the ongoing work of the OECD and WP9 and the OECD/Business Technical Advisory Group (TAG) to the WP9.
22. We note that many VAT issues in the Discussion Draft are not specific to the digital economy. Instead, they are conceptual issues related to the design and the application of the VAT system. All stakeholders agree that conceptually, a broad based VAT system, with ideally no or very few exemptions, and one standard VAT rate, would represent the most efficient and effective structure for all relevant parties. It would take substantial complexity out of the VAT system, would ensure neutrality for business, and would ease both compliance for business and administration for governments.
23. BIAC agrees that the most effective and efficient option to ensure appropriate VAT collection on cross-border B2C services is to require the non-resident supplier to register and account for these supplies in the jurisdiction of the consumer. We support the adoption of consistent 'place of taxation' and simplified procedures/mechanisms to allow easy and efficient collection. Registration thresholds should apply where necessary to minimise the compliance burden on business and the administrative burden for governments.

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## Detailed comments

### General Comments

1. BIAC appreciates the opportunity to have input at this stage of the process. We understand that this is a report on the digital economy that identifies options for further discussion rather than makes recommendations. Keeping this in mind, we have the following general comments.
2. First, we endorse wholeheartedly the conclusion that there should not be a separate taxation regime for the "digital economy", however defined.
3. Second, we are concerned that parts of the Discussion Draft range far beyond the Digital Economy. Some of this discussion impacts other BEPS Action items, but other parts touch upon issues explicitly excluded from the BEPS project – in particular “source“ vs. “residence” taxation. In relation to the latter we believe that these fundamental issues should be addressed directly and separately, rather than tangentially in this paper, for the reasons briefly set out below. It is only by squarely facing the issues and doing the difficult analytical and political work that these foundational questions can be properly resolved. In relation to the discussion in the Discussion Draft of proposals affecting other Action Items, we believe that rather than trying to resolve them in this document, the best place to undertake that analysis is in work being undertaken on those substantive Action Items. So, we comment briefly on the suggestions made with respect to other BEPS areas, but without proposing courses for action. We do, however, comment in more detail on the proposals in Chapter VII on specific rules for the digital economy.
4. As an overall matter, the Discussion Draft raises the issue of whether a market jurisdiction should have the jurisdictional basis to impose a net income tax based solely on the fact that an enterprise may be able to make sales of goods or services (digital or otherwise) into the jurisdiction. We understand that arguments have been made that a market jurisdiction should have an entitlement to tax the profits of sales into the jurisdiction, based on the value of the market place, even if the enterprise may have no actual presence in the market jurisdiction. It may well be that this is an appropriate discussion to have in relation to, for example, comparability factors under Transfer Pricing rules (as has, indeed, been occurring in relation to the ongoing project on intangibles). However, BIAC believes that the appropriate tax to impose by reference to the place of consumption is a VAT. BIAC believes that the further work on this Action Item would be clarified by an explicit analysis of whether current business models or practices (digital or otherwise) warrant a deviation from the principle that the right to impose an income tax should be based on the presence of actual business operations in a state. For completeness, we would further suggest that this work include an analysis of the purpose and economic burden of the corporate income tax versus the VAT.
5. We also think it important to resolve an apparent important inconsistency between certain of the proposals in this Discussion Draft and other recent OECD/G20 work on the role of business substance to determine the right to tax and the measure of taxable income. The draft revisions to Chapter VI of the Transfer Pricing Guidelines (“TPG”) specify that the returns to intangibles should be allocated by reference to the location of personnel who perform or control the development, enhancement, maintenance, and protection of the intangible, and not by reference solely to ownership, funding and bearing risk. In contrast, this digital economy Discussion Draft expresses concern that taxpayers control the location of functions and assets, and thereby suggests that the location of the actual business activities giving rise to the development, delivery and support of digital products and services may not be the

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determinants of the jurisdiction to tax income arising from those activities. We believe this apparent inconsistency needs to be resolved. Either the place of performance of profit producing **activities** is a key factor or it is not. Uncertainty and unpredictability would be greatly increased if place of performance were used to determine the entitlement to returns on intangibles, but not to determine tax nexus for enterprises delivering digital goods or services.

6. We note with approval the many recent statements by OECD representatives that the OECD continues to endorse the arm's length principle ("ALP"). We also strongly support the conclusion in this Discussion Draft that the proposals to be developed under the other Actions of the BEPS Action Plan will address the challenges posed by the digital economy. As noted above, however, Chapter V of the Discussion Draft describes how some of the ideas now being developed under those other Action Items would address the tax challenges of the digital economy. We are concerned, however, that a number of proposals described in Chapter V (discussed in more detail below) if adopted would move the OECD's application of the ALP substantially in the direction of formulary apportionment. BIAC believes that the OECD should assess all capital allocation, interest expense allowance, and similar proposals by the criterion of whether the proposal is consistent with the purpose of the ALP. A hybrid tax system would allow countries to assert the ALP selectively (and almost certainly, inconsistently with the practices of other countries), or to adopt elements of formulary when it enhances tax revenue. Businesses would be caught in the middle and subjected to a high risk of double taxation. Further, a hybrid system will substantially increase the administrative burden associated with an either/or approach. Taxpayers will still be producing transfer pricing studies, but will also be required to produce information that will support apportionment in some cases. The current proposals for Transfer Pricing Documentation and the Country-by-Country Reporting template illustrate this tension.
7. BIAC sympathizes with OECD executives and staff for the extreme time pressure under which the OECD has been required to develop these proposals, and thanks them for already taking into account many comments made by business in consultations. We appreciate the opportunity to comment on what is explicitly identified as a non-consensus draft, and hope that our comments will be useful to allow the OECD to complete the next steps of this project with efficiency. We also understand the political imperatives under which the OECD believes it is operating. Nevertheless, the proposals raised in this draft are complex issues which require time and care to work through the analysis and study the expected repercussions. We believe that decisions on significant changes to the international tax law should not be made in haste. We, therefore, stand to help the Working Party and Secretariat in any way we can so that they can produce consensus comments which enhance the OECD's reputation for careful, analytical work that supports the foundation of sound tax policy. We look forward to contributing to a productive dialogue with the OECD as it continues this important work.

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## Specific Comments

### **I. INTRODUCTION AND BACKGROUND**

8. BIAC strongly supports the Discussion Draft's reference to the Ottawa Taxation Framework (from 1998) principles – neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. We endorse the view that these principles are still relevant and, supplemented as necessary, can constitute the basis to evaluate both direct and indirect tax options to address the tax challenges of the digital economy. (Para. 7)<sup>1</sup> We apply those principles in our comments on section VII to analyse the proposed options.

### **II. INFORMATION AND COMMUNICATION TECHNOLOGY AND ITS IMPACT ON THE ECONOMY**

9. BIAC commends the Task Force for compiling a thorough and thoughtful analysis of the digital economy in Chapters II and III of the Discussion Draft. BIAC agrees with the Task Force that the digital economy is characterized by rapid technological progress and shares the Task Force's view that the digital economy of tomorrow may look nothing like the digital economy of today.

### **III. THE DIGITAL ECONOMY, ITS KEY FEATURES AND THE EMERGENCE OF NEW BUSINESS MODELS<sup>2</sup>**

10. BIAC strongly agrees with the Task Force 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.” (Para. 59) As a corollary to this statement, BIAC notes that it is equally difficult to distinguish the digital economy from the larger economy. Moreover, with the ever increasing digitalization of commercial activity, BIAC notes that it is difficult to distinguish “pure play” digital/internet companies - i.e., companies that use the internet as their principal method to deliver goods and services, including communicating with users and suppliers through hosted web pages - from other companies. The Discussion Draft implicitly acknowledges this point in its treatment in Chapter II of the Discussion Draft of the internet of things, virtual currencies, and 3D printing, all of which create a business convergence between digital/internet service providers and providers of manufacturing, design, development, and financial services.
11. BIAC nevertheless acknowledges that digital/internet companies distinguish themselves from low-technology enterprises through the positive contributions that digital/internet companies make to the economies in which they are based. BIAC reaches this conclusion because academic studies demonstrate that an economy in which a high-technology enterprise, such as a digital/internet company, is based enjoys positive externalities in the form of increased employment in the local service sector that exceed those associated with the presence of a low-technology enterprise.

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<sup>1</sup> These fundamental principles were further elaborated on and supplemented by the post Ottawa VAT work on e-commerce – the E-commerce Guidelines and the Consumption Tax Guidance papers in 2003 – and also the current work on the development of the International VAT guidelines.

<sup>2</sup> As the OECD proceeds with this topic, it might want to include a definitional section. One of the issues with the Discussion Draft is that the definition of important terms is frequently unclear.

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### The Digital Economy Is Indistinguishable from the Economy

12. As noted above, BIAC agrees with the Task Force that the digitalization of the economy has made the digital economy and the larger economy generally indistinguishable from one another. To this end, BIAC wishes to refine certain points in Chapter III of the Discussion Draft to reflect this conclusion.

### The Digital Economy Is Not Characterized by the Presence of New Business Models

13. The Discussion Draft states that “[t]he digital economy has given rise to a number of new business models” (Para. 60) and notes that examples of such “new” business models include auction solutions, logistics services, online sales, the development and sale of applications, online advertising, cloud computing, and payment services. BIAC respectfully submits that the activities that the Discussion Draft identifies are not examples of “new” business models. Rather, these activities are examples of the use of information and communication
14. Technology (ICT) to operate existing business models more efficiently and to extend these business models through opportunities for new products and services. This conclusion follows because, as the Discussion Draft acknowledges, these “new” business models have offline analogues, through which marketplace, payment, logistics, auction, and other services have been provided since the 19th century. For example, in more traditional companies digital activity generally flows from existing sale and supply chains and the digital component is used to enhance capabilities within those flows.
15. The Discussion Draft observes correctly that ICT enables enterprises to conduct “many types of business at substantially greater scale and over longer distances than was previously possible.” (Para. 60) BIAC considers this feature of ICT to be one of its key virtues. With ICT, small- to medium-size enterprises are able to reach discrete and specialized markets at earlier stages in their development than was previously possible. This creates considerable economic efficiencies, and goods and services can reach even these specialized markets with much greater efficiency than before. As a result, businesses and consumers around the world have access to a greater variety of goods and services, and more opportunities for economic advancement, than ever before. We would also note that the ability to monitor and apply standards remotely has actually led to the localization of production in some cases. Communications enhancements have reduced the need to keep development and production in close proximity.
16. ICT does not change the fundamentals of business models, however. 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.

