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BUSINESS AT OECD FEEDBACK ON ADDRESSING THE TAX CHALLENGES OF THE DIGITALIZATION OF THE ECONOMY PUBLIC CONSULTATION DOCUMENT

Dear David,

Business at OECD (BIAC) thanks the OECD for the opportunity to provide comments on the consultation document on Addressing the Tax Challenges of the Digitalization of the Economy. The far-reaching scope of this project is both impressive and challenging. *Business at OECD* understands that elements of the international tax system are becoming unstable, and that the pressure for uncoordinated unilateral action that could severely impede growth creating cross-border trade and investment is growing. We believe that the OECD is the only forum where the stable international consensus that could stop or reverse this trend can be reached, and we are very supportive of this project. However, there is a long way between where we are (and have come from), and where we need to go to reach that consensus – especially as on that journey there will be winners and losers among countries in terms of revenue, which is the underpinning of national sovereignty.

For a new international consensus on revenue allocation to be stable and lasting, therefore, there needs to be not only broad agreement, but also deep agreement between countries. To reach that deep agreement there must be a clear articulation – and then acceptance – of principled reasons for modifying current international norms. Attractive though it may seem in the short term, if the new rules are based solely on a pragmatic accommodation that most countries can live with today, that will almost certainly not prove stable tomorrow. Therefore, in relation to each of the four (current) proposals, we believe it is very important to articulate why the current rules no longer work from an economic, legal and political point of view, and, then articulate how any new rules will work into the future on economic, legal and political grounds.

We believe some principles that underlie the current system must also underpin any new rules (for example, adhering to the Ottawa Tax Framework Principles) and those are contained in our own *Business Principles for Addressing the Tax Challenges of the Digitalizing Economy*[1]. Besides the general principles, the underlying details of any new rules will be critical, and we believe those details also require a principled articulation.

[1] http://biac.org/wp-content/uploads/2019/01/FINAL-2019-01-21-Business-at-OECD-Digital-Principles-Position-Paper.pdf

Below are a few key areas where we believe this articulation is required:

- What is it about a "market" that justifies the allocation of more profit to that jurisdiction? Related to that, does marketing create value regardless of the (superior) performance of a product or service?
- What is the appropriate balance between the reward to innovation (R&D, entrepreneurial risk-taking, etc.) and the reward to the destination/market? And, in particular, what does economic theory and practice tell us about that?
- What in the current Transfer Pricing (TP) rules, and particularly the Arm's Length Standard (ALS), no longer works? Are the concerns practical or theoretical? If mostly practical, can the theory underlying TP and the ALS be preserved while moving towards more mechanical solutions and/or safe harbors, which preserve the theoretical benefits, while solving some of the practical issues?
- To continue the above, separate entity accounting, long the basis for the international tax rules, is partially or wholly swept aside under at least the Pillar 1 options. Again is this for practical reasons or for philosophical/theoretical reasons? This should be clearly articulated – as should the reason why the system-wide profit of business with more than one line of business should be allocated to jurisdictions with no connect with some of those lines.
- What is it about the development, enhancement, maintenance, protection and exploitation (DEMPE) analysis that doesn't work in relation to market jurisdictions?
- In relation to the Global Base Erosion proposal, given the ongoing implementation of the BEPS action items (including the MLI provisions, largely not yet in effect) there should also be a clear articulation of why a further extension of BEPS by way of minimum taxes and/or denial of deductions is required urgently now, rather than at some point in the future.

In addition to a need a need to clearly articulate these crucial principles, however, there are also practical issues to be considered. In particular, a number of the potential solutions referred to in the paper – including full residual profit split methods – could be very complex, not just for taxpayers but also for tax authorities. So, I should be very clear that *Business at OECD* is not opposed to pragmatic, simpler solutions, and indeed many of our members would greatly welcome those. But, to reiterate, there must be clear principles underlying those pragmatic solutions that can serve as the rock upon which these new rules can be built to last.

We understand this will be hard, but, to adapt what I often said during the BEPS process: "The only thing that worries me more than the digitalization project succeeding is the digitalization project failing." *Business at OECD* will offer all the help it can to ensure this project succeeds, and looks forward to starting that process at the upcoming public consultation meetings in March.

Sincerely,

Will Morris
Chair BIAC Tax Committee Chair BIAC Tax Committee

<u>In reading these comments, it must be recognized that the time allowed for comments was incredibly short for such major potential changes, the details of many of which were unfamiliar to businesses until the consultation document was published. While we are anxious to achieve a stable international consensus, and will work hard to do so, these comments are, therefore, very much first impressions. And because of both the time limits, and the early stage in this process, we do not at this stage endorse any of the proposed routes. In a sense this reflects the "without prejudice" stance taken by countries for this next phase. We look forward to continuing this work.</u>

Executive summary

1. We are grateful to be able to provide comments and feedback into this important OECD initiative. As the voice of business at the OECD we recognize the critical need for a multilateral consensus based solution to the perceived tax challenges of the digitalization of the economy. Not reaching a consensus view would be harmful for growth and innovation because without consensus diverging unilateral or plurilateral actions will continue to be taken by various jurisdictions given the political headwinds of the day. Anything short of multilateral consensus at the OECD / Inclusive Framework level, with minimum standards, peer review, and stronger dispute resolution mechanisms, will result in increased instances of double taxation, levels of uncertainty, and complexity. Essential to reaching consensus in this sense is inclusive consultation.

2. Given the range of challenges seeking to be addressed, the complexities of the issues and the short timeframe, we strongly urge the OECD to incorporate further opportunities for consultations to ensure unintended consequences are minimized.

3. We also suggest that deep economic analysis of the global impacts on international trade and investment is considered on any of the proposals before they are recommended, to understand that they will actually be effective, and what the broader economic and potential unintended consequences may be. While academic analysis has been undertaken on a range of proposals that seek to shift income taxation rights towards the place of destination, none of the four proposals appear to have yet been subject to deep economic analysis (either in isolation of combined). Given their specific novelties and the potential for global application, deeper and global and national economic analysis is required on all of the proposals and should be undertaken as part of the OECD's upcoming work.

4. We present in this Executive Summary some key over-arching comments before discussing more particular comments specific to the individual proposals in the following sections.

5. We welcome the OECD's recognition of the importance of certainty and dispute resolution in the consultation document. Business thrives in an environment that includes optimal tax certainty and reduced complexity and administrative burden. However, an efficient dispute resolution system is critical to quickly and equitably resolve tax disputes that do arise. We would welcome this being extended to include dispute prevention. Dispute resolution and dispute prevention mechanisms are strongly favored by business, but even absent this project, improvements could be made to existing mechanisms. Not only will this become even more critical if the tax system moves towards multilateral profit sharing approaches,

but this project is a key opportunity to improve the existing systems and to investigate whether they could apply multilaterally.

6. Members of *Business at OECD* stress that the international tax and transfer pricing system must be equitable (both to source and market countries, as well as taxpayers and governments), efficient, reliable and practical. Any changes made either within or beyond the arm's length standard should be carefully evaluated and only implemented following an adequate period of review and input by the various stakeholders notably governments, business, tax administrations, and members of civil society. We note the BEPS project saw some consensus solutions beyond the arm's length standard (e.g., Action 4 regarding interest expense limitation rules). To find long-term success, it will be imperative governments articulate their principled rationale for any deviations from the arm's length standard.

7. The challenges that the attribution and nexus pillar is seeking to address are focused on transactions and interactions where there are no payments and therefore no comparables available to determine a "true" arm's length price. A system must be found that approximates an arm's length price for such situations without disturbing scenarios where there are demonstrable arm's length prices available if it is to be successful and not create distortions.

8. We commend the OECD Secretariat and Inclusive Framework countries for pushing forward on the Tax Challenges of the Digitalization of the Economy project. The scope of undertaking is impressive and challenging.

    - We believe the results of the BEPS project generally, and Actions 2, 3, 4, 5, 7 and 8-10 specifically have made great strides to reduce base erosion and profit shifting by multinationals. However, until the BEPS Action 11 work (regarding BEPS measurement and monitoring) advances, the full impact of the BEPS project will not be known. For example the Principal Purpose Test in BEPS Action 6 and the MLI (which we believe will have profound effect on the use of tax treaties for effective tax avoidance) will only be effective for some of the thousands of affected treaties from 1 January, 2019 onwards. More will follow throughout 2019 and 2020. Before proposals with such a fundamental impact to the entire international tax and transfer pricing system are moved forward we recommend additional empirical analysis be conducted to analyze the post-BEPS project situation. This is particularly true in relation to the global anti-base erosion proposal, which seeks to address the same problems as many of the BEPS Action Items, which were completed, have been implemented, but their effectiveness not yet analyzed. We particularly question the value of pursuing further action seeking to address the same concerns before the success (or any shortcomings) of currently agreed and implemented measures has been assessed.

    - Furthermore, the multilateral instrument (MLI) regarding dispute resolution (e.g., mandatory arbitration provisions) has recently been signed by states and we do not yet know what impact that will have on the application of the existing OECD double tax treaty framework.

- The pillar one proposals do not appear to be seeking to address the same perceived challenges. It is therefore challenging to endorse one or several of the proposals ahead of others without implication that the underlying problem that it seeks to address is the most pressing. Similarly, appreciating that one proposal may meet its objective is not necessarily congruent with believing that it will meet the other challenges. Greater clarity in the common perceived problems would be welcome, and would also go some way to defining a useful framework against which to balance features of each proposal.