### Digital/Internet Companies Do Not Enjoy Lower Costs than Their Offline Counterparts

17. The Discussion Draft suggests that e-commerce companies enjoy a competitive advantage over their offline counterparts because e-commerce companies are able to “eliminat[e] the need for many of the wholesalers, distributors, retailers, and other intermediaries that were traditionally used in businesses involving tangible goods.” (Para. 64) BIAC notes that the

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digitalization of certain forms of commerce has not resulted in a net reduction of costs. Instead, digitalization has shifted these costs to new operational areas. In place of costs associated with renting and operating retail space and transacting with intermediaries, e-commerce companies bear significant costs associated with developing, hosting, and operating websites that are accessible to consumers around the world every day of the year. These websites require ongoing R&D to ensure that they retain the right level of functionality to provide consumers with the interactive experience that consumers expect from a virtual marketplace. In some cases functions are shifted to third parties. For example, a digital economy enterprise which sells tangible goods still needs to develop logistics systems to deliver the goods to its customers, just as a department store needs to handle its inventory. In many cases for enterprises operating in the digital economy, these non-core functions are outsourced to third parties. The statement in the Discussion Draft also fails to sufficiently acknowledge how more traditional companies operate. Digital distribution functions may be an adjunct to rather than a replacement for traditional distribution networks.

18. Moreover, costs associated with activities such as product development, marketing, and customer support persist in the businesses of digital/internet companies, just as they do in other businesses. In many cases, these costs may be higher for digital/internet companies that must contend with short product cycles, the rapid obsolescence of technology, and low barriers to entry into markets. As the Discussion Draft acknowledges, this competitive pressure drives some digital/internet companies to give away hardware, and to treat this hardware as an operational cost, in an effort to expand the market of customers for their goods and services. (Para. 15) In addition, the use of technology and data in business brings with it specific legal costs, such as costs of complying with local country export controls and data privacy rules. More traditional companies that are expanding their capabilities in the digital sphere are expending significant amounts of capital in the development of new products and have applied an impressive amount of resources in educating their customers as to the benefits of these capabilities. The Discussion Draft underestimates the financial commitment that companies must make and the significant risks they incur in order to become successful within the digital economy.
19. The Discussion Draft states that technological advances make it possible for businesses to carry on economic activity with minimal need for personnel to be present. The Discussion Draft notes that businesses can increase in size and reach with minimal increases in the number of personnel required, so-called scale-without-mass. (Para. 98) While some start-up companies certainly have succeeded in developing valuable businesses at an early stage in their development, we believe this point is greatly exaggerated as a description of the industry as a whole. Well-known “digital economy” companies have tens of thousands of employees. Business cannot effectively scale without human and asset resources.<sup>3</sup> This misimpression of the amount of business substance actually required to operate a significant “digital economy” enterprise distorts discussions on the appropriate nexus rule for such companies through the false implication that such enterprises lack substance outside the market jurisdiction.

#### Key Features of the Digital Economy Are Key Features of the Economy

20. The Discussion Draft identifies what the Task Force considers to be six “[k]ey features” of the digital economy. (Para. 91) BIAC agrees that certain of these features are present in the digital economy but observes that these same features are present in the larger economy.

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<sup>3</sup> One major digital economy company, for example, has 99,000 employees worldwide with 41,000 outside the U.S. Many of its foreign marketing subsidiaries have over 1000 employees. Another digital economy company has around 30,000 people of which around half are in the US. There is “mass” behind this scale.

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For example, the Discussion Draft characterizes “[r]eliance on data” as a key feature of the digital economy. BIAC notes that all enterprises, including digital/internet companies, “collect data about their customers, suppliers, and operations.” (Para. 103) Moreover, this practice is not new. By way of illustration, customer-facing enterprises used mailers, loyalty cards, and contests to collect and analyse data about customer behaviour long before the internet came into being. What digital has provided is the ability to collect such data in a faster and more accurate manner. For example, data regarding engine performance was historically collected by airline mechanics, pilots and flight reports. Much more accurate data is now collected from the engines themselves. The collection of data is not a new development and does not require sweeping changes to the rules regarding nexus and tax base.

21. BIAC respectfully questions whether the digital economy can properly be characterized as having a tendency toward monopoly/oligopoly if volatility is also a key feature of the digital economy. (Paras 117 – 118) With low barriers to entry, the digital economy is consistently witness to rapid ascents and declines. The now-defunct Friendster was considered “the hottest thing in social networking”<sup>4</sup> in 2003, one year before the founding of Facebook. Although Facebook arguably dominates the English-language social networking space today, its successor could be founded tomorrow. The trajectory of digital/internet companies thus stands in contrast to historic monopolies, like that enjoyed by the United Fruit Company, which dominated the banana trade virtually unchallenged for much of the 20th century.
22. BIAC respectfully submits that the Discussion Draft overstates concerns about the mobility of intangible assets, users, and business functions in the digital economy. Enterprises in all areas of the economy, including pharmaceutical, biotechnology, semiconductor, and natural resources enterprises, develop, acquire, and exploit intangible assets. These enterprises transfer intangible assets just as they transfer other, tangible assets, such as equipment. Transfers of both tangible and intangible assets may constitute gain recognition events and result in direct tax at the level of the transferor. In addition, in many cases, the physical ease with which an enterprise may transfer an intangible asset as opposed to a tangible asset is offset by IP protection and other compliance burdens associated with intangible asset transfers. Most OECD/G20 countries have developed rules that create significant tax costs upon the cross-border transfer of intangibles. These rules should generally provide a proper framework for addressing the issue of intangible transfers.
23. BIAC also observes that users are generally not mobile because users live and work in one place. Situations in which users reside in one country and purchase and/or access applications while located in a second country are less common. Similarly, business functions are generally not mobile. Personnel who perform R&D, IT, logistics, marketing, management, and other functions remain situated in a particular location. These personnel have always been able to move among different locations and are no less rooted to a single location now than before. BIAC nevertheless acknowledges that ICT enables enterprises to centralize certain functions, such as finance, legal, management, and customer support functions, in a single location to reduce costs and improve efficiency. This location might (or might not) be remote from market jurisdictions. By definition, centralizing such functions means that the centralized activity will be remote from the majority of market jurisdictions. Centralizing functions does not entail the mobility of functions, however. Instead, centralizing functions requires that these functions remain fixed at a single location. Current transfer pricing rules can be used to address the issue of mobility with respect to services that are used internally.

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<sup>4</sup> Robert McMillan, “The Friendster Autopsy: How a Social Network Dies,” WIRED.COM (Feb. 27, 2013).

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24. In its treatment of the mobility of business functions, the Discussion Draft suggests that digital/internet companies are able to “carry on economic activity with minimal need for personnel to be present.” (Para. 98) BIAAC respectfully disagrees with this contention. BIAAC observes that all enterprises, including digital/internet companies, require human resources to scale, as evidenced by the tens of thousands of employees of the leading digital/internet companies. Although digital/internet companies may retain fewer salespeople as compared to their offline counterparts, these same companies employ significant numbers of development, marketing, operations, IT, and other personnel. Put differently, digital/internet companies have reallocated the responsibilities of their employees but have not eliminated the need for employees. This statement also reflects a potential misunderstanding by the OECD of how companies operate in the digital sphere. Technology is developed by engineers, scientists and other sophisticated professionals that have the ability to innovate. The technology is developed where these people are located and can be both labour and capital intensive. Most of these people are located in countries which are hardly thought of as tax havens and there is not a tremendous amount of mobility within this population.
25. BIAAC also respectfully questions the utility of Figure 8, which appears below paragraph 98 of the Discussion Draft and which depicts the “[a]verage revenue per employee of the top 250 ICT Firms.” As a threshold matter, BIAAC notes that revenue generally does not translate into profits for digital/internet companies and thus represents a false metric for the productive capacity of employees of these companies. In addition, neither Figure 8 nor the source in which Figure 8 originally appears - i.e., the OECD Internet Economy Outlook 2012 - sets forth the names of the “top 250 ICT Firms.” As a result, BIAAC is unable to assess the relationship between the average revenue per employee in Figure 8 and the profitability of the firms in question. Moreover, BIAAC respectfully submits that an objective assessment of the relative profitability of ICT employees must take place in the context of other high margin industries, such as financial services, consulting services, and oil and gas.

#### Significance of Investment Decisions

26. Paragraph 101 notes that businesses are increasingly able to choose the optimal location for productive activities and assets, even if that location may be distant from the location of customers or the location of other stages of production. The ability of businesses to choose the optimal location for assets and activities is not limited to the “digital economy” and thus cannot be used to justify separate rules for digital enterprises. BIAAC believes that this statement reflects concern on the part of some delegates that this ability to choose the optimal location for productive activities and assets will permit taxpayers to locate productive activities and assets where they are subject to little or no tax. BIAAC believes that there are four true statements about tax and investment decisions, unrelated to the digital economy:
1. Taxpayers take into account the level of tax they will incur on their productive investment when they make decisions about where to locate these activities.
  2. Low taxes or tax incentives will not make up for an unfavourable investment climate.
  3. Tax incentives can tip the scales towards a location that has an otherwise favourable investment climate.
  4. A difficult tax environment including high rates, lack of clarity and the difficulty of resolving disputes can discourage investment in an otherwise favourable environment.
27. In an open global market place, if countries seek to encourage business to make productive investments in their jurisdictions, then consequences of these factors are clear. Countries

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need to focus on making the investment climate favourable. Tax regimes are a part of this, including tax regimes that are clear, predictable, and generally impose lower rates of tax on a broader base.

28. This paragraph also raises concerns that countries wish to have it both ways. The BEPS project generally has a theme of requiring **more substance** in order to support taxpayers' allocating income to a particular jurisdiction.<sup>5</sup> This focus on increased substance is inconsistent with the suggestion that income of a MNE can be taxable in a jurisdiction where that MNE has *no* assets, functions, or employees.<sup>6</sup> That is, if a country wishes to focus on the "people functions" leading to the development of intangible property and assert that the people functions are the principal source of profit creation (in distinction to the contributions of risk and capital), then that country should not at the same time assert that another country where the "people functions" are carried on, which lead to the creation of products that are marketed in the first country, must yield to the first country insofar as the right to tax the full return from those functions is concerned. This point will be discussed in more detail in comments on section VII, but BIAC believes that the Task Force underestimates the need for people and assets in the production of digital economy products.
29. The Discussion Draft does recognize the volatility of the market and notes that the few companies that have managed long-term success typically have done so by investing substantial resources in research and development and in acquiring start-ups with innovative ideas, launching new features and new products and continually evaluating and modifying business models. (Para. 118) BIAC is concerned that although volatility and the resulting need to continuously innovate is acknowledged, it is not taken properly into account for purposes of profit attribution. Particularly in the context of the Discussion Drafts on intangibles, BIAC has been making the point that the OECD is undervaluing the contributions attributable to managing business risk. These fundamental business decisions are generally centralized in one or a few designated MNE group members, and are not decentralized into the market jurisdictions. For example, risk management policies are generally determined at headquarters, but their daily implementation and control are generally decentralized into a few regional management companies.

#### IV. IDENTIFYING OPPORTUNITIES FOR BEPS IN THE DIGITAL ECONOMY

30. The draft acknowledges that the nature of the strategies used to achieve BEPS in digital businesses is similar to the nature of strategies used to achieve BEPS in more traditional businesses. (Para. 120) Some of the characteristics of the digital economy may exacerbate the risk of BEPS, particularly in the context of indirect taxation. BIAC would like to point out that MNEs are much more likely to be VAT compliant with respect to digital economy transactions than smaller enterprises. Obviously, all businesses should comply with their tax obligations, but in the case of VAT, MNEs function as an uncompensated tax collector. The trade distortive effects that the OECD has pointed out in other contexts therefore operate in the opposite direction. That is, consumers may be discouraged from acquiring digital goods and services from MNEs because they do comply with their VAT obligations while smaller companies do not. Tax authorities may find that digital economy-based technology solutions may improve overall compliance with VAT by SMEs.

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<sup>5</sup> The OECD has identified actions 6 through 10 as directed at ensuring a taxpayer's transactions have substance. In addition, action 5, relating to harmful tax practices, is directed at ensuring that countries require substantial activity for any preferential regime.

<sup>6</sup> That is, if two men and a dog cannot support the attribution of income to a low-tax jurisdiction, then no men and no dog cannot support the attribution of income to the market jurisdiction.

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## *BEPS in the Context of Direct Taxation*

31. The draft identifies four elements of BEPS planning: avoiding a taxable presence; avoiding withholding tax; low or no tax at the level of the recipient; and no current tax at the level of the parent. (Para. 122)

### **Eliminating or reducing tax in the market country**

#### *Avoiding a taxable presence*

32. The domestic laws of most countries require some degree of physical presence before business profits are subject to tax. Articles 5 and 7 require a permanent establishment before a non-resident may be subject to tax. Accordingly, a non-resident company may not be subject to tax in the country solely by reference to the fact that it has customers there. (Para. 123)
33. The Discussion Draft also states that the ability of companies to maintain some level of business connection "within a country" without being subject to tax on business profits from sources within that country is the result of particular policy choices reflected in domestic law and tax treaties, and is not in and of itself a BEPS issue. (Para. 124) However, digital companies may be able to take greater advantage of these opportunities. This combined with the elimination of taxation in the residence state, creates double non-taxation, and does raise BEPS concerns. (Para. 124)
34. First, BIAC believes a distinction needs to be drawn between actual presence "within a country" and sales "to a country". Activities "within a country" include sales affiliates, customer support operations, and other personnel and assets that actually are established in market jurisdictions by many digital economy companies. This is distinct from making sales to customers located in a country, which should not be considered a business connection "within a country".
35. BIAC believes that these choices relate to the fundamental jurisdictional issue<sup>7</sup> concerning when it is appropriate to impose income tax on participants in the economic life of a country. A legitimate substantive basis for imposing a tax may arise from different contacts between the country and the person or thing taxed. The location of a person, the situs of property, the performance of an activity, the entry of a person or property into a jurisdiction all can support the jurisdiction to impose a tax. Different contacts support different types of assertions of taxing authority. For example, importation of non-income producing property into a jurisdiction would support the imposition of a customs duty, but not an income tax on the person importing the property. Although all taxes are designed to raise revenue, they legitimately reach different aspects of the economic life of a country. Thus countries use a variety of tax instruments to reach each of these aspects and a country may have a legitimate jurisdictional basis for imposing one tax but not a different tax based on the type of connection between the country and the thing that they wish to tax.
36. The notion of an income tax -- particularly a net income tax -- requires identification of the person receiving the income as a first step in determining the items of income and expense around which the income tax net is drawn. Since that must be the first step in identifying the

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<sup>7</sup> Countries should only impose tax if they have a substantive basis for their taxing authority. They may attempt to do so in other cases and may succeed if they have enforcement power, but an exercise of taxing authority in such a situation where there is no substantive basis is illegitimate and the OECD/G20 should not condone such an exercise of taxing jurisdiction.

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income tax base, the characteristics of that person seem more relevant than they might for other taxes, for example, excise taxes. Even in the case of a gross basis income tax, the identity of the person receiving the income is relevant to the determination of the amount of tax imposed; bilateral income tax treaties grant benefits on fixed or determinable type income on the basis of the residence of the recipient. So, the status of the recipient of income is a key concept in determining the amount of an income tax. Because of the intrusiveness of the income tax, this status is relevant in a way that is not for other taxes.<sup>8</sup> Thus the basic jurisdictional nexus is between the person earning the income and country with which that person has substantial contacts justifying the imposition of a tax that requires detailed information concerning the person subject to the tax. BIAC believes that this is the fundamental reason that countries have historically adopted an origin based income tax model and refrained from imposing an income tax, particularly a net income tax, in the absence of substantial contacts of the enterprise located in the country. Because of these sound reasons the OECD/G20 should not lightly reject these historical standards.

37. The single fact that may differ in the case of the digital economy is that the scale of remote sales has increased. The policy choice, therefore, is whether this fact justifies a modification to the traditional nexus standards. BIAC believes that this increase in scale does not justify a general change, or a special rule for the digital economy, since over time trade in these goods and services will become more reciprocal among jurisdictions.
38. Traditionally, gross basis withholding taxes may be imposed on certain types of income even in the absence of an actual business presence. For a gross basis withholding tax to be considered appropriate, the income should be of a type the production of which does not require significant expenses. As previously discussed, the Discussion Draft asserts that internet businesses have significantly more revenues per employee. BIAC would like a further explanation of how those figures were derived. We believe that in most cases internet businesses are like any other. That is, it is difficult to move from a good idea to a business profit. Most businesses fail. Even successful businesses may have long periods of start-up losses before becoming profitable such that a model that imposes tax on a gross basis is likely to impose tax in many cases on amounts that do not reflect net profits. Gross revenue per employee, even if high, does not mean that those businesses do not incur significant costs. People may be replaced by technology, but technology costs may be expensive. For example, search revenue per employee may be high but traffic acquisition costs (TAC) may significantly reduce the profit opportunity on that revenue.
39. Historically, there have been two primary bases for imposing income tax: source and residence.<sup>9</sup> Tax treaties generally recognize that a jurisdiction where the source of income is located (the jurisdiction in which the income “arises”) has the primary right to impose an income tax on that income, and the jurisdiction of residence has a secondary right to impose tax. A person’s income is generated by that person’s activity and/or property. Source rules generally are intended to reflect the location of the person’s activity, or the location of the person’s property, that generates the income or the origin of that income. Neither concept focuses on the location of the customer.

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<sup>8</sup> See the FATCA rules.

<sup>9</sup> The BEPS Action Plan provides: “While actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.” (Action Plan p. 11.) So, while jurisdictions may debate these issues, the BEPS project is not intended to changing the current standards.

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40. Source rules are not universal or immutable, but there are some basic principles that are generally used to determine source. Some of those principles are: place of activity (performance of services, profits attributable to a PE), place of use (rents and royalties<sup>10</sup> from property), residence of the payor (interest and dividends), and residence of the recipient (capital gains, and business profits, not otherwise dealt with, and not attributable to a PE outside the residence country).
41. The income tax, at its most basic level, is an origin based tax on income created by activities conducted in a particular place. That is, jurisdictional nexus is created by the location of activities<sup>11</sup> and assets of the person earning the income. The country or countries that have a substantial nexus to those activities and assets should have the jurisdiction to tax that income.

*Minimizing functions, assets, and risks in market to jurisdictions*

42. The Discussion Draft asserts “[i]n the context of the digital economy, an enterprise may typically establish a local subsidiary or a PE, with the local activities structured in a way that generates little taxable profit.” (Para. 125) The Discussion Draft acknowledges that this is not a BEPS issue in and of itself, even if the enterprise takes taxes into account in deciding where to locate personnel and functions. (Para. 125) The Discussion Draft asserts, however, that this creates “incentives to purport an allocation of functions for tax purposes in ways that may not correspond to actual business functions performed, and that would not be chosen in the absence of tax considerations.” (Para. 125) How much profit a local entity generates depends on the functions, assets and risks of that entity. There has been a lot of public comment on this issue, but the public comment does not necessarily reflect the actual operations taking place in particular countries. In many cases, “digital economy” companies only locate a small portion of their worldwide labour force in a jurisdiction and those personnel are not responsible for intellectual property. Thus, minimal presence and low value functions are what leads to the low profit attribution.
43. The Discussion Draft states that authority to conclude contracts is one of the functions that may “purportedly” be in a non-resident entity, while the “effective authority” to conclude contracts is in fact in the local entity.<sup>12</sup> (Para. 127) The draft continues as follows: “assets, in particular intangibles, and risks related to the activities carried out at the local level may be allocated via contractual arrangements to other group members operating in a low tax environment in a way that does not correspond to actual risks assumed or to functions performed, assets used, or risks assumed related to the intangibles.” (Para. 125) The draft also identifies “undervaluing” intangibles at the time of transfer as a risk. (Para. 126)
44. The Discussion Draft also states “[o]perations in higher tax jurisdictions often are “allegedly” stripped of risk, do not “claim” ownership of intangibles or other valuable assets, and do not hold the capital that funds the core profit making activities of the group.” (Para. 126 internal quotations added.) BIAAC has addressed some of these concerns in our comments in our responses to the Discussion Drafts on intangibles. BIAAC is very concerned with the tone of

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<sup>10</sup> The market jurisdictions may believe that returns attributable to accessing a market are royalties. The OECD’s Discussion Draft on intangibles rejects that view because the market cannot be owned or controlled by any person. Assuming that this view is retained in the final version then the royalty analogy is not the appropriate method for determining the source of income derived from the delivery of digital goods or services.

<sup>11</sup> The word “activities” is used broadly here. Activities would include investing, bearing risk, holding title and managing property.

<sup>12</sup> Contract approval parameters are generally set at the headquarters company or regional management company, not at the local market level. Difficult contract negotiations are generally escalated to the headquarters or regional management company.

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this Discussion Draft, that it reflects an assumption that MNCs systematically misrepresent to tax authorities the actual functions, assets and risks located in a jurisdiction.

45. The emphasis on “alleged” and “purported” is misplaced. Within the limits of the law, taxpayers are allowed to decide on the structure of their transactions. Taxpayers and tax authorities may disagree with the consequences of transactions, but the pejorative language is unhelpful to the resolution of these difficult issues. The discussion of these issues needs to take place at the level of the appropriate policy without comments that imply taxpayers are generally not following the current rules. Under current law, in cases where function does not follow form and taxpayers only “purport” to do things rather than actually doing them, tax authorities have the appropriate tools to challenge those allocations of income and assert taxing jurisdiction.