9. We have concerns with each of the four proposals outlined in the consultation document, which we hope can be addressed in reaching a consensus solution. In particular (and in summary):

    - The user participation proposal clearly seeks to ring fence the digital economy (i.e., highlight digitalized businesses), which is not in line with the OECD's conclusions in the 1998 Ottawa report on *Electronic Commerce: Taxation Framework Conditions*, the 2015 *BEPS Action 1 Report*, or the 2018 *Tax Challenges Arising from Digitalization Interim Report*. We do not support this approach, although there is merit in looking (broadly) at which activities of businesses contribute toward value creation. Activities that contribute to value generation may be a more stable basis for defining nexus and principles for the attribution of profits, although restricting these (either de facto or de jure) to particular business models defeats this potential advantage.

    - We understand that there is a desire among the countries that support the "marketing intangibles" approach to allocate more to (or "reward") the market jurisdiction. We believe an approach that seeks to identify the activities that have contributed toward residual/intangible profits and to reward them accordingly is worth further investigation. However, the current proposal asserts the appropriateness of this in relation to one type of intangible, rather than articulating clearly how such value is created in the market jurisdiction in order to justify a <u>principled allocation to such jurisdiction.</u> The project should first consider definitions of what constitutes certain intangibles, before agreeing what is in and out of scope (as this is precisely what was achieved as a result of BEPS Action 8). It is hard to reconcile material intangible value in a location where one has no control over the activities that generate the value with the existing transfer pricing guidelines.

    - The proposal on significant economic presence is a clear and fundamental departure from the existing international tax framework, proposing its replacement with a formulary apportionment based system. The OECD acknowledges that formulary apportionment is not immune from manipulation and would not ensure that profits were truly aligned with value.[2] The proposed thresholds appear to be (de facto) based solely on revenues. We are concerned about the administrability and equity of such a system.

- The global anti-base erosion proposal is extremely complex, and potentially undermines the sovereignty of nations to set their own fiscal policy within the guidelines of the conclusions of BEPS Action 5, which ensure that taxing rights are aligned with economic substance. We are particularly concerned that the incentives that this proposal will give to governments will be to move away from tax incentive toward other (potentially more arbitrary and less transparent) research and innovation regimes outside the tax system (e.g., less transparent cash grant funding), and accordingly fear that it might actually heighten the concerns that countries have around the ability of other countries to attract economic activity and taxing rights. It also appears to be contrary to the base premise of BEPS, which is to ensure taxation where value is created.

- Complexity and the possibility for double taxation will also be heightened if proposals relating to both base erosion and allocation of taxing rights are taken forward concurrently.

10. The activities of enterprises have the potential to destroy as well as create value. Value may also be destroyed or losses generated by activities outside of an enterprise's control. In addition, business cycles and complex multinational activities that evolve, acquire, and grow, typically involve periods of investment, growth, losses and profits. A key concept largely ignored in all of the proposals is the allocation of losses in addition to profits. Despite the recognition of this point during the BEPS Project (and its inclusion throughout the updated OECD Transfer Pricing Guidelines), this is not always a point that is respected by tax administrations or taxing thresholds, which tend to favor allocating profits only. The OECD Transfer Pricing Guidelines consistently refer to the allocation of profits and losses and it is a fundamental feature of the underlying principles of taxation (and consistent with the concept of aligning taxing rights with value creation) that any solution agreed ensure that a share of losses is also attributable where an enterprise's relevant activities generate them.

11. In addition to considering losses and expenses on an annual basis, any change to the nexus and profit allocation rules may raise difficult technical questions around tax treatment of such a transition. Transition rules should ensure market and innovation jurisdictions are equitably treated. Exit charges can pose significant cash flow challenges when relating to intra-group transfers (i.e., where no cash receipts are received). We therefore discourage proposals that explicitly encourage or implicitly allow such charges to accrue on deemed disposals from innovation to market jurisdictions. If innovation country entities face an exit charge related to the transition, it will be critical that market jurisdiction entities obtain a fair market value basis in the marketing intangible allocated to their jurisdiction that could be amortized over time. This should help ensure the related market jurisdiction entities do not

[2] https://www.oecd.org/tax/beps/beps-frequentlyaskedquestions.htm, accessed 26 February 2019.

earn taxable profits in excess of their net return after considering the economic outlays required to establish the business locally.

12. In addition, the broader legal and financial implications must be considered. Effective tax rates at individual company level may become distorted where profits or losses of the company are reallocated. Individual entities must follow strict accounting rules, and allocations of profits or losses may require payments between them (and/or ongoing correspondent adjustments). It may not be possible for businesses to allocate profits or losses to a business in this way if the tax allocation rules move away not only from accounting standards, but also economic reality. It may also be challenging to reallocate profits or losses (or identify ETRs) where differences between different local rules (accounting or tax) currently govern the tax base (e.g. timing issues). Fiduciary duties and broader economic impact should be considered (and this will be particularly challenging where entities are not wholly owned by the same group).

13. Improved dispute resolution mechanisms are absolutely required and we recommend this is explicitly recognized as a third pillar of the project where agreement and adoption is required as a minimum standard, with peer review, that is part of any overall agreement. Double taxation harms business innovation and growth, and drawn out disputes are costly burdens to both business and governments. The concepts contemplated in the proposals (e.g., allocating profits and losses of a MNE group on a plurilateral or multi-bilateral basis) must be coordinated closely by all market jurisdictions to avoid double taxation. This necessitates much stronger dispute resolution mechanisms, including binding arbitration, on a multilateral basis. This includes multilateral tools and programs like ICAP and MAP (among others). Strong dispute resolution mechanisms would create a well-balanced approach. In addition, strong dispute prevention mechanisms such as APAs would be welcomed and reduce the pressure on dispute resolution.

14. On 21 January 2019 we released a list of 11 policy recommendations we believe should be considered when developing modifications to the underlying international taxation norms to update them for the modern digitalizing economy. We have assessed the 4 proposals described in the public consultation document against these 11 principles (refer to summary table below). We would like to call attention to a few key items related to our principles.

    - **The reforms should be based on long-standing and well-founded underlying principles of international taxation**

        - Business believes the long-standing and well-founded underlying principles of international taxation including taxation of net income, nexus, permanent establishment, and transfer pricing based on the arm's length standard (all of them updated under BEPS) should remain, and any changes should be to <u>improve and update</u> these underlying principles, not radically replace them. The revised framework should be applicable to all digitalizing businesses and be flexible enough to accommodate future business model evolution.

- As stated above, the concept of losses is largely ignored in all of the proposals. We believe it is critical the profit allocation system fully contemplate losses as well as profit, taking into account the multi-sided business models, in order to be economic and reflective of business reality.

- The marketing intangible proposal appears to have its genesis in long-standing transfer pricing concepts and could potentially be drawn in such a way as to satisfy this principle. However, given the ways in which the application under this proposal goes beyond the arm's length standard, it is vital that there be a fundamental articulation of how and why this intangible creates value in the market as opposed to somewhere else. We understand the current political pressures for reallocation, but to ensure the widespread agreement over the longer term necessary to restore the hoped-for stability to the international tax system, there needs to be not just broad but also deep agreement on a principled basis for this – not just an agreement for the time being on a split that everyone (currently) can live with.

- Marketing intangibles, as defined in the OECD Transfer Pricing Guidelines, is a known concept – although the descriptions in the consultation paper of what activities would be expected to contribute to such intangibles are not consistent with our understanding of "marketing" or the existing concept. Importantly, this proposal contemplates allocating all routine profits and all non-routine profits (except for non-routine profits related to marketing intangibles) under the existing arm's length standard. However, by the definitions in the consultation document it appears that different results could be achieved for the same activities between related and unrelated parties – this is particularly stark in an examination of B2B v B2C transactions. As noted below, it is not in line with existing principles to ring-fence particular activities or industries, or to tax related party and unrelated party transactions (with the same underlying activities, either of a company, its related parties, or third parties) in different ways that could create distortions. More work is therefore needed to ensure that the returns for "marketing intangibles" result in an equitable allocation for all businesses regardless of their operating or distribution models.

- The user participation proposal does not satisfy this principle as it attempts to impact only three types of businesses in a novel way. We do not think this a sustainable proposal for the long term as businesses and business models will continue to change in unpredictable ways.

- The significant economic presence proposal is also novel and does not satisfy this principle because it puts forward thresholds that will almost always be met by large businesses and seeks to tax their activities on a formulary basis with no regard for existing principles.

- The income inclusion rule, manifested via a controlled foreign corporation anti-deferral regime may be able to be fit into the existing international tax framework, albeit it will likely have broader distortions as noted below. The tax on base erosion payments raises questions regarding the importance and relevance of the concepts of source vs residence.

- **The reforms should not ring-fence the digital economy**

  - The OECD concluded in its BEPS Action 1 report that the digital economy cannot be ring-fenced as the whole economy is becoming digitalized. *Business at OECD* agrees with this conclusion.

  - Out of the nexus and profit allocation proposals, the user participation proposal explicitly involves ring-fencing, the SEP proposal on the other hand does not risk ring-fencing (either explicitly or de facto), while the marketing intangibles proposal may or may not involve ring fencing depending on how the proposal would be implemented.