#### *Maximizing deductions in market jurisdictions*

46. This section asserts that companies artificially inflate expenses including interest, royalties, and service fees. (Para. 128) We reiterate here the comments above. If the payments are not arm’s length, tax authorities may challenge these allocations. The discussion on appropriate rules should be based on the appropriate policy.

#### **Avoiding withholding tax**

47. The Discussion Draft provides that companies may use treaty shopping structures to avoid withholding tax that would otherwise be due and this raises BEPS concerns. (Para. 129) BIAC will be providing comments on the recently proposed Discussion Draft on Treaty Anti-Abuse rules.

#### **Opportunities for BEPS with respect to VAT**

48. This topic is discussed at the end of this letter.

#### **V. TACKLING BEPS IN THE DIGITAL ECONOMY**

49. BIAC strongly agrees with the view expressed in this section of the Discussion Draft that other Action Plan items that will have an impact on BEPS in the digital economy. We also strongly agree with the statement that is necessary to evaluate the impact of those other changes before considering unique rules for the taxation of the digital economy that may turn out to be unnecessary.<sup>13</sup> The Discussion Draft provides insight into where some of the future action items may be headed. It is worth noting that with all the proposed changes, there is no evidence in the Discussion Draft that the countries see improved dispute resolution as part of the package of items necessary to tackle BEPS in the digital economy. As business has repeatedly made clear, improved dispute resolution is critical to implementing any fundamental restructuring of the international tax principles. The interpretation of these new rules will generate disputes and improving dispute resolution must be addressed.

#### **Restoring taxation on stateless income**

50. “Structures aimed at artificially shifting profits to locations where they are taxed at more favourable rates, or not taxed at all, will be rendered ineffective by ongoing work in the context of the BEPS Project.” (Para. 146) Presumably this includes all the transfer pricing action

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<sup>13</sup> The timing on this Action Item may be premature. Action Item 1 should probably have been Action Item 15. That is the impact of all the other changes should have been considered before taking action of the “digital economy.”

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items (Actions 8, 9, and 10). The Discussion Draft also recognizes greater transparency and mandatory disclosure of aggressive tax planning arrangements, uniform transfer pricing documentation requirements, and country-by-country reporting as contributing to this. BIAC has previously submitted comments on these issues. We would like to highlight that the OECD needs to be mindful of the burden created by reporting requirements and ensure that burden is appropriate and proportionate.

### **Measures that will restore taxation in the market jurisdiction**

51. These measures include the prevention of treaty abuse (Action 6). A Discussion Draft on this was published recently. BIAC has submitted separate comments on this topic.
52. On preventing the artificial avoidance of PE status (Action 7 – which is due by September 2015), the Discussion Draft mentions possible changes to the rules concerning the conclusion of contracts and dependent agents (Para. 150) and possible changes to the Article 5(4) preparatory and auxiliary activities. (Para. 151)

### **Measures that will restore taxation in both market and ultimate parent jurisdictions**

53. The Discussion Draft identifies three action items in this context. These are the work on hybrid mismatch arrangements, the work on base erosion via interest deductions and other financial payments, and the actions to assure that transfer pricing outcomes are in line with value creation.

#### *Neutralize the effects of hybrid mismatch arrangements*

54. The OECD recently published two Discussion Drafts on these topics. BIAC will be developing comments on these Discussion Drafts.

#### *Limit base erosion via interest deductions and other financial payments*

55. The Discussion Draft points out that “many large and well-established digital economy players are cash rich and they often finance new ventures, the acquisition of start-ups, or other assets with intra-group debt.” (Para. 155) Intra-group financing entities are often established in low tax jurisdictions. The existing rules permit companies to fund profit-generating activities of the group with intercompany debt even though the group as a whole may be much less heavily leveraged. (Para. 156) This issue is not unique to digital economy companies and may be less prevalent in the “digital economy” than in other sectors of the economy.
56. The Discussion Draft identifies this as an area where mechanisms within or beyond the arm’s length principle may be necessary and suggests a formulary approach which ties deductible interest payments to external debt payments which may lead to results that better reflect the business reality of MNE groups. (Para. 157) This would obviously be a significant change from current law and a significant move towards formulary apportionment. BIAC has serious doubts concerning the feasibility of such an approach. In order for this to work, countries would not only deny deductions for intra-party debt, they would also have to permit a deduction for a portion of the external interest expense incurred by an entity located outside of their jurisdiction. Since, these countries are now allowing that deduction presumably they would also want the option to impose a withholding tax on the portion of external interest paid. Instead of actual intra-company debt would there now be deemed intra-company debt that would be subject to withholding tax? That does not seem appropriate since there would be no income in that jurisdiction since the only income is held by unrelated parties who are not necessarily located in the jurisdiction of the entity that incurs the third party debt. Would each

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company have a share of the external debt? If so, how would each company determine a share of that in a timely manner such that withholding tax could be imposed without burdening capital markets? Perhaps withholding agents have to determine which treaty applied to some portion of each payment. Perhaps withholding agents would withhold at the highest possible applicable rate and investors would be required to apply for refunds in every jurisdiction to which interest was allocated.

*Counter harmful tax practices more effectively*

57. The Discussion Draft notes that a number of OECD and non-OECD countries have introduced preferential tax regimes for IP. (Para. 158) The OECD will be examining whether those regimes constitute harmful tax preferences, specifically whether they require substantial activity. If the regimes are found to be harmful, then the relevant country will be given an opportunity to abolish the regime or remove the features that create the harmful effect. This may have more of an impact within the EU because of the limitations on State Aid. If certain regimes are found to be harmful, they may violate the EU's prohibitions against State Aid; countries may, in fact, be obliged to get rid of them (or face penalties). If countries establish tax incentives, then taxpayers should be free to take advantage of them. It is not a BEPS concern if a consequence of taking advantage of a legal tax incentive is low or no tax on the income covered by that incentive.

*Assure that transfer pricing outcomes are in line with value creation*

58. This is the work being done under action items 8 through 10 and should have the effect of aligning income with the location in which the income arises.

*Intangibles, including hard-to-value intangibles, and cost contribution arrangements*

59. The BEPS work on intangibles will address the below value transfer of intangibles by taking several steps. (Para. 160) These include:
1. A broad definition of intangibles -- this is intended to ensure that any intangible for which unrelated parties would pay compensation must be compensated in a related party transfer;
  2. Entities that contribute value by performing or managing development functions or by bearing or controlling risks are appropriately rewarded;
  3. Valuation techniques may be used when appropriate comparables cannot be found;
  4. In the case of partly developed or hard to value intangibles, post-transfer profitability (commensurate with income) should be taken into account.
60. BIAC has submitted comprehensive comments on the topic of intangibles and stands by those comments.

*Business risks*

61. The Discussion Draft states that the BEPS work will require the control of risk, the financial capacity to bear the risk, and the management of risk to be more closely aligned. (Para. 163) Even more importantly, the Discussion Draft states "the guidance will also identify risks that, by their nature, are borne by the MNE group as a whole and therefore which cannot readily be assigned to a single group entity." (Para. 163) The Discussion Draft does not say what would

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be done with these risks. Ignoring commercial risk is one of the principal tenets of formulary apportionment (those advocating for formulary approaches basically consider the return from intangibles and risk to be spread over all the activities of the group). So, ignoring risk would be a significant move in the direction of formulary apportionment. As mentioned earlier in this comment letter, the managing of global risk is one of the principal functions of senior management. Management is responsible for identifying the direction of the business, deciding which ventures to pursue and which to abandon, and developing or acquiring new products or businesses which they believe will be successful. These basic decisions determine whether a company will become and remain successful. Even successful businesses must continuously evaluate and manage these risks. These risks are not managed in the contract manufacturing entity or the contract research and development facility, but they are key to the continuing vitality of any business<sup>14</sup> and an approach that either ignored these risks or allocated them on the basis of a formula would fundamentally misallocate business risk. This approach would divorce taxation from business and economic realities; a result that appears contrary to the goals of the OECD. Additionally, formulaic apportionments carry significant risks of creating their own base erosion problems.

#### *Base eroding payments*

62. The Discussion Draft describes, in brief, certain targeted measures that could be helpful in addressing base eroding payments. These could include measures that preserve some reliance on the ALP but depart from it in certain respects. These approaches could include caps on certain payments or formula based allocations. (Para. 165) Our earlier comments on allocating interest using formulas could be relevant here depending on what is allocated and whether withholding taxes potentially apply. This would be another significant step in the direction of formulary apportionment.

#### *Global value chains and profit methods*

63. The Discussion Draft provides that:

*“Attention should therefore be devoted to the implications of this increased integration in MNEs and evaluate the need for greater reliance on value chain analyses and profit split methods. This work should also address situations where comparables are not available because of the structures designed by taxpayers and could also include simpler and clearer guidance on the use of profit splits along the lines that have been successfully applied in connection with global trading and other integrated financial services businesses.”* (Para. 166)

64. The output is to be delivered by September 2015.
65. BIAC is very concerned that all of these elements taken together represent a significant erosion of the ALP. As we stated at the beginning of this letter, this hybrid approach will potentially lead to a high risk of double taxation and will potentially create a significant drag on trade and investment.

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<sup>14</sup> Even companies that have been successful over a long period can fail because they fail to manage business risk and change. Kodak is a prime example of the sort of failure.

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## Measures that will restore taxation in the jurisdiction of ultimate parent

66. The Discussion Draft provides that to address BEPS in the digital economy, CFC rules must effectively address the taxation of mobile income created by the digital economy. (Para. 168) To address this situation, consideration should be given to CFC rules that target income typically earned in the digital economy, such as income earned from the remote sale of digital goods and services. (Para. 169)<sup>15</sup> Remote selling is neither new nor unique to the digital economy. Internet/cloud technology has made remote selling pervasive in the economy. So it would be difficult and unfair to limit rules on remote selling to digital economy transactions. The draft also says that the work will need to take into account the need for anti-inversion rules. (Para. 169)
67. BIAC believes that the purpose of the corporate income tax and the economic burden of that tax are relevant to whether a CFC approach or another approach is appropriate to reducing the incidence of low or non-taxation. That is, if other BEPS concerns are addressed and yet there is still low-taxed income: does any country have jurisdiction to tax that income? If so what is the basis of that jurisdiction? The corporate income tax ensures a comprehensive income tax; without a corporate income tax, corporate earnings would not be taxed until paid out to individual shareholders.<sup>16</sup> It is also widely acknowledged that corporations do not bear the economic burden of the corporate tax, although it is less clear where that burden falls. Traditionally, the impact of corporate taxation has been believed to be borne by the shareholders of the corporation since it reduces the value of their shares. More recently some have argued that the burden of the corporate tax falls on labour or the consumer. The U.S. Congressional Research Service believes the traditional analysis is generally correct.<sup>17</sup> This is relevant to the policy analysis because if the corporate tax functions as a pre-payment of the personal income tax and the economic burden of the tax in fact usually falls on the shareholders of the corporation, then the jurisdiction which ought to be determining whether residual tax should be imposed on a corporation that is earning income subject to a low rate of tax ought to be the jurisdiction in which the shareholders reside. Taxing the ultimate individual shareholders is probably impractical. However, taxing the ultimate parent in the jurisdiction in which it resides is probably a reasonable proxy for taxing the individual shareholders. If that conclusion is correct, is the jurisdiction of the ultimate parent obliged to tax low taxed income or can it make a sovereign choice to tax that income only on repatriation to the ultimate parent or not at all? BIAC believes that countries do have the sovereign right to make these choices and that after appropriate returns are paid based on a FAR analysis, the right to impose an additional tax on corporate profits ought to be reserved to the jurisdiction of the ultimate parent.
68. This issue goes to the origin theory of income taxation vs. the supply/demand theory. Under the supply/origin theory: "profits originate where the factors that produce the profits operate and the source of the "normal" return of equity capital should therefore be identified "to the location in which the actual operation of the capital occurs";<sup>18</sup> ... the mere consumer market does not represent a factor contributing to the added value of the company.<sup>19</sup> "[A]ctivity somewhere, as reflected by the entrepreneur's risk assumption, labour deployment, and property investments, remains a necessary component to an enterprise's creation of products

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<sup>15</sup> See the recent US Treasury proposal on CFC rules for the digital economy.

<sup>16</sup> The Corporate Income Tax System: Options for Reform, the Congressional Research Service, p. 15.

<sup>17</sup> Ibid at 16.

<sup>18</sup> Anne Schafer and Christoph Spengel, *ICT and International Taxation: Tax Attributes and Scope of Taxation*,

<sup>19</sup> Business Profits TAG, final report, paragraph 40.

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and services. Nothing in the "new" economy changes the proper justification for a state to impose an income tax on an enterprise."<sup>20</sup>

69. The Final Report also says: "No member of the TAG argued that tax rules should be modified to shield countries from the effect of technological developments on their tax base. Countries do not have a right to a particular level of tax revenues regardless of where business profits originate."<sup>21</sup> So, if activities have shifted to outside the jurisdiction, countries will lose tax revenue and that is appropriate. BEPS is intended to address **artificial** profit shifting. If the income is attributable to actual activities that have moved out of the jurisdiction, then the profit shifting is not artificial. We are concerned that the digital economy proposals are inconsistent with the other BEPS action items that strive to attribute more profit to the location where activities take place. We believe that countries cannot have it both ways. If they want to look to the location of people functions in the context of the attribution of income to the development of intangibles, they should also look to the location of people functions in the context of the digital economy.
70. BIAC also believes that this does not deny a market jurisdiction an appropriate share of taxing jurisdiction because proper application of a destination based VAT will provide an appropriate base for taxing the value attributable to the market.<sup>22</sup>
71. In contrast to an income tax, a VAT is intended to impose a broad-based tax on final consumption by households. The central design feature of a VAT is that the tax is collected through a staged process. Each business in the supply chain takes part in the process of controlling and collecting the tax, remitting the portion of the tax corresponding to its margin. That is the VAT of a business is the difference between the VAT on its taxed inputs and the VAT on its taxed outputs. The tax is collected in principle on the "value added" at each stage of the collection process.
72. The economic burden of a VAT is supposed to be borne by the ultimate consumer (in contrast to the corporate income tax). We believe that the OECD should take a careful look at the economic burden of both of these taxes in the context of the digital economy. If companies are competing on price then VAT compliant MNEs may be bearing the burden of the VAT because SME competitors may be less likely to be VAT compliant and will undercut more compliant companies on price. Thus, VAT compliant businesses may be bearing at least a portion of the VAT. Also, companies may want to use a uniform pricing model across jurisdictions and in order to avoid pricing differentials caused by different VAT rates, some VAT may be borne by MNEs (which may mean that it is ultimately borne by shareholders). Business also believes that in determining the economic burden of the VAT compliance costs should be taken into account. These costs are higher than they need to be because governments have not coordinated their rules; compliance is more burdensome than it needs to be; penalties are significant; and there is no process for resolving double taxation disputes.

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<sup>20</sup> Business Profits TAG final report paragraph 50.

<sup>21</sup> *Ibid* para. 118.

<sup>22</sup> There are political reasons that some jurisdictions do not want to rely on a VAT to tax the value attributable to the market. These vary but include the fact that, as discussed, the economic burden of a VAT is supposed to fall on the final consumer. That is, jurisdictions may wish to tax corporate income precisely because the economic burden does not fall on their residents. In some jurisdictions VAT rates are already very high and there is not a lot of scope to raise rates further. Sub-national governments may impose VATs, so revenue from a VAT would have to be shared between national and sub-national governments. Some jurisdictions may have constitutional or other restrictions that limit their ability to impose a VAT. These political concerns of course need to be properly taken into account, but that should be done after the tax policy analysis of the proper scope of the income tax and the VAT, so countries understand that they are making political concessions to achieve a consensus solution.

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Precisely because the economic burden is supposed to be borne by the customer, the compliance costs business incurs are an economic burden on the company.<sup>23</sup>

73. The fundamental policy issue in relation to the international application of the VAT is whether a VAT should be imposed by the jurisdiction of origin or the jurisdiction of destination. Under the destination principle, tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction. If countries adopt a destination based VAT, in the case of a cross-border transaction, the country of origin is ceding its taxing jurisdiction to the country of destination. This may be the right policy, but the economic result is that the country of destination is taxing value added in other jurisdictions.
74. Under the destination principle, exports are not subject to tax (and are entitled to a refund of input tax) and imports are taxed on the same basis as domestic supplies. **Thus, the value that was added outside of the jurisdiction of consumption is subject to full VAT in the jurisdiction of final consumption.** In other words, the jurisdiction of consumption is able to impose a tax on the value created by activities taking place outside the jurisdiction and assets whose use and value is outside the jurisdiction.
75. Under the origin principle, each jurisdiction would levy VAT on the value created within its own borders. Thus, jurisdictions would tax exports on the same basis and at the same rate as domestic supplies and would tax imports as domestic supplies with a credit for the hypothetical value of its VAT (not the actual VAT paid in the country of export). By imposing tax at the various rates applicable in the jurisdictions where value is added, the origin principle could influence the economic or geographical structure of the value chain and undermine neutrality in international trade.
76. Obviously this is true and could also be true for origin-based income taxes. That is, imposing income tax on the place where value is created can and does influence the economic and geographical structure of the value chain, as discussed above companies take taxes into account in deciding where to locate productive activities. The OECD has recognized that consumption taxes are preferable to income taxes, precisely because consumption is less mobile and does not create distortions. This does not mean that all taxes – income taxes in this case -- should be imposed on the basis of place of consumption. A distinction between origin based income taxes and destination based consumption taxes allows both the jurisdiction of origin and the jurisdiction of destination to tax value creation in an appropriate way.
77. Although VAT is a tax on final consumption, VAT is not imposed on actual consumption but on proxies that are intended to predict the likely place of consumption. In the context of developing VAT guidelines, the OECD is identifying which proxies work best in certain circumstances. Once proxies are identified, actual consumption is irrelevant to determining the place of taxation. That is, the proxy trumps the place of consumption if they differ. In the context of digital transactions there are four possible proxies being considered. Those proxies are: consumer residence; actual location of the consumer; residence or location of the supplier; and place of performance. It is likely that the only really feasible proxy in the majority of cases will be consumer residence. The residence of the consumer is the proxy (and therefore the deemed place of consumption) for digital transactions. In other words, the place

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<sup>23</sup> Some have argued that making use of the infrastructure of a country ought to be a sufficient basis for finding a PE and imposing an income tax. We disagree with that view, but note that MNEs not only make use of the infrastructure of a country, but also contribute to it. Serving as the government's VAT collector is a prime example of such a contribution.

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of actual consumption would be irrelevant and the place of consumer residence would generally be the place of consumption.

78. BIAC believes that this division of taxing jurisdiction between VAT and income tax allows both jurisdictions (e.g. origin and destination) to tax a “fair share” of the value attributable to each economic transaction. That is, the country where the functions that generate income have jurisdiction to tax income and the country of consumption (probably deemed to be the country of the consumer’s residence) has jurisdiction to impose a VAT. Each country gets one “bite of the apple”, with the VAT share on final consumption actually being the far larger amount as it is imposed on gross revenue without regard to profitability.

## **VI. BROADER TAX CHALLENGES RAISED BY THE DIGITAL ECONOMY**

79. The Discussion Draft states that the evolution of business models in general and the growth of the digital economy in particular have resulted in non-resident companies operating in market jurisdictions in a fundamentally different manner today than at the time that international tax rules were designed. (Para. 174) The draft also asserts that the traditional model of doing business in market economies is obsolete. (Para. 174) BIAC believes that these assertions grossly overstate the impact of digital methods of doing business on market economies. Companies still require people, assets and functions which will create a tax presence in significant jurisdictions. The main challenges of the digital economy are identified in paragraph 177 as:

1. Nexus – the reduced need for physical presence in order to carry on business raises questions as to whether the current rules are appropriate;
2. Data – the use of data raises questions concerning how to attribute value created from the generation of data through digital products and services, and how to characterize a person’s supply of data;
3. Characterization – how should payments attributable to new digital products and services be characterized;
4. VAT collection – particularly with respect to goods and services acquired by private consumers.

### **Nexus and the ability to have a significant presence without being liable to tax**

80. The Discussion Draft recognizes that advances in digital technology have not changed the fundamental nature of the core activities that businesses undertake to generate profits. Businesses still need to source and acquire inputs, create or add value, and sell to customers. (Para. 178) The digital economy has had an impact on how these activities are carried out. There is a need, therefore, to consider whether the current rules are fit for purpose. (Para. 180) The ability to provide digital products and services to a market at lower costs means that high quality products and services can be provided to small and remote markets that would normally not benefit from current technological advances. This has a positive impact on these markets and tax rules should encourage this development. Imposing expensive and complex tax burdens which are unrelated to local profit or activity would have the opposite effect.