  - References to the "digital technology" or "automated means" when assessing purposeful and sustained interaction with a jurisdiction need further clarification, although it seems that wherever lines are drawn those may ring fence certain business models.

  - The income inclusion and tax on base eroding payments proposal does not appear to ring-fence as it would apply to all MNEs.

- **The reforms should respect the Ottawa Taxation Framework principles**

  - Principles such as neutrality, efficiency, certainty, simplicity, effectiveness, fairness, flexibility underline the seminal Ottawa Taxation Framework. Proportionality and sustainability were added as key principles during the BEPS project. We believe these core principles must be adhered to.

  - Assessing whether these principles have been met by any of the proposals as described in the Consultation Document is difficult at this stage. However, these should be kept in mind and be clearly articulated in the ultimate design of the proposals as they move forward.

- As an initial view, it seems that the biggest challenges for each proposal will be seen in the following of the expanded Ottawa principles (X's marking areas of greatest challenge):

	User contribution	Marketing intangibles	SEP	GABE
Neutrality	X	X	X	X
Efficiency	X	X		X
Certainty	X	X	X	X
Simplicity	X	X		X
Effectiveness	X	X		
Fairness	X	X	X	X
Flexibility	X		X	X
Proportionality	X	X	X	X
Sustainability	X	X	X	

- **The reforms should reduce instances of double taxation (which the proposals will likely increase)**

  - Whenever businesses operate across borders there is risk of instances of double taxation. Double taxation stifles growth and innovation. Any changes to the existing international tax and transfer pricing framework must be designed to reduce instances of double taxation and provide for efficient and enforceable ways to settle disputes.

  - The OECD is the leading institution in international tax matters and reaching consensus on new standards is of paramount importance. Without consensus diverging unilateral actions should be expected. These actions foster uncertainty and double taxation.

  - We suggest dispute resolution be incorporated as a minimum standard, with peer review, in the consensus solution. Mandatory binding arbitration, mutual agreement procedures, ICAP type programs should be explored. Reaching proactive agreement with tax authorities [such as in bilateral, trilateral, or multilateral advanced pricing agreements (APAs)] brings benefits to companies and to governments. Processes and procedures to enhance APA efficiency and effectiveness would be welcomed by business. These are good for taxpayers and tax administrations.

  - However, given the complexity of the proposals, and the fact that all seek to look beyond the single entity concept in determining profits attributable (i.e., beyond bilateral transactions), the additional multilateral dispute resolution mechanisms essential to the success of the project must be committed to by all countries.

- Likewise, if multiple proposals are to be taken forward concurrently additional coherence between the proposals (especially SEP) will need to be carefully managed. This may also provide an opportunity to improve foreign tax credit regimes.

- **The reforms should be introduced as a comprehensive package**

  - We are encouraged to see the issues of nexus and profit allocation being addressed in a comprehensive way in section 2 of the public consultation document.

  - However, we do have concerns that the global anti-base erosion proposal does not appear to be addressing the same challenges as the preceding three proposals (i.e., nexus and allocation concerns arising from digitalization). To the extent that they seek to achieve differing objectives, there may be benefits in decoupling the projects.

- **The reforms should have global agreement**

  - As stated above, failing to reach international consensus will result in diverging unilateral rules which will result in double taxation and increased tax disputes—occupying taxpayer and tax administration resources.

  - We look forward to the future work of the G20/OECD Inclusive Framework members as they continue to evaluate the proposals on a "without prejudice" basis and advance the project towards the 2020 deadline. We are hopeful consensus can be reached.

- **The reforms should minimize the administrative burden on taxpayers and tax administrations**

  - Assessing each of the proposals' administrative burden on taxpayers and tax administrations is difficult at this stage. However, this should be kept in mind and underline the ultimate design of the proposals as they move forward.

  - When possible we encourage the proposals to be designed with thresholds and objective criteria to reduce administrative burden and potential disputes.

  - It should also be noted that the greater the level of commitment and agreement among the Inclusive Framework members towards a coherent solution that is implementable, and implemented fully in all countries, the lower the administrative burden should be for large businesses (even if the overall package results in complexity). That said, if the solution is too complex, then, regardless of the level of agreement, it will hamper full implementation in developing countries and discourage SMEs from expanding internationally.

- **The reforms should be developed through inclusive consultation with all businesses and other stakeholders**
  - We are encouraged by the G20/OECD Inclusive Framework's inclusion of business and other stakeholders as part of this public consultation feedback. We also welcome the additional 5 days that were added to the consultation timetable.
  - However, three weeks remains a relatively short timeframe for comprehensive review of proposals that could fundamentally change the entire international tax system.
  - Continued engagement with business and other stakeholders will be paramount when moving forward with this project (e.g., with the underlying design of the proposals), including, we hope, further opportunities for public discussion and engagement. *Business at OECD* looks forward to continued participation in this project.

BusinessatOECD

Assessment of proposals against Business at OECD's principles

Legend
Proposal appears to violate principle
Proposal appears to be partially compliant with principle / depends on the implementation
Proposal appears to be compliant with principle

Assessment of proposals against Business at OECD's Principles

The reforms should:	User participation	Marketing intangibles	Significant economic presence	Income inclusion and tax on base eroding payments
1. Be based on long-standing and well-founded underlying principles of international taxation				
2. Not ring-fence the digital economy				
3. Respect the Ottawa Taxation Framework principles				
4. Be grounded in the concept of value creation				
5. Reduce instances of double taxation				
6. Be introduced as a comprehensive package				n/a[1]
7. Be reflected in model treaties and commentary				
8. Provide tax certainty for taxpayers and tax administrations, including strong dispute resolution mechanisms				
9. Have global agreement	To be seen			
10. Minimize the administrative burden on taxpayers and tax administrations				
11. Be developed through inclusive consultation with all businesses and other stakeholders				

Notes

1. Not applicable. Principle calls for nexus and profit attribution to be addressed at the same time. This principle does not apply to the income inclusion and tax on base eroding payments proposal.

DETAILED SECTION-BY-SECTION COMMENTARY

Section 2 – Revised profit allocation and nexus rules

16. We understand that some of the G20/OECD Inclusive Framework members perceive there to be challenges with the existing profit allocation and nexus rules. We continue to believe the OECD standards and arm's length standard should be the basis of international tax, and believe they are flexible enough to address concerns.

17. If the over-arching objective to recognize value created by a business's activity or participation in user/market jurisdictions is to be pursued, we are pleased to see the approach taken by the G20/OECD Inclusive Framework is to address in tandem the profit allocation and nexus rules. We believe it would be inappropriate to modify one but not the other, particularly if nexus rules are updated first (as was shown by BEPS Action 7).

18. The challenges that the attribution and nexus pillar is seeking to address are focused in part on transactions and interactions where there are no payments for such services and where there are therefore no comparables available to determine an arm's length price. A system must be found that approximates an arm's length price for such situations without disturbing scenarios where there are clear arm's length prices available if it is to be successful.

19. We expect any changes to the nexus and profit allocation rules will result in increased disputes over taxing rights because certain countries will lose existing taxing rights so other countries may gain taxing rights. Critical for business is to increase the efficiency and effectiveness of existing dispute resolution mechanisms. Any dispute between states should be timely and appropriately solved. We believed that mandatory binding arbitration should be required to be adopted as part of the BEPS minimum standard and see an opportunity in this project to revisit dispute resolution mechanisms to strengthen them, broaden them (to make the multilateral), and make them binding.

20. Given the scope of the proposals, some states will likely lose revenue as compared to the existing system. It will be important for business (who may also be incurring higher compliance costs) that such states do not increase tax rates or introduce new revenue raising measures in response. This would be harmful for business growth and innovation.

21. The proposals for updating the nexus and profit attribution rules in an attempt to expand the taxing rights of user and market jurisdictions refer to "non-routine income", "residual income", and "income" throughout. Any profit attribution rules must contemplate not only the allocation of residual income but also of residual losses. If losses are not taken into account market jurisdictions will receive a windfall and jurisdictions where DEMPE functions are undertaken will be required to finance unsuccessful ventures with fewer opportunities to tax returns from successful ventures. This is neither economic nor rational.

22. In addition to considering losses and expenses on an annual basis, any change to the nexus and profit allocation rules may raise difficult technical questions around tax treatment of such a transition. Transition rules should ensure market and innovation jurisdictions are

equitably treated. Exit charges can pose significant cash flow challenges when relating to intra-group transfers (i.e., where no cash receipts are received). We therefore discourage proposals that explicitly encourage or implicitly allow such charges to accrue on deemed disposals from innovation to market jurisdictions. If innovation country entities face an exit charge (in relation to any "transfer" of asset or future income potential) related to the transition, it will be critical that market jurisdiction entities obtain a fair market value basis in the marketing intangible allocated to their jurisdiction that could be amortized over time. This should help ensure the related market jurisdiction entities do not earn taxable profits in excess of their net return after considering the economic outlays required to establish the business locally.

23. In some cases the proposals contemplate utilizing a residual profit split (RPSM) approach for determining the amount of taxable profits to be allocated to market jurisdictions. Residual profit allocation is a somewhat novel concept that is not widely used and understood by taxpayers and tax administrations around the world. Furthermore, the OECD project to update the profit split guidance in the OECD TP Guidelines is not yet finalized and so we would recommend that work is completed before considering any mechanics to how any of the proposals involving income/loss allocations would work in practice.