### **Data and the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services**

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81. The Discussion Draft provides that data gathered from various sources is a primary input into the process of value creation in the digital economy. (Para. 183) A key challenge is the attribution of value to this data and the extent of value relative to other sources of value – systems, software and people. It may be challenging to assign an objective value to raw data (Para. 183) and determine the ownership of that data. Personal data is generally considered to be owned by the individual to whom it relates, rather than by a company. (Para. 183)
82. BIAC believes that raw data has little or no intrinsic value, especially generally available raw materials such as usage data. Value is created by the aggregation of data and the application of analytics, which is achieved through investment in people and technological resources.

### **Characterization of income derived from new business models**

83. This section of the Discussion Draft raises the question of whether monetization models utilizing new delivery methods of goods and services challenges the rationale behind existing categorisations of income and consistency of treatment of similar types of transactions. These issues are raised, in particular, with respect to "cloud computing" transactions, including infrastructure as a service, software as service, or platform as a service. (Para. 187)
84. The Discussion Draft includes a lengthy factual description of the nature of cloud computing transactions. (Paras 79 - 84). BIAC generally agrees with that description and the broader factual statements contained in Chapters II and III of the Discussion Draft relating to cloud computing models. To consider the appropriate characterisation for such transactions, the Discussion Draft notes that it will be necessary to examine the rationale behind existing rules in order to determine whether those rules produce appropriate results in the digital economy and whether differences in treatment of substantially similar transactions are justified in policy terms. (Para. 188)
85. With respect to the characterisation of cloud computing transactions, we note the prior OECD work in this area, which produced guidance that remains useful today. In 2001, the OECD published the final report of the Technical Advisory Group on Treaty Characterisation of Electronic Commerce Payments.<sup>24</sup> That TAG addressed the characterisation analysis for a variety of e-commerce transactions for purposes of the OECD Model Convention. The TAG discussed general principles which should be applied to the characterisation analysis, then applied those principles to 24 specified transactions. Those 24 transactions included several remote access transactions, including "application hosting", "web site hosting", "data warehousing", and "streamed (real time) web based broadcasting", which would be described as "cloud computing" transactions today.
86. The TAG evaluated the available precedents for characterising such payments as business profits or royalties, and concluded that the most useful guidance existed under U.S. tax law. Accordingly, the TAG adopted the principles of U.S. Internal Revenue Code section 7701(e) to guide its characterisation analysis. The TAG report states as follows:

27. The Group also examined a few transactions where it could be argued that tangible computer equipment (hardware) was being used by a customer so as to allow the relevant payment to be characterised as "payments for the use of, or the right to use, industrial, commercial or scientific equipment" [the report here referred to application hosting, web site hosting and data warehousing examples].

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<sup>24</sup> Taxation and Electronic Commerce - Implementing the Ottawa Taxation Framework Conditions (2001).

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28. The Group examined various factors used to distinguish rental from service contracts for purposes of section 7701(e) of the U.S. Internal Revenue Code and found these factors to be useful for purposes of determining whether payments are for “the use of, or the right to use, industrial, commercial or scientific equipment”. Once adapted to the transactions examined by the Group, these factors, which indicate a lease rather than the provision of services, can be formulated as follows:

- (a) the customer is in physical possession of the property,
- (b) the customer controls the property,
- (c) the customer has a significant economic or possessory interest in the property,
- (d) the provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract,
- (e) the provider does not use the property concurrently to provide significant services to entries unrelated to the service recipient, and
- (f) the total payment does not substantially exceed the rental value of the computer equipment for the contract period.

29. This is a non-exclusive list of factors, and some of these factors may not be relevant in particular cases. All relevant facts bearing on the substance of the transaction should be taken into account when determining whether the agreement is a service contract or a lease.

87. The TAG then applied these principles to application service provider and data warehousing examples, concluding in both cases that the payment would be for the provision of services, and not for the lease of industrial, commercial or scientific equipment, as follows:

30. Applying these factors to application service provider transactions, the Group concluded that these should generally give rise to services income as opposed to rental payments. In a typical transaction, the service provider uses the software to provide services to customers, maintains the software as needed, owns the equipment on which the software is loaded, provides access to many customers to the same equipment, and has the right to update and replace the software at will. The customer may not have possession or control over the software or the equipment, will access the software concurrently with other customers, and may pay a fee based on the volume of transactions processed by the software.

31. Likewise, data warehousing transactions should be treated as services transactions. The vendor uses computer equipment to provide data warehousing services to customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment, and has the right to remove and replace equipment at will. The customer will not have possession or control over the equipment and will utilise the equipment concurrently with other customers.

88. The guidance provided in the TAG continues to be useful today in characterising payments for cloud computing transactions. While the TAG language discussed above has not been formally incorporated into the OECD Commentary, guidance on certain analogous

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transactions recently has been incorporated in the Commentary.<sup>25</sup> In particular, the Commentary discusses how satellite operators and their customers frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilize the capacity of a satellite transponder to transmit over large geographical areas. The Commentary concludes that in most cases, payments for these transactions should be characterised as business profits rather than royalties. This is true even in the context of treaties that include the leasing of industrial, commercial or scientific (ICS) equipment. In reaching its conclusion, the Commentary points to the fact that customers typically obtain access to the transponder's transmission capacity, rather than physical possession of the transponder itself. We believe this analytical approach should apply to cloud computing transactions, and that the current Commentary guidance is consistent with the TAG report and the principles of section 7701(e).

89. In most cases, an application of the factors accepted by the TAG to XaaS transactions would characterize payments for cloud computing transactions as business profits (based on the provision of a service), rather than royalties. As with transponder leasing agreements, we believe this is true even in treaties that include the leasing of ICS equipment in the definition of royalties because the user generally does not acquire physical possession of the server in most cloud computing transactions.
90. We would be pleased to work with the OECD to develop language for the Commentary that provides guidance for payments from cloud computing transactions.

### **Collection of VAT in the digital economy**

91. Detailed comments on VAT are provided at the end of this document.

## **VII. POTENTIAL OPTIONS TO ADDRESS THE BROADER TAX CHALLENGES RAISED BY THE DIGITAL ECONOMY**

### **Framework for evaluating options**

92. The Discussion Draft states that the Ottawa framework of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility continues to be a good starting point. (Para. 204) BIAC strongly endorses the use of the Ottawa framework. The framework will also need to take into account the key features of the digital economy as outlined in section III.
93. The principle of neutrality means that "ring fencing" the digital economy and applying separate tax rules is neither appropriate nor feasible. (Para. 205) BIAC agrees completely with this conclusion.
94. Another key point is that the OECD expects that action on the other action items will raise the effective tax rates of digital economy companies. If that is not the case and effective rates in the digital economy remain extremely low, then "addressing the broader tax challenge of the digital economy becomes a more pressing concern." (Para. 208) While not surprising, this statement seems somewhat inconsistent with the notion that countries are free to choose to impose low (or no) tax on income properly attributable to that jurisdiction because it implies that a certain level of income tax ought to be paid at the corporate level in all cases. If income is subject to tax in the appropriate jurisdiction, then whether that jurisdiction chooses to impose a low tax or any tax at all, is a sovereign choice for that jurisdiction. If that jurisdiction

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<sup>25</sup> See e.g., OECD Commentary on Article 12, para. 9.1.

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does not choose to impose tax, then (apart from appropriate CFC rules) other countries should not be able to assert a claim to tax that income.

## **Options proposed to the Task Force**

### *Modifications to the exemptions from permanent establishment status*

95. The Discussion Draft raises the question whether the activities described in Article 5 (4) of the OECD Model Convention could constitute core functions of a business. (Para. 210) At least in the case of maintaining a warehouse, that activity normally could be considered a "core" activity only of an enterprise whose principal business function is to provide warehousing services. Warehousing is an activity within almost every industrial supply chain. But it is seldom if ever a core function – indeed it is an area that many companies outsource in full or part and it is a function that is generally acknowledged as being easy to benchmark, given the multitude of third party comparables. It would also be unfair and distortive if companies that outsource their warehousing function are potentially treated differently from those companies who primarily insource. BIAAC believes that if Article 5(4) is to be changed, then any such changes should modify the preparatory or auxiliary exception only for those enterprises whose primary source of revenue is an Article 5(4) activity. BIAAC supports a policy that all businesses are subject to tax in the jurisdictions in which revenue-generating functions relating to their core competencies take place.
96. Changes to the definition of PE are part of Action Item 7 which is due by September 2015. BIAAC will provide comments at the appropriate time on OECD/G20 proposals modifying these rules. Business prefers bright line rules that provide certainty, so to the extent the changes the OECD/G20 is considering move in that direction, that would be a plus. However, as we discuss at length in other parts of this comment letter, PE rules that minimize exposure to local country tax have a sound basis in policy. The OECD/G20 should not make broad changes without careful consideration of the consequences.

### *A new nexus based on significant digital presence*

97. The Discussion Draft includes an option of an alternative nexus test when a business is “fully dematerialized.” (Para. 212) This seems to directly contradict the statement in paragraph 205 that ring-fencing the digital economy is neither appropriate nor feasible. Paragraph 213 provides a potential test for determining whether "fully dematerialized digital activities" are conducted, including the following elements:
- The core business relies completely or in considerable part on digital goods or services;
  - No physical elements or activities are involved in the value chain other than the existence use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialization of location-relevant data;<sup>26</sup>
  - Contracts are concluded exclusively remotely via the Internet or by telephone;
  - Payments are made solely through credit cards or other electronic means;

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<sup>26</sup> This condition is the most difficult to understand how it could apply to any significant enterprise. Assuming that the object of this option is to define a category of digital enterprises that provide valuable services cross-border, it is hard to conceive of such a business that does not include as part of its value chain development, operations, customer support, marketing, management and similar functions which allow the enterprise to identify new services, develop the technologies to perform the services, and deliver the service to the market.

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- Websites are the only means used to enter into a relationship with the enterprise; no physical stores exist for the performance of core activities **other than offices located in the parent company or operating company countries** (emphasis added – BIAC questions why these operations seem to be ignored);
  - All or the vast majority of profits are attributable to the provision of digital goods or services;
  - The legal or tax residence and physical location of the vendor are disregarded by the customer;
  - The actual use of the digital good or the performance of the digital service does not require physical presence.
98. If a fully dematerialized business is considered to exist, then a significant digital presence could be considered to exist in a country, under the following circumstances:
- A significant number of contracts for the provision of fully dematerialized digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country;
  - Digital goods or services of the enterprise are widely used or consumed in the country;
  - Substantial payments are made from clients in the country to the enterprise; or
  - An existing branch of the enterprise in the country offers secondary functions.
99. As a general comment before analysing this under the Ottawa principles, it is interesting to note that the tests do not look to whether the payment by the recipient of the good or service is deductible. BIAC believes that this is because many of the transactions intended to be covered by this option are B2C so a deduction would not be available. It would seem that in order for this to be a base erosion problem, a deductible payment would be necessary. To reiterate, as to profit shifting, the BEPS project should be targeting artificial profit shifting, if profit producing activities shift, profits should move. Countries do not have a right to a particular level of tax revenues regardless of where business profits originate. It seems fundamentally inconsistent for market jurisdictions to argue that income from intangibles should be allocable to people functions (where the research and development takes place) and ignore the people functions when the transaction is digital (where the digital content is created). The digital content ultimately is created by people, so if people functions should trump then there is no basis for a nexus that looks solely at consumption activity. Otherwise, this option is inconsistent with the emphasis on people functions in the draft Chapter VI TPG revisions.