24. The proposals seem to be based on an allocation of worldwide aggregate profit attributable to the business' worldwide marketing intangibles which is a considerable expansion of current RPSMs used to allocate transaction profits between two affiliated participants in defined transactions. We caution the G20/OECD Inclusive Framework from relying on a complex residual profit allocation approach as the basis for what may amount to the formulary apportionment of unitary profits. Even if the proposals are modified to be limited to the traditional, more theoretically rational RPSM, the use of such approach will require a tremendous amount of resources to administer and comply with if its application is broadened to a wider range of transactions / interactions. This will be particularly challenging for resource constrained administrations (and developing countries in particular). Differences in national accounting and tax standards complicate the use of residual profit splits. Challenges concerning issues of transparency and tax audit are also noted by our members.

25. The use of standardized, objective allocation keys and formulas is problematic. No two businesses are the same, thus, by definition, standardized allocation keys are not fair to all taxpayers. Functional analyses performed by knowledgeable taxpayers and transfer pricing economist specialists consistent with the arm's length standard (or any broader principle defined) will result in results more appropriate for more businesses. Macro and micro economic conditions, business and product lifecycle status, research and development, technology and patent information, etc. must be considered when allocating income amongst jurisdictions in which an MNE has a taxable presence. This cannot be reduced to uniform standard allocation keys, tables, or formulaic approaches.

26. In relation to the previous paragraph, we do acknowledge not just the desire, but also the need for more administrable rules (especially for developing countries), which may include

more mechanical tests, perhaps by way of safe harbors. However, in this case, these mechanical tests must still adhere as closely as possible to results that would arise under the application of standard Transfer Pricing/Arm's Length Standard principles (as may be amended). In addition, in instances where entities are not wholly owned, practical challenges associated with profit allocation approaches may result and remedies will be needed.

27. We agree with the sentiment of paragraph 81 regarding strong dispute prevention and resolution components. We disagree with the wording of paragraph 81 (we believe the new proposals must, not may, incorporate strong dispute prevention and resolution components).

28. We disagree with the suggested use of country-by-country reporting data to conduct application of the proposals. As set out in BEPS Action 13, the country-by-country report should be used as a high-level risk assessment tool, and its design features were crafted in line with this understanding of its application. Because of the way that CBCR data is calculated (e.g., based on statutory returns and in the absence of consolidation and elimination) they cannot accurately be used to determine the attribution of profits, as is acknowledged in para 5.25 of the OECD 2017 Transfer Pricing Guidelines.

Section 2.2.1 – The "user participation" proposal

29. With regard to user participation, we see two overarching fundamental areas to address in our comments, (i) scope and (ii) methodology/ practical items.

30. Scope

   - *Business at OECD* fundamentally disagrees with this proposal because it is intended to apply to a very limited subset of business (although, logically, it may end up applying to a much wider group). The OECD's work from BEPS Action 1 concluded it was not possible to ring-fence the digital economy as the digital economy was becoming the economy itself. This is consistent with the OECD's work leading to the Ottawa principles of 1999, and was reiterated in the 2018 OECD Interim Report on the tax challenges of the digitalization of the economy. *Business at OECD* shares this view and reiterated as such in its January 2019 Digital Tax Principles. The proposal goes even further than merely ring-fencing the "digital economy" —as set out in the consultation document the proposal would apply only to social media platforms, search engines, and online marketplaces.

   - Applying any revised profit allocation and nexus rules only to those three groups of business activities is a flawed approach. In addition to potentially being discriminatory and out of compliance with international obligations, the proposed rule would raise many questions of definition and threshold questions in its application.

   - Designing a rule to apply only to social media platforms, search engines, and online marketplaces will prove difficult in practice. Invariably the definitions set out in the OECD rule (which would be adopted by countries as individual domestic laws) would raise questions and likely bring into scope companies that do not appear to be social media platforms, search engines, and online marketplaces.

     - Indeed, at one level, many businesses rely on "interaction" with users (that is to say, consumers). Although intentionally targeted today at small number of business activities, it is hard to identify the coherency of such limitation along the proposed lines, and potential explicit or implicit expansion might be expected – whatever its original proposers might hope.

     - It is unclear why it is that the user contribution concept should lead to different results depending on transaction title flow, but with arguably the same user contribution. As one example, consider two situations, one in which a user utilizes an internet platform to purchase a tangible good (e.g., the online website for a "brick and mortar" company), and one in which a user utilizes an internet platform to purchase a tangible good from a third party (an "online marketplace"). If the basis for taxation is the user contribution – which is the same in both cases – why should the (tax) outcome differ?

- The UK has attempted to scope in these same three types of business activities to its digital services tax (DST) and practical scoping challenges have resulted. The full results of the UK's consultation on this measure (and, if it is introduced in April 2020, its application) may prove a constructive source for identifying the range of issues that will need to be addressed. In particular, we note the following challenges:

  - We observe that the current definition for social media platforms in the UK DST rule could capture the following scenarios:

    - Platforms which provide free content (e.g., online publishers of content), if the authors of that content also happen to read content on the platform.

    - Platforms used by businesses for the purposes of engagement and relationship-building with their customers, but which are peripheral to the core business and not directly monetized.

    - Arrangements involving sharing or pooling of data across an industry sector via an intermediary platform owner, e.g., insurers pooling insurance claims histories or drivers contributing their own telematics data.

    - Business platforms allowing customer reviews of the business's products or services in order to help promote those products/services rather than to target advertising at users.

    - There is also currently uncertainty whether telecoms providers could be interpreted as a social media platform given they enable users to share media content such as photos or videos.

  - The proposed definition of a search engine in the UK DST rule includes "where a central part of the business offering" is to "view webpages beyond those provided by the platform itself". The current terminology with reference to "a central part of the business offering" is ambiguous and could capture external links even where they are an ancillary part of a broader website. Where a link is contained to a third-party site, in some instances it may be difficult for business to conclude this is not part of "a central part of the business offering" as an active decision will have been made to include that link.

  - We observe that the online marketplaces definition in the UK DST rule has the potential to capture a wide variety of businesses. This causes concerns including:

    - How to distinguish between online marketplaces that sell their own products versus those owned by a third party selling through the marketplace

   - How to treat online marketplaces for franchising arrangements where it's common for a franchisor to provide a central website to sell the goods of their franchisees. This would be a central part of a business model, as it provides a cohesive brand and seamless customer experience but is not a pure profit activity.

   - How to treat online marketplaces that recognize total revenue from a sale of a good to a customer versus those that only recognize the commission element of a sale as revenue.

- Any rule that tries to apply only to certain types of business will result in ring-fencing of some kind, distorting competition. In reality businesses have many product lines and business units. For example, many businesses have a (free) "social media" platform as part of their engagement strategy with their customers. This may take the form of online communities, Q&A sections of websites where users can share knowledge regarding the product offering by the platform or blog features. These (free) "social media" functions are not monetized but form part of a wider offering and create brand awareness. However, this activity is an auxiliary feature rather than a fundamental part of the product offering (which will be monetized by other means).

- The user participation proposal would not only impact those businesses that fall within its scope, it would also impact those businesses that interact with or rely on in-scope business activities for their own business activity. For example, a business might advertise via a search engine, buy data from a social media platform, or sell its products via an online marketplace.

- Furthermore, a tax designed for three categories of business activities is poor policy design that will likely need to be readdressed in a short period of time. There is no way to predict what type of digital companies, business models, and business activities will look like in the future. The design of the international tax and transfer pricing system should be principle-based and able to be applied to varying and new businesses now and in the future.

- We are unconvinced by the assertion inherently made by the user participation proposal that users create value for enterprises and even if they do create value whether such value should influence the allocation of the enterprise's taxable income. Alternatively, an enterprise's users could be viewed akin to a supplier. In this case the value created by users should not impact the allocation of the enterprises taxable income.

- There is a further question as to whether users create value at all for the business types mentioned. Consider a social media platform user where the user account is inactive, or a user who does not actively post or consume content, or a bot that posts content—computing the value created by such "users" will be extremely difficult in practice.

- It is unclear whether and how user participation in the three business models identified varies as compared to businesses not in scope of the proposal, or with each other. This further justifies an approach that does not result in ring-fencing.

- It is therefore clear that wherever a line is drawn in relation to business activities, it will be arbitrary.

31. <u>Methodology/practicality</u>

- If the user participation proposal is taken further, there is a lot of work to be done with respect to the underlying mechanics and application. While the design mechanics and application questions are many, it has been argued that one "upside" of the user participation proposal in this regard is the new rules would in principle only be applicable to a small number of companies. However, aside from the inherent unfairness in such a proposal, as mentioned earlier there is a large risk the rule will bring into scope many businesses beyond the three types the proposal is designed for and we have serious concerns around practicality and uncertainty this would cause across a wide range of businesses. Further, *Business at OECD* opposes any measure that attempts to ring-fence the digital economy.

- In reality, the concept could likely not be limited to a narrow group of digital companies because user contribution is equally found in other areas. In fact, taken to its logical conclusion, the concept would be very wide in ways that make it hard to predict. Any distinction between active and passive user contributions is neither intellectually convincing nor does it seem to be practically administrable.

- Determining in-scope profits would be challenging for integrated business models where some but not all of their activities are subject to the user contribution nexus and profit allocation rules.