#### Ottawa Principles:

100. Neutrality: As the Discussion Draft notes in paragraph 205, ring-fencing the “digital economy” would violate the neutrality principle. That is, tax rules and therefore conditions would differ between traditional and electronic commerce. The option of special nexus rules clearly ring-fences some portion of the “digital economy” and therefore violates this principle. Paragraph 216 also raises neutrality issues because it raises the possibility of separate income attribution rules for “fully dematerialized digital businesses.”

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101. Efficiency: BIAAC believes that the efficiency criterion is also violated. BIAAC believes that the nexus based on significant digital presence must be based on taxation of net, not gross, income.<sup>27</sup> Net basis taxation will require some sort of return and depending on how the many subjective terms – significant number, substantial payments, widely used – are defined this could result in tax returns in many additional countries where the company has no physical presence at all. Establishing the accounting systems necessary to file returns in many additional countries is a significant burden and one of the principal reasons for the historical PE standard.
  102. Certainty and Simplicity: The nexus test contains many subjective criteria such that the criterion of certainty will be violated. The test uses terms such as “considerable part”, “significant number”, “widely used or consumed”, “substantial payments”, which are all subjective and probably intended to be subjective. The determination of a “significant number” will vary widely between jurisdictions depending upon factors such as market size.
  103. At the same time, however, one of the core elements of the definition would seem to apply only in exceedingly rare cases. One element of the proposed definition of a fully dematerialized digital business is that “no physical elements or activities are involved” in the value chain other than servers, websites and the collection of location-relevant data. Any enterprise of sufficient size to have its goods or services “widely used” in a country will have many employees who perform critical business activities other than “the collection, processing, and commercialization of location-relevant data.” As written, it is hard to conceive of an enterprise to which this element of the definition could apply. This would lead companies to be concerned that the test does not really mean what it says.
  104. Effectiveness and Fairness: This criterion is more difficult to judge given that the standard is “that taxes imposed are designed to produce the right amount of tax at the right time, and avoid creating new opportunities to artificially avoid taxation.” The Discussion Draft does not provide details of how profits would be attributed to a taxable presence imposed under this new nexus standard. Accordingly, it is difficult to judge whether the right amount of tax would be imposed at the right time. The nexus rules fail the fairness test depending on whether what appear to be absolute tests are in fact absolute tests.
  105. Flexibility: This criterion is difficult to apply; since it is difficult to anticipate which direction technology will take. However, the number of absolute tests proposed likely will make the test less flexible. For example, new technology may make the criterion of “contracts are concluded exclusively remotely via the internet or by telephone” irrelevant.
  106. BIAAC believes that the proposed option of a new nexus based on a significant digital presence clearly fails the Ottawa principles.
  107. Looking at the new nexus test more generally, we believe that the only argument in favour of the adoption would be that it would permit market jurisdictions to impose an income tax on “fully dematerialized digital activities” in certain limited cases. Whether this is appropriate is a political decision for countries. On the other hand, this option would result in significant controversy and double taxation. This option also would discourage the expansion of digital goods and services into remote economies, which will adversely affect economic growth.

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<sup>27</sup> In part, because one of the other alternatives is a gross basis tax.

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108. Accordingly, BIAAC recommends that if countries wish to collect more tax from these transactions they should impose VAT on a wider range of deliveries of digital goods and services and not adopt income tax rules that violate the Ottawa principles as described above.
109. The Discussion Draft also proposes the option that a fully dematerialized business could be considered to have a significant digital presence if it uses personal data obtained by the regular and systemic monitoring of Internet users in that country through the use of multi-sided business models. (Para. 215) BIAAC believes that this is narrower than the above proposals, but it is not clear who is doing the regular and systemic monitoring of the Internet users: the enterprise itself? If the data is obtained and analysed by another entity, then it would seem the profits from those activities should be attributable to the other entity and therefore should not give rise to a nexus for the business purchasing the data.
110. The Discussion Draft acknowledges that development of these options would “require evaluation of the above elements to determine which combination of factors would result in an appropriate nexus to address the tax challenges of the digital economy effectively, while providing enough clarity to minimize dispute. It would also require consideration of how profits would appropriately be attributed, and whether doing so would require modification of the current rules for the attribution of profits to PEs. The work would also need to consider whether such a change would require a change in the attribution rules for all enterprises or whether the changes could be limited to “fully dematerialized digital business.” (Para. 215)
111. This seems inconsistent with the statement in the Discussion Draft that ring-fencing the digital economy and applying separate rules is neither appropriate nor feasible.

### **Virtual permanent establishment**

112. The Discussion Draft includes "for the sake of completeness" virtual permanent establishment options considered by the Business Profits TAG. (Para 217) It does not seem that these options are being actively considered by the Task Force since the options are merely stated with no assessment of pros and cons as were expressed by the Business Profits TAG. BIAAC opposes the adoption of any of these virtual PE options because adoption would violate the Ottawa Principles.
113. Neutrality: A virtual PE establishment is not real; there is, in fact, no place of business in the cases in which the virtual PE options seek to deem a PE to exist. The neutrality principle would be violated to the extent that the options would result in different tax outcomes for conventional and digital forms of commerce.<sup>28</sup>
114. Efficiency: Extending the PE concept to cover situations where websites are being hosted in a country would create serious compliance difficulties. A business may not even know where a website is hosted. Tax administrations would have to attempt to enforce their tax rules in the absence of physical assets and employees.<sup>29</sup>
115. Certainty and Simplicity: The virtual PE proposals would add uncertainty to the determination of whether a PE exists. For example, businesses may not know where the servers hosting its operations are located. Businesses may have difficulty identifying where contracts are concluded and to the extent there are thresholds, it may be difficult to have reliable information

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<sup>28</sup> Final Report of the Business Profits TAG, para. 332.

<sup>29</sup> Ibid at para. 333.

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on whether the thresholds are exceeded and it will be difficult to know at the outset whether the thresholds will be exceeded.

116. Effectiveness and Fairness: The virtual PE options attempt to tax business activities that are not carried on within a country. Thus, creating a PE is “unfair”. It is also likely to be ineffective both because it will be difficult to administer and unless profit attribution rules are fundamentally changed, little or no profit will be attributable to the virtual PE.
117. Flexibility: It is unclear whether these models would be flexible enough to deal with emerging technologies.<sup>30</sup>

### **Creation of a withholding tax on digital transactions**

118. A further proposed option is a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider. (Para. 218) Presumably, the justification for such a tax is that the provider delivers a substantial amount of goods or services into a jurisdiction but does not maintain a taxable nexus in that jurisdiction. Consistency with trade obligations would need to be considered, as would the difficulties of imposing a withholding tax in the context of B2C transactions. The burden of complying with a withholding tax may be imposed on financial institutions. (Para. 218)
119. A withholding tax would allow the market jurisdiction to collect some revenue without the burden of imposing net income filing requirements and determining the profits attributable to the market jurisdiction. It would likely therefore be simpler in some respects. However, this option raises difficult characterization issues and those issues have caused significant controversy and double taxation in the software and service industries. Revenue is a poor proxy for net income. As discussed above, developing digital products and services may require significant investment in time and money. Many products and services never make any money on a net basis. Because of these concerns any withholding tax should be at a very low rate. India’s High Powered Commission recommended a 3% rate for these reasons.
120. Neutrality: “It would be difficult to justify applying withholding tax only on cross-border e-commerce and not on traditional cross-border trade. Such a tax would violate the neutrality principle as presented in the Ottawa framework principles. The alternative of applying the tax to all forms of cross-border trade would mean, however, the introduction of tariff-like taxation, which might well be against WTO rules and principles.”<sup>31</sup>
121. Efficiency: There are also administrative concerns many of these transactions will be B2C<sup>32</sup> and very low value. It is unlikely that individual consumers will collect and pay over a withholding tax. Imposing a withholding tax on these transactions will create significant burdens for the financial system.
122. Certainty and Simplicity: A withholding tax applicable only to digital transactions would require a definition of the transactions to which it applied. This would likely be a difficult task.<sup>33</sup>
123. Effectiveness and Fairness: Given the difficulty of imposing a withholding tax on B2C transactions, this option may not be effective. It also appears to fail the fairness test since the

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<sup>31</sup> Ibid at para. 260.

<sup>32</sup> We reiterate that in the case of B2C transactions there should not be a base erosion concern.

<sup>33</sup> Final Report of the Business Profits Tag, para. 265.

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withholding tax would be levied regardless of profitability. A tax on gross revenues is a very poor proxy for a tax on net income.

124. It seems to us that the administrative issues will be essentially the same as those which would be created by imposing VAT on cross-border digital transactions. Since the VAT is the conceptually more appropriate tax in this context, the consideration argues for preferring a VAT over a withholding tax.

### **Consumption tax issues**

125. Business believes that a combination of an origin-based income tax and a destination-based VAT appropriately divides the jurisdiction to tax between the countries where income producing activities occur and the countries where consumption of goods and services occur. The VAT issues can and should be addressed by the ongoing work of the OECD and WP9 and the TAG. They have clearly demonstrated that they are able to produce an international consensus in the area of VAT. The OECD's Committee on Fiscal Affairs (CFA) approved the business-to-business (B2B) aspects of the VAT Guidelines in January 2014. The indirect tax issues highlighted in the Discussion Draft are already due to be further examined by the OECD – *“how to ensure the effective collection of VAT with respect to the cross-border supply of digital goods and services”* – is covered by the WP 9 work related to B2C and is currently discussed in the well-established OECD VAT TAG process. BIAC is actively contributing to this work. This work also plays a critical role in resolving the VAT aspects addressed in the BEPS discussion draft on the digital economy. The OECD can assess whether the existing process is likely to continue to produce consensus. Business participants in the technical advisory group are optimistic that an international consensus will be reached on additional guidelines concerning the taxation of digital goods and services in the area of B2C transactions.