- We understand the four-step non-routine or residual profit split approach for the calculation of the profit allocated to a user jurisdiction in respect of the activities / participation of users in paragraph 24. However, we have serious questions about the design elements described in paragraph 24.

  - The profit allocation mechanics should be designed to reward the economic and financial risks born by funding investment in infrastructure technology, and production. If designed haphazardly, the computation risks under-rewarding such activities. Technology companies spend heavily on research and development[3] and the impact of such funding should not be under rewarded by the transfer pricing profit and loss allocation system.

[3] https://www.visualcapitalist.com/global-leaders-r-d-spending/ This chart shows the top 20 global companies and their R&D expenditures for 2017. The numbers for the top six companies are: Amazon 17.4; VW 15.18; Alphabet 14.5; Intel 12.8; Samsung 12.8; and Microsoft 12.7.

- Specifically, paragraph 24(2) describes the potential use of a “simple pre-agreed percentage” for attributing a proportion of the value created by the activities of users.

    - We would like to understand what academic research or empirical results exist supporting the use of pre-set metrics for attributing value created by users to understand better the proposal and suggestion of paragraph 24(2).

    - While using pre-agreed percentages would be administratively less-burdensome, the results would not be equitable for all businesses and potentially lead to disputes if individual countries do not conform to the OECD-agreed percentages. This problem could be relieved by strong, multilateral dispute resolution mechanisms that include this formula -- but it is challenging to see why all countries would sign up to this commitment when it will prove so difficult to update when the economy digitalizes/changes further.

    - As no two businesses are the same, the use of pre-agreed percentages by definition cannot be equitable to all businesses (even if different industry sector percentages are used). Also, using different sets of percentages depending on business type or business line will introduce areas ripe for uncertainty, definitional and threshold questions, opportunities for avoidance, and increased disputes between taxpayers and tax administrations, and between different tax administrations themselves.

- After the profit attributable to users has been determined, paragraph 24(3) describes using an “agreed allocation metric (e.g. revenues)” to allocate those profits between the jurisdictions in which the business has users. We suggest additional work be undertaken to explore what and how many metrics should be used, and whether different industry / sectors should use different allocation metrics.

- With regard to tracking the location of users, it may not be practical, possible, or legal for MNEs to do so.

    - Ethical and legal reasons

        - Data privacy regulations require consent of users to share information with MNEs. Some users do not want their personal data and location to be stored and tracked and we question why tax rules should require such a tracking.

        - Some users are minors and children. MNEs may have differing views as to the ethical support for sharing information about such users

    - Some users are not human or have no location. We question whether the location of a bot user ought to influence the allocation of profit.

  - Technological reasons

    - Where users are not required to provide MNEs any location information, often the only means to identify user location will be via reference to the user's IP address.

    - Virtual private networks (VPN), proxy servers, and other mechanisms are increasingly common and help individuals access the Internet safely and securely. VPNs and proxy servers can mask user locations or provide an incorrect location determination.

  - Practical reasons

    - For some MNEs the location of their users is not relevant. Introducing a tax requirement to track users would put an undue administrative and technological burden on businesses whose time and resources are better spent on other matters.

    - Some users are highly mobile and cross jurisdictional borders with regularity. Tracking user data for mobile users would be difficult for businesses.

    - Audit substantiation requirements (for financial statement and tax compliance) would result in required audit trails for tracking user data. This burden on companies and professional service firms is unwarranted.

- Even if it were possible and legal to track a user's location, using revenue and users as the allocation metric has theoretical design challenges. Oftentimes there is no actual revenue associated with a user (revenue coming from customers). Some users are less active than others – treating every user the same raises questions (consider the "value" of a famous performance artist with 50M connections versus a common user with fewer than 100 connections on the same social media platform).

- Paragraph 27

  - We agree with the reference in paragraph 27 to the need for strong dispute resolution component to minimize additional controversy and double taxation. The consultation document indicates strong dispute resolution component "could also be combined (with the user participation proposal)".

We believe efficient effective dispute resolution is critical for businesses to thrive and innovate. Therefore we suggest the Inclusive Framework make improving dispute resolution part and parcel to the Tax Challenges of the Digitalization of the Economy project (not just a potential combination but an integral one).

- Paragraph 28

  - Restricting the proposal based on the size of the business to further reduce the administrative burden for tax administrations and taxpayers has some merit as it would reduce complexity for business. Setting the threshold is a balance between reducing administrative complexity (which we advocate) and ring-fencing (which we do not advocate). We suggest that should thresholds be considered, they are set sufficiently low such that the new rules apply to most businesses with activities covered by the proposals. Otherwise the proposal will impact only some large successful businesses which is counterproductive and creates incentives for mischief (e.g., definitional and accounting questions with the aim of staying below the threshold). We have concerns with proposals that seek to discriminate against certain businesses or industries. Further we suggest any threshold be indexed for inflation or increased stepwise over time to accommodate inflation.

Section 2.2.2 – The "marketing intangibles" proposal

32. The marketing intangibles proposal does not ring-fence the digital economy – a key and clear message from the OECD since Action 1 of BEPS – as the proposal is not intended to apply only to a subset of highly digitalized businesses. However, it may de facto ring-fence consumer-facing businesses (which may or may not include some highly digitalized businesses) – see below for further details.

33. While sharing some design elements and goals of the user participation proposal (referring to section 2.2.4 of the consultation document we note there are some similarities and also differences), an approach that looks to the market to identify relevant intangibles for which reward should be allocated to the market may be more principle based and flexible, potentially making it better equipped for future business models and technologies we cannot predict at present. In that way the marketing intangibles proposal is much more ambitious but also potentially more robust and resilient if it is designed and implemented soundly and focused in such a way that does not result in de facto ring-fencing or discriminate against technology and production activities.

34. The proposal should be built on the existing frameworks and transfer pricing foundations that have existed in international law for many decades. However, at a base level, the goal of the G20/OECD Inclusive Framework project is to reach consensus around an approach that would allocate more income to market jurisdictions than would be allocated under the existing OECD Transfer Pricing Guidelines (the proposals explicitly state they "go beyond transfer pricing"). Within that framework, *Business at OECD* seeks to provide constructive input aimed at identifying decisions points, suggesting guidelines for decision-making, and facilitating consensus.

35. Rather than attempting to "shoe-horn" a solution into the traditional transfer pricing framework, tax authorities could explicitly acknowledge that they seek a non-arm's length solution in limited circumstances. The consultation document is clear on that point (see, *e.g.*, paragraph 41). Although we do not endorse such a policy direction, that mind-set should improve dialogue and promote both proportionality in design and economically realistic results. It could also be examined whether the practical challenges that may arise from a reallocation of assets and income (e.g., customs duties, VAT, capital gains consistency, dividend withholding taxes, company law solvency (distributable reserves), FX hedging, etc.) might be avoided by alternative approaches that seek to reach the same effective allocation of taxing rights through simpler.

36. In general, we believe that the current nexus and transfer pricing rules, while imperfect and often applied inconsistently across jurisdictions, are capable of reaching reasonable results that can be agreed by all parties in most cases. To the extent that any solution departs from the arm's length standard, the deviation should be as limited as is practicable, so as to preserve the elements of transfer pricing analysis that have not been identified as causing concern. We note, as does the consultation document, that the BEPS project has already changed behavior for the better. The BEPS minimum standards, together with recent US

minimum tax legislation, ought to be given a chance to work where consistent with the goals of the Inclusive Framework.

37. We believe that any solution should satisfy certain key parameters, including the following:

- Outcomes should be consistent with economic reality, broadly speaking, and result in only modest reallocation of taxing rights.

- To the extent practicable, the solution should be targeted as narrowly as possible to address the perceived shortcomings in the current tax architecture while avoiding disturbing areas which are acknowledged by all to produce appropriate outcomes.

- The mechanics of the solution should balance theory and practice appropriately.

- Essentially, this approach requires a global residual profit split analysis, after which an allocation must be made between jurisdictions based on the economic contribution of those marketing intangibles, probably the most difficult type of intangible to price (e.g., an MNE performs both product and project-related business in a jurisdiction – what is the economic contribution of, for example, a brand name in that case, which inherently has different value for different business models and is intrinsically linked with many other value drivers). In practice, from a transfer pricing perspective, the calculation of a residual or non-routine profit of a business (i.e. the profits that remain after routine activities have been allocated an arm's length return), can be a significant exercise in itself and requires very subjective valuation positions. If a global exercise of this nature is required for a very large MNE with a very diverse portfolio within many different business models, this will be a tremendous task. Further, this approach must then be implemented and accepted by all tax authorities globally (i.e., has to be all-in). If not, the allocation exercise (even if it is formulary in nature) becomes obsolete if not universally accepted.

- To the extent that the solution allocates non-routine (entrepreneurial) system profits to the market jurisdiction, so should any losses be allocated.

- The solution should be considered by the tax authorities as durable; for example, any formulary element should not be regarded as an invitation to further adjustment solely to address fiscal needs.

- The solution should be administrable to all businesses, and enhanced commitments for training, advance rulings and dispute resolution.

- Additional analysis and consultation should be conducted to evaluate how any changes to the transfer pricing mechanics could influence or be impacted by other relevant areas of cross border trade (such as customs and duties, and VAT).

- As noted earlier, in instances where entities are not wholly owned, practical challenges associated with profit allocation approaches may result and remedies will be needed.

38. With respect to the stated policy reasons behind the proposal, we have two observations. First, we agree that the allocation of returns from trade intangibles should be allocated in accordance with traditional transfer pricing analysis (including risk allocation/DEMPE functions). Second, we note that it is important to draw more clearly the distinction between the (1) general receptivity of a market to investment and (2) the creation through active (if remote) intervention of a user base or network (refer to paragraph 33 of the consultation document).

39. As described, the marketing intangibles proposal raises definitional issues that inevitably will require line-drawing, such as the differences between "marketing" and "trade" intangibles. Although it is possible that the Inclusive Framework could reach consensus on this question, given the difficult definitional issues involved, it seems likely that the broad application of a simple approach is most likely to achieve consensus.

40. In particular, we are highly skeptical that agreement could be reached on how to allocate non-routine profit between trade intangibles and marketing intangibles. That division varies dramatically among businesses, even within the same industry, and history well illustrates the complexity, indeed near intractability, of the problem. Further, even if it were practicable to isolate profit attributable to marketing intangibles, it is perhaps even more difficult to allocate between markets.

41. In that regard, we consider it unrealistic that, as a general proposition, all marketing intangible profit should be allocated to the market jurisdiction. Rather, only to the extent that such profit is closely linked to the market jurisdiction should it be allocated locally. It would be uneconomic and inconsistent with the value creation framework for local jurisdictions to claim rewards for all of the investment that goes into developing global brands, for example.

42. We agree with the commentary in the consultation document's paragraph 46 that any income allocation "would be dependent entirely on the facts of each case and the economic contribution to profits provided by the marketing intangibles." And that "This would retain the existing rules requiring an identification of the specific marketing intangibles and a calculation of their contribution to profit." It is critical that specific business fact patterns and unique attributes be taken into account and considered in the profit allocation rules.

43. While conceptually the calculation of global non-routine profit may be possible, due to the number of assumptions within the calculation, agreement will be difficult. Without broad agreement, the risk of double taxation is significantly increased.

44. The OECD work to date on safe harbors could be useful in designing a modified distributor return approach. Safe harbors are similarly approximate and not strictly adherent to the arm's length standard.

45. The marketing intangible proposal targets a broader segment of businesses than the user participation proposal and may create opportunities for a design that is more likely to meet the needs of the Inclusive Framework given more flexibility in the potential design.

46. We strongly agree with paragraph 47's comment that the proposal should offer taxpayers the possibility of early certainty on the taxation under this approach and come with a strong dispute resolution component. Refer to earlier discussion of dispute resolution for more details.

47. By focusing only on consumer interaction, the proposal risks ring fencing B2C businesses / transactions and treating them differently to other businesses / transactions. This is arbitrary and results in a de facto ring fencing of consumer facing businesses. However, we would note that the exclusion of trade intangibles in the consultation document was unexpected. In the very short time available for comment, therefore, it has not proved possible to reach consensus among the *Business at OECD* members regarding whether the marketing intangibles proposal should impact B2C companies only or also B2B companies. We reiterate that, generally speaking, ring-fencing is not good tax policy, but on this important point we recommend the G20/OECD IF reflect further upon this point, and consult a broad range of stakeholders.

48. Paragraph 31 describes how the (intrinsic) functional link between an intangible and a market jurisdiction can be manifested. The first way is understood as a reflection of the intangible "in the favourable attitudes in the minds of customers and so can be seen to have been created in the market jurisdiction". A number of questions can arise in relation to this statement such as, what is a favorable attitude and how it should be measured, what if in the same market jurisdiction different groups of customers have different attitudes, what should be the consequences of unfavorable attitudes, etc. This also raises the question of whether the proposals can apply to heavily regulated industries, where customer engagement is subject to strict regulation such that there is relatively little scope to generate customer-related intangibles in the manner described.

49. Related to the above, is the distortions this may cause and the consequential behavioral impact that this may have. If a local third party distributor is able to acquire products (and to a lesser extent services) without an allocation of the suppliers profits being allocated to the local market, then a related party supplier would clearly be discriminated against in the local market. This is demonstrably not in line with the arm's length standard, and could result in behavioral impacts (such as utilization of third party distributors only) which are counter to free-trade, harmful to growth, and do not achieve the policy objectives.

50. The challenges that the attribution and nexus pillar is seeking to address are focused on transactions and interactions where there are no payments for such services and where there are therefore no comparables available to determine an arm's length price. A system must be found that approximates an arm's length price for such situations without disturbing scenarios where there are demonstrable third party comparables to determine arm's length prices if it is to avoid distortion.

51. We believe strongly (like the BEPS Action 1 conclusion) that any solution must not attempt to ring-fence the digital economy. Digitalization is fundamentally changing the way all businesses operate. Some business models are more advanced than others in this regard, but all are heading in the same direction. Against this backdrop it would be inappropriate

for any changes in approach to be ring-fenced to certain business models, however it is equally inappropriate for the changes to apply indiscriminately and impact other business models which are already adequately dealt with under the existing international tax framework. Given the wide breadth and scope of the marketing intangibles proposal, we believe it is critical the G20/OECD Inclusive Framework include sufficient time to consult with policy makers, tax administrations, civil society, and taxpayers as well as include empirical analyses before reaching any consensus on the underlying mechanics of the proposal.

52. We would also recommend coordination with this proposal and the ongoing project on updating, implementing, and following/administering the profit split guidance featured in the OECD TP Guidelines. Furthermore, definitions are critical and we would also suggest that a recognition of where profit is allocated across the value chain both before and after nay marketing intangible allocation makes commercial sense. We are concerned this proposal will inadvertently distort the fair sharing of profit or loss across often at times complex value chains.

Section 2.2.3 – The "significant economic presence" proposal

53. As per the consultation document, the "significant economic presence" (SEP) proposal "is motivated by the view that the digitalization of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without a significant physical presence." However, this has always been true of imported goods and services. The SEP (and elements of the other proposals) speaks to a broader dissatisfaction with the historical distribution of taxing rights. We believe that the SEP needs to be supported either by a more convincing economic argument, or by a clear statement as to why market jurisdictions should always be permitted to tax not just sales but also system profits.

54. We understand the Inclusive Framework has spent less time on the SEP proposal as compared to the other proposals. It is therefore not surprising that the SEP proposal only receives a little over one page of coverage in the consultation document and the implications made in the OECD TaxTalks webcast on 29 January, 2019.

55. We support the use of de minimis thresholds for determining whether a taxpayer has a SEP in a jurisdiction. However, the broad range of options put forward in the consultation document to accompany the "revenue" test, look to be drawn so broadly that revenue will, in practice, be the only relevant determining factor for any businesses with more than incidental sales. We are not convinced of the merit for allocation of taxing rights where such involvement in a local market may be only incidental (and, in the digital age, may not even have been sought by the enterprise).

56. This also appears to be much broader than the policy intention implies (including all e-commerce, for example, which was explicitly examined as part of the development of the Ottawa principles). One negative behavioral impact might arise would be that businesses decline sales (or do not allow access to their websites) in fear of breaching the threshold inadvertently or where the sales do not warrant the compliance costs that would be incurred. This is not in the interest of customers, governments, or business, and could be particularly damaging for SMEs and smaller remote markets which generally have lower ROIs.

57. If revenue thresholds are proceeded with, the thresholds could be stated on an absolute (e.g., less than $x amount of digital sales revenue in a jurisdiction) and relative (e.g., less than y% of worldwide digital sales in a jurisdiction) basis in order to prove useful for large and small MNEs.

58. The proposal does not explicitly mention losses. We believe there must be a mechanism to benefit net operating losses across the jurisdictions in which a MNE has a SEP.

59. Additional time and resources must be spent to better understand how the significant economic presence proposal would be implemented and administered.

- Questions concerning which entities are considered in the MNE group, which entity has the tax filing obligation, and audit procedures should be further investigated and discussed.

- We would like to understand how the proposal would be implemented (e.g., via treaty, MLI, or some other mechanism) and interact with existing transfer pricing and profit allocation rules for physical or "traditional" permanent establishments, withholding taxes, and VAT.

- Furthermore we stress the need for improved dispute resolution mechanics if something like the significant economic presence proposal were to transform the international tax and transfer pricing system given we foresee a huge increase in disputes across territories. Refer to earlier discussion of dispute resolution for more details.

60. The SEP proposal is immense in scope. While the user participation proposal purports to only impact businesses operating social media platforms, online marketplaces, and search engines, and the marketing intangibles proposal reallocates non-routine marketing intangibles return, the SEP proposal would change the way in which all corporate profits are allocated between jurisdictions. As described earlier in our comments, we believe work on Action 11 BEPS measurement and monitoring should be advanced and considered before a proposal like SEP moves forward.

61. Unlike the marketing intangibles proposal, the SEP appears to change the way all income and loss is allocated amongst jurisdictions in which a MNE has a SEP. This includes routine and non-routine returns related to tangible assets and all intangible assets (including product intangibles, manufacturing intangibles, technology intangibles). Given the scope of the G20/OECD Inclusive Framework mandate, we question seriously whether the entire transfer pricing system would need to be modified to accommodate this proposal, and accordingly we cannot endorse it.

62. The SEP proposal uses rigid allocation key metrics (see paragraphs 52 and 53 of the consultation document) that are economically inappropriate in the divergent international business world we live in.