### **Exempt sector and multi-location entities**

126. The Discussion Draft identifies remote digital supplies to exempt business (Para. 137) and to a multi-location enterprise (MLE) (Para. 140) as aspects which, under certain conditions, create opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT. Concerns particularly relate to the extent that Guidelines 2 and 4 of the OECD's "Guidelines on place of taxation for B2B supplies of services and intangibles" are not implemented.
127. Before commenting on this aspect in further detail, we would like to first highlight some more conceptual aspects that are not specific to the digital economy.
128. All stakeholders, including governments, business or academia, agree that conceptually, a broad based VAT system, with ideally no or very few exemptions, and one standard VAT rate, would represent the most efficient and effective structure for all relevant parties. It would take substantial complexity out of the VAT system, would ensure neutrality for business, and would ease both compliance for business and administration for governments.
129. Therefore, these issues relating to the exempt sector and MLEs in the exempt sector are not specific to the digital economy. Instead, they are conceptual issues related to the design and the application of the VAT system. As the Discussion Draft points out these issues arise to the extent that Guidelines are not implemented. (Para. 136) Thus, implementation of the Guidelines would alleviate these BEPS concerns. (Para. 171) Business supports the implementation of the Guidelines and urges governments to implement the principles of the Guidelines in a consistent fashion.

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130. BIAC would also like to point out that the imposition of new VAT on exempt purchasers of digital (and non-digital) products and services is a significant issue. Universities, hospitals, governments, local government bodies and many others buy vast quantities of services (digital and otherwise) and do not have the budget to pay additional VAT. Although this is not purely a digital issue, as the OECD examines the application of VAT to the exempt sector, these issues should be taken into account to ensure that the exempt sector is not exposed to significant additional costs whilst also ensuring a level playing field for domestic and foreign providers of goods and services.
131. Finally, we would like to clarify two editorial aspects of the Discussion Draft to ensure a common understanding:
132. In paragraph 140, an MLE is referred to as a multinational business that has establishments in different jurisdictions. This could be misunderstood as including subsidiaries of multinationals. However, putting this statement into the context of the relevant example described in the Discussion Draft, and considering the work already done on the VAT Guidelines, it should be clear that it can only mean a multinational business established as a single legal entity with branches of that same entity in different jurisdictions.
133. Paragraph 171 states that *“Guideline 2 recommends that the taxing rights on cross-border supplies of services and intangibles between businesses be allocated to the jurisdiction where the customer has located its **main** business establishment and that business customers be required to self-assess VAT on remotely delivered services acquired from offshore suppliers according to the rules of the jurisdiction in which they are located”*. We agree with the allocation of the taxing rights to the jurisdiction where the customer is located, and with the required self-assessment of VAT by the business customer, but we would like to point out that in context of Guideline 2 of the International VAT Guidelines, which deals with legal entities that are established in one location (Single Location Entity, SLE), the taxing rights will always be allocated to the jurisdiction where this legal entity is located. Therefore, there is no “main” business establishment in this context, as the business is only established in one location.

### **Consumption tax options**

134. The Discussion Draft states that the main VAT challenges created by the digital economy relate to exemptions for importation of low value parcels (Para. 219) and the increase in direct sales of services to consumers (Para. 222) (not the tax treatment of the exempt sector). Paragraph 189 states that the challenge posed by the digital economy may result “in no VAT being levied at all on these flows, with adverse effects on countries VAT revenues and on the level playing field between resident and non-resident vendors. (Para. 189)
135. With respect to low value imports and remote digital supplies to consumers, there is a need to find a balance between the need for appropriate revenue protection, avoidance of the distortion of competition and the need to keep the cost of collection proportionate to the small level of VAT collected. (Para. 193)
136. With respect to remote digital supplies to consumers, the Discussion Draft notes that compliance by non-resident suppliers is essentially voluntary as VAT jurisdictions have limited means to enforce compliance by non-resident non-established suppliers. (Para. 195) Experience suggests that MNEs do comply, in part because of reputational reasons. (Para. 195) We expect that this issue will be returned to Working Party 9 to be dealt with by the VAT/TAG.

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137. BIAC agrees that the most effective and efficient option to ensure appropriate VAT collection on cross-border B2C services is to require the non-resident supplier to register and account for these supplies in the jurisdiction of the consumer. (Para. 221) Countries should consider simplified registration regimes to minimize the compliance burden. (Para. 222)
138. Remote digital supplies to consumers are covered by the WP 9 work on B2C as part of the development of the International VAT Guidelines, and are currently being discussed in the VAT/ TAG.
139. To safeguard VAT revenues and to be able to accurately, timely, and efficiently comply with the VAT obligations, clear, consistent and easy to apply rules are of utmost importance for business. This is even more important in the B2C context, both for imports of low-valued goods and for remote digital supplies to consumers, where businesses have to deal with high volume and low value cross-border transactions.
140. Striking the right balance between the VAT at stake and the administrative costs for business and governments related to that collection is crucial. The wrong balance discourages compliance and can lead to a distortion of competition for business. This is a significant concern for the international business community related to cross-border B2C supplies, particularly in the context of e-commerce related supplies. It is important to recognize that VAT revenues are best safeguarded and collected when the administrative costs of collection and compliance are reduced. Nevertheless, thresholds and exemptions will still be necessary. Business should not be forced to deal with compliance burdens in relation to a de minimis level of transactions, especially where the business may have no control over whether the obligation is incurred because customer's ability to purchase goods and services without regard to borders.
141. The question that therefore arises is how can collection be made as easy and as efficient as possible for business while ensuring enforceability for governments?
142. Two aspects play a vital role here:
- a) Internationally consistent 'place of taxation' rules are required that allow business to determine, in an easy and efficient manner, where a transaction should be taxed for VAT purposes.
  - b) Internationally consistent simplified procedures/mechanisms are required, particularly for foreign businesses selling digital supplies cross-border, to allow business to collect and pay the VAT in an easy and efficient manner, while at the same time, improving enforceability for governments.
143. In a B2B scenario, the two aspects identified above are covered by the International VAT Guidelines based on the destination principle and the recommendation to apply the reverse charge regime as the collection mechanism. Adoption of the Guidelines by governments would ease the burden of the collection of the VAT for business while ensuring full enforceability for governments.
144. Consistent application of the destination principle by governments around the world, together with the application of a reverse charge regime is vital. It was suggested in the 'E-commerce Guidelines and the Consumption Tax Guidance' papers issued in 2003 and has been further explored and reconfirmed again by the VAT Guidelines. In a B2C scenario, it will be more difficult but not impossible to implement consistent place of taxation rules and simplified procedures. Flexibility on the use and evidence of place of taxation proxies, easy access to

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information, easily accessible, simplified, and standardized and technology friendly administrative procedures and an effective administrative cooperation between governments are crucial to make this happen.

145. A tax is not worth anything if it cannot be collected. Particularly when it comes to high volume low value transactions, the OECD should aim for place of taxation rules that allow VAT to be collected in an easy and efficient manner.
146. Business needs flexibility both on appropriate proxies for place of consumption and appropriate indicia to determine the application of those proxies. It may, in some cases, be impossible not just burdensome for business to identify the residence of their customers and they therefore may need to rely on appropriate indicia of residence such as the address associated with a credit card. Only if flexibility is ensured will business be able to effectively collect the VAT at stake. Substantial work has already been done on this aspect in some jurisdictions, for example in the EU, which should be considered, learned from and further explored.
147. Procedures/mechanisms need to be as simple as possible. This will enable foreign businesses to collect and pay the VAT in efficient manner, while improving enforcement for governments. Business agrees that vendor collection is the most viable option. (Para. 222) Business also agrees that simplified registration systems and registration thresholds are necessary to minimise the compliance burden on business. (Para. 223) The simplified registrations system should allow business the choice and maximum flexibility (i.e. direct registration, simplified registration, collection by a 3<sup>rd</sup> party intermediary on behalf of the supplier, etc.).
148. Such a system will only work if business has easy access to information in order to know how to comply and if governments provide easily accessible, simplified, standardized and technology friendly administrative procedures. Technological solutions should be web-based, secure, and should cover remote selling of goods and remote supplies of services. In addition, governments must establish effective administrative cooperation. Without such cooperation, it will be impossible to simplify and standardize the compliance requirements, leading to inefficiencies for business and less compliance with VAT overall. Thus, business supports the notion expressed in paragraph 224 that improved international cooperation between jurisdictions is likely to be required. We would note, however, that this paragraph focuses on cooperation in enforcement actions. While such cooperation is both necessary and appropriate, cooperation needs to begin with designing simple, consistent VAT systems and extend through the cycle to dispute resolution. The issue of double VAT taxation is difficult for two reasons. First, unlike an income tax dispute, it is essentially impossible to split the tax because the issue is always in which jurisdiction did consumption occur? Therefore to reach resolution one jurisdiction has to concede that its VAT will not apply. Second, although VAT is covered by the Mutual Agreement Procedures of income treaties and the MLAT, we believe it is unlikely the Competent Authorities would be willing to deal with VAT issues. If the Competent Authorities were to accept a VAT case, it is unlikely they would have a basis to reach agreement because of the jurisdictional nature of these disputes.
149. Remote B2C digital supplies may involve multiple parties in the supply chain which can make it difficult to determine who the supplier of the service is to the final consumer. Knowing the supplier is key, particularly when aiming at supplier registration as the mechanism to collect the VAT at stake. The OECD must develop clear rules on this. These rules should be informed by EU rules in this area.

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150. In some cases business may wish to use third party intermediaries in the collection process. This should be an option for foreign business, not a requirement. Financial intermediaries may not have the relevant information to determine VAT properly. So financial intermediaries can only be a part of the solution if both the supplier and the intermediary agree.
151. All of these aspects need to be further explored and the OECD VAT TAG process is the right platform for governments and business to work together to develop an efficient solution. This solution can only work through effective administrative cooperation between governments.
152. Finally, there is one very important point to highlight when it comes to supplier registration as collection mechanism for VAT purposes. As mentioned in footnote 25 of the VAT Guidelines, a registration for VAT purposes by itself does not constitute a permanent establishment. Business experiences more and more that, by acting as VAT collectors for governments, foreign VAT registrations are misused by governments and are re-qualified as a permanent establishment for corporate tax purposes, forcing business to pay corporate tax in a jurisdiction where, based on international direct tax principles, no corporate tax should be due. In the long term, and if this continues to happen on a larger scale, such developments might undermine an efficient collection of VAT by dissuading businesses from registering for VAT purposes. This would result in VAT revenue losses for governments and distortion of competition for business.

#### **Co-ordination with other digital economy options**

153. In section VII, various options unrelated to VAT are proposed to address the broader tax challenges raised by the digital economy. Some of these options could have an impact on VAT. For example, any changes to the current permanent establishment concept may have an effect on the application of the simplified VAT registration procedure. Such changes might also influence the application of the reverse charge mechanism.
154. Therefore when considering these options from a direct tax perspective, adequate time must be dedicated to fully understanding the potential VAT consequences.