63. Paragraph 53 mentions using the "global profit rate of the MNE group" to determine the tax base. We strongly disagree with this approach. Profitability varies vastly across business lines, products, countries / markets, seasonality, periodicity, etc. Indeed it is common for an MNE to make sales into and have a significant economic presence (as contemplated by the proposal and the factors listed in paragraph 51) in a jurisdiction while being loss making for several years while being profitable overall. The overall profitability could result from more mature markets at different stages of the business cycle or from other business and product lines. The use of a global profit rate for the MNE group to determine the tax base would likely result in double taxation (it would only take one country not conforming to this profit allocation methodology to have double taxation). A profitable MNE could be discouraged from entering new markets, stifling innovation and growth.

64. Further, paragraph 53 refers to using "sales" as a basis for determining the tax base. It is unclear whether this is meant to mean all sales or only "digital sales".

65. Differences between national tax accounting income and expense measurement and realization rules mean each country would have its own view as to what is the taxable base to be divided. This would also result in double taxation.

66. Allocating global profits on the basis of factors such as sales, assets, and employees risks under rewarding the jurisdictions where DEMPE functions exist. The BEPS Action 8-10 work indeed would be rendered useless. This is anti-competitive for business as countries may not be as incentivized as they are today to maintain overall good business environments (for locating HQ type functions) nor fostering innovation, research and development, etc.

67. All of the same practical, legal, and ethical challenges of tracking users as described in the user participation section of our comment letter would apply to tracking users for purposes of the significant economic presence proposal.

68. Business is deeply troubled by the suggestion in paragraph 55 to use a gross-basis withholding tax as the mechanism for collecting corporate income tax. In practice business finds obtaining refunds for over collected taxes can be difficult if not practically impossible in certain countries, resulting in systematic double taxation when mixed with insufficient foreign tax credit regimes in the countries of residence. Furthermore, in instances where a company is loss making (within a particular jurisdiction, or globally), gross-basis withholding taxes are uneconomic and discourage business innovation and economic growth.

69. For all of the above reasons, *Business at OECD* strongly objects to the SEP proposal.

Specific questions for public comments (section 2.4 of the consultation document)

87. Commentators' views are requested on the policy, technical and administrability issues raised by each of the three proposals described above. In particular, comments are specifically requested on the following questions:

1. What is your general view on those proposals? In answering this question please consider the objectives, policy rationale, and economic and behavioural implications.

Refer to comments above.

2. To what extent do you think that businesses are able, as a result of the digitalisation of the economy, to have an active presence or participation in that jurisdiction that is not recognised by the current profit allocation and nexus rules? In answering this question, please consider:

It is true that businesses are able to have an active presence or participation in a jurisdiction without having a taxable nexus nor profit allocation there. This capability preceded digitalization. However, this is not as common today, after the BEPS project, as it was before the BEPS project.

i. To what types of businesses do you think this is applicable, and how might that assessment change over time?

Businesses with a higher degree of digitalization are likely to be more able to have an active presence or participation in a jurisdiction that is not recognized by the current profit allocation and nexus rules. However, it still is challenging for businesses to achieve significant scale without such a presence. Over time, as all businesses become highly digitalized, the ability to have an active presence or participation in a jurisdiction that is not recognized by the current profit allocation and nexus rules will increase. *Business at OECD* believes that businesses will still require a physical presence to achieve and sustain a significant presence in major markets. In addition refer to comments above.

ii. What are the merits of using a residual profit split method, a fractional apportionment method, or other method to allocate income in respect of such activities?

A residual profit split will likely bring extremely high levels of complexity to the income allocation mechanism. We believe the arm's length standard is, and will continue to be, the best way to allocate profits in the vast majority of circumstances. Fractional apportionment methods raise serious questions including how to determine and agree on the calculation mechanics and metrics, how to measure such metrics, influence on corporate behavior driven by tax (metric) purposes, and instances of double taxation if jurisdictions do not agree on the mechanics and metrics. In addition refer to comments above.

3. What would be the most important design considerations in developing new profit allocation and nexus rules consistent with the proposals described above, including with respect to scope, thresholds, the treatment of losses, and the factors to be used in connection with profit allocation methods?

Business at OECD stands by its *Business Principles for Addressing the Tax Challenges of the Digitalizing Economy*. Of critical importance for business are: the new profit allocation and nexus rules respect the arm's length standard, not ring-fence the digital economy (or any other segment of the economy), respect the expanded Ottawa taxation framework (including principles of neutrality, efficiency, certainty, simplicity, effectiveness, fairness, flexibility, proportionally, and sustainability), reduce instances of double taxation, provide tax certainty for taxpayers and tax administrations, including strong dispute resolution mechanisms, and have global agreement.

The rules must ensure market jurisdictions share in both profits and losses, otherwise innovation jurisdictions will be financing a tax windfall to market jurisdictions. In addition refer to comments above.

4. What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

Mandatory binding arbitration should be a minimum standard adopted by Inclusive Framework members, including requirements for peer review. Certainty programs such as ICAP, APAs, and MAP should be expanded and encouraged. In addition refer to comments above.

Section 3 – Global anti-base erosion proposal

70. We question whether the section 3 income inclusion rule and tax on base eroding payments are actually needed if meaningful international consensus is reached with respect to section 2 (nexus and profit allocation). Furthermore, the timeline for reaching consensus (i.e., delivering a progress report to the G20 in June 2019, and reaching international consensus on a solution in 2020) is far too short to bring into scope the complex policy and technical issues raised by the section 3 concepts. In addition, it is not possible to design coherent rules under this proposal until the allocation of taxing rights is agreed, as it is not clear where the effective tax rates being examined will be incurred, or by whom.

71. The aim of the global anti-base erosion proposal as described in paragraph 89 also makes us question why this scope of work has been included in the overall *Tax Challenges of the Digitalising Economy* project. As mentioned "This risk is particularly acute in connection with profits relating to intangibles, prevalent in the digital economy, but also in a broader contest; for instance group entities that are financed with equity capital and generate profits, from intra-group financing or similar activities, that are subject to not or low taxes in the jurisdiction where those entities are established." Clearly this is reaching beyond the mandate of the G20/OECD Inclusive Framework with respect to Action 1 of BEPS (related to the digitalizing economy). As such it makes little sense to aim to complete this work on the same track (and deadline timing).

72. Measurement and monitoring of BEPS (Action 11) must advance before meaningful work on the global anti-base erosion proposal continues. It is not yet clear whether this work is needed. On 15 January, 2019 the OECD released a new report and database, Corporate Tax Statistics. The new database, which will be updated annually, aims to improve the measurement and monitoring of BEPS. We understand future editions will also include an important new data source – aggregated and anonymized statistics of data collected under country-by-country reporting now being implemented under BEPS Action 13 – that will allow "backward-looking" assessment of effective tax rates actually paid by firms.

73. We believe the results of the BEPS project generally, and Actions 8-10 specifically, have made great strides to reduce base erosion and profit shifting by multinationals. However, many of the BEPS action items have only been very recently implemented (and some remain to be). In particular, the MLI has largely yet to take effect, but with its Principal Purpose Test and other measures, will undoubtedly have a very significant anti-base erosion and profit shifting effect. Before a proposal with such a fundamental impact is moved forward we recommend additional empirical analysis be conducted to analyze the post-BEPS situation.

74. More fundamentally, the global base erosion proposal disregards the base premise for BEPS, which is to ensure taxation where value is created. In fact, they achieve the opposite by taxing profits that are generated in a subsidiary at the level of the shareholder. There is no principle-based justification for this, assuming relevant substance is indeed in the subsidiary. This is a form of extra-territorial taxation and there will be significant spill-over effects, particularly if the proposals are developed on a country by country basis.

75. The global base erosion proposal will undermine the opportunities for countries to design their tax regimes in line with their economic policies and priorities and undermine the principle of capital import neutrality, which is a key policy objective for many countries that have implemented a participation exemption.

76. Many countries already have controlled foreign corporation rules. Operation of the income inclusion rule and the tax on base eroding payments rule (as well as necessary coordination and implementation measures) introduces complexity that may not be justified. If work on nexus and profit allocation is successful companies' non-routine / marketing intangible income will be taxed in market jurisdictions—thus we question whether the income inclusion rule is even needed.

77. Furthermore, the US tax reform significantly changed the status quo. With the introduction of the global intangible low-taxed income (GILTI) provision, it is not possible for a US parented company to have "nowhere taxed income" any longer. For these reasons it makes sense to reassess the motivation and need for the section 3 income inclusion and tax on base eroding payment proposals.

78. We agree with the consultation document's call for further work to clarify the kinds of entities, arrangements and behaviors that are within the intended scope of the global anti-base erosion proposal, specifically the call for practical examples to be prepared.

79. We are concerned that the global anti-base erosion proposal is a departure from the OECD BEPS Plan, "No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it."[4]

80. We agree the role of substance and BEPS Action 5 should be considered. We believe it to be important tax rules do not impact structuring and location decisions made for economic or business reasons. It may make sense to introduce a business purpose rule whereby the global base-erosion rules are "turned off" if a sufficient business purpose exists. Without such a rule the income inclusion and tax on base erosion payments could distort business location decisions and countries' incentive decisions.

81. A strength of the BEPS Action 5 nexus approach is that it ensures that tax incentives such as low rates can only be awarded where there is a match between economic substance and the allocation of income. This is not always the case with non-tax incentives, which may be less transparent and more arbitrary. The incentives for governments should be considered in implementing rules that effectively outlaw incentives to be introduced through the tax system.

82. We would like the Inclusive Framework to expand and clarify what it means by "thickly capitalized" entities (see paragraphs 94 and 99 in the consultation document).

[4] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, page 10.

83. We also question the ability of the proposal to be introduced in a coherent and equitable fashion, given the challenges with updating treaties (even under a multilateral instrument). The inclusion of Most Favored Nation articles in some tax treaties (and other) would make this even more challenging. Non-Discrimination Articles must also be respected, so domestic transactions must also be considered (e.g. where tax grouping or local tax rules may result in different results than when payments are made between domestic and foreign companies).

Section 3.3 – Income inclusion rule

84. Paragraph 96 suggests the use of a 25% common ownership test for determining related parties for which the income inclusion rule would apply. We believe a 50% threshold would be more appropriate. Companies may face data limitation restrictions with respect to companies less than 50% commonly owned.

85. One difficult aspect in designing and implementing the income inclusion rule would be the determination of the minimum tax threshold and "tax back" rates.

    - Individual countries have sovereignty in tax matters, thus each country should be able to set its own rates. If rates were set by an international consensus, not only would individual country sovereignty be restricted, but non-harmful tax competition which is good for both business and governments would be reduced. Tax competition encourages governments to run efficiently. Governments would have little incentive to reduce corporate income tax rates below the agreed threshold level. Increased corporate income tax burden stifles innovation and economic growth. Ultimately, as modern economic research shows, corporate income tax is borne largely by individuals in the form of the price they pay for goods and services purchased from corporations, lower returns on their investment in corporations, and workers in the form of decreased wages.

    - Presumably it would not make sense to set the "low tax" threshold rate lower than the CIT rate established in industrialized countries like Hungary (9%) or Ireland (12.5%). Otherwise the income inclusion rule could distort economic activity and influence business location decisions (and, we understand, raises significant EU law issues).

    - Another question is the rate at which to "tax back" amounts that are determined to be taxed too low. In the US GILTI system, the tax rate applicable to "low taxed" income is equal to 50% of the domestic headline CIT rate. The "tax back" rate should be lower than the domestic tax rate otherwise the income inclusion rule could distort economic activity and business location decisions (e.g., companies could be disincentivized from locating business operations in foreign locations despite strong business reasons).

    - If the income inclusion rule is applicable we believe that the tax back jurisdiction should only apply tax up to the minimum threshold – not the jurisdiction's statutory rate.

86. The US GILTI regime is referenced in the consultation document as a potential regime to design the proposal off of. We caution against this given the extreme complexity of the US GILTI regime. Any international standard minimum tax system, if it is expected to be applied by all 128 members of the Inclusive Framework, must be far more simplified than the US GILTI regime.

87. The consultation document implies that EU law may be a controlling factor in the design of guidance for the income inclusion rule (otherwise it may not pass the Cadbury-Schweppes test). Designing a rule / tax system to apply to 128 countries to comply with EU law should not result in a worse outcome for non-EU business.

88. Unlike the US GILTI regime we recommend the income inclusion rule allow for carryforwards of foreign tax credits. Otherwise double taxation can result.

89. To make the income inclusion easier to implement and to help ensure it impacts only companies which are engaged in aggressive tax planning, we suggest the determination of whether income is "low taxed" is made on an aggregate consolidated basis (rather than on an entity by entity or country by country basis). This may also assist in reconciling challenges regarding the precise rate of tax suffered when a payment is effectively reallocated under the income allocation work stream to multiple territories. An aggregated consolidated approach also is less likely to directly offend the tax sovereignty issue identified above.

90. A decision would need to be made with respect to the mechanical computation details of the "low tax" test. One alternative to reduce administrative complexity (assuming the test were to be evaluated on an entity by entity basis) would be to assess the headline CIT rate of the jurisdiction in which the entity is resident for tax purposes against the given threshold.

91. It may be prudent to consider existing anti-deferral rules when making the determination as to whether income is "low taxed" in order to provide a safe harbor. For example, all income earned by non-US affiliates of a US parented MNE is taxed under the GILTI regime, so the income inclusion rule should not apply.

Section 3.4 – Tax on base eroding payments

92. Similar to the income inclusion rule, we question seriously the need for a tax on base eroding payments after the nexus and profit attribution work is completed. However, we provide comments below setting out *Business at OECD's* view of the section 3.4 tax on base eroding payments proposal.

93. Section 3.4.1 – Undertaxed payments rule

    - Paragraph 103 suggests the use of a 25% common ownership test for determining related parties for which the income inclusion rule would apply. We believe a 50% threshold would be more appropriate. Companies may face data limitation restrictions with respect to companies less than 50% commonly owned.

- The consultation document rightly indicates there are several complex technical and design issues that must be addressed in creating an undertaxed payment rule as contemplated by the Inclusive Framework. These issues should not be minimized---we believe additional time is needed for the Inclusive Framework to consider these issues in appropriate detail.

- Individual countries are sovereign and free to set their own tax rates consistent with their domestic policy goals, economic conditions, perspective on national macroeconomic and financial policy issues, etc. An undertaxed payments rule must maintain individual country sovereignty on tax matters. Accordingly, individual countries should be able to set their own rate for determining what would constitute an "undertaxed payment". It may be prudent to utilize a threshold based on a set percentage of the domestic tax rate.

- Further, to avoid economic harm and double taxation, where a transaction involves multi-directional flows, the rule should be applied to the net economic impact of those flows.

- Paragraph 104 mentions the rule covering "conduit" or "imported" arrangements. We suggest the Inclusive Framework clarify what types of transactions it has in mind. We caution that the rule should be designed in a way that does not make taxpayers "trace" each payment on an unlimited basis. This adds to complexity and uncertainty.

- The rule should define which taxpayers are subject to the rule (size based thresholds, etc.). A size based threshold makes sense to reduce taxpayers subject to the rule and therefore keep administrative compliance low. The size based threshold should be large enough to exclude many SMEs but not so large that it only targets the largest corporations. We suggest the threshold be indexed for inflation or otherwise increased as a function of time. We suggest no distinction be made for industry/sectors in order to avoid ring-fencing.

- The rule should define in-scope "payments". *Business at OECD* suggests the rule provide for an ordinary course exception whereby payments made in the ordinary course of business (e.g., for COGS or intra-group service payments) are not be subject to the rule. The exception should include intercompany cost of service payments (unlike the US BEAT rule which appears to only exempt COGS payments, which, in effect, discriminates against service companies). If COGS and cost of service payments are not excluded creates an incentive to unwind distribution arrangements which is contrary to the objective of Action 7.

- Application of the rule when the payment is subject to some level of withholding tax should be considered. A graduated calculation is reasoned (rather than an "all or nothing" approach which might encourage nominal levels of withholding tax to mitigate the tax).

94. Section 3.4.2 – Subject to tax rule

- As alluded to in the consultation document, there are several ways such a new rule could be implemented (e.g., changing Article 7, 9, 10, 11, 12, 13, or 21 of tax treaties). We suggest additional time and resources be devoted to exploring the pros/cons of each option from a technical and practical lens.

- We do not believe that treaty benefits should be denied in the case of third party transactions, as it is not always possible for businesses to know the position of counterparties, and it does not appear necessary given the purported policy concerns.

- Similar design issues as discussed with respect to the income inclusion rule would apply to the subject to tax rule.

- The coordination of the income inclusion rule and subject to tax rule should be analyzed in detail. We suggest the subject to tax rule be a "backstop" that could only apply if the income inclusion rule did not apply.

- Ensuring that other countries take withholding taxes suffered and deductions denied into account when calculating the effective tax rate suffered on a transaction (or by a controlled party) will be critical.

- In addition, if not decoupled from the income allocation work stream, it will be critical to ensure that credit will be available for taxes potentially paid in a broader range of countries than in the direct transactional chain.

Specific questions for public comments (section 3.6 of the consultation document)

Commentators views are requested on the policy, technical and administrability issues raised by the proposals described above, including those raised in paragraphs 100 and 105. In particular, comments are specifically requested on the questions set forth below:

1. What is your general view on this proposal? In answering this question please consider the objectives, policy rationales, and economic and behavioural implications of the proposal.

As explained above we believe BEPS Action 11 work should be advanced before concluding whether the anti-base erosion proposals are necessary. In addition refer to comments above.

2. What would be the most important design considerations in developing an inclusion rule and a tax on base eroding payments? In your response please comment separately on the undertaxed payments and subject to tax proposals and also cover practical, administrative and compliance issues.

The inclusion and tax on base eroding payments rules must not influence business location decisions, be easy to comply with, and give credit for foreign taxes incurred. In addition refer to comments above.

3. What, if any, scope limitations should be considered in connection with the proposal set out above?

Consider use of a size based threshold so these proposals do not impact SMEs. As mentioned above we believe a 50% common ownership threshold is appropriate (not 25%). If a company is subject to similar rules (e.g., US GILTI and BEAT) these rules should not apply. In addition refer to comments above.

4. How would you suggest that the rules should best be co-ordinated?

Additional time and analysis is required to develop well thought out coordination rules. In addition refer to comments above.

5. What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

Mandatory binding arbitration should be a minimum standard adopted by Inclusive Framework members. Certainty programs such as ICAP and MAP should be expanded and encouraged, but will not alone be sufficient. See above our further comments regarding this point. In addition refer to comments above.