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13 April 2014

Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
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Via Email: CTP.BEPS@oecd.org

RE: Discussion Draft on BEPS Action 1: Address the Tax Challenges of the Digital Economy

To Whom It May Concern:

On 19 July 2013, the OECD published an *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Action Plan or the Plan) setting forth 15 actions the OECD will undertake to address a series of issues that contribute to the perception that individual countries' tax bases are being eroded or profits shifted improperly. Pursuant to the Plan, the OECD issued a public discussion draft on 24 March 2014 on *BEPS Action 1: Address the Tax Challenges of the Digital Economy* (hereinafter the Discussion Draft or Draft). The Discussion Draft discusses the OECD's views of the digital economy and sets forth several options that the OECD may adopt to address the tax challenges that digital activities may present.

The OECD requested comments on the Discussion Draft no later than 14 April 2014. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in Europe, North America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 members represent over 3,000 of the largest companies in Europe, the United States, Canada, and Asia.

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TEI Comments

TEI commends the OECD for the Discussion Draft's detailed and broad overview of the digital economy, some of the tax challenges it may present, and potential options to address those challenges. TEI agrees that the framework for analysing options to address the possible tax challenges of the digital economy should include the principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.[1]

More important, TEI agrees with the Discussion Draft's statement that "[a]ttempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not"[2] and "that ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible."[3] It is simply not practical to sort modern business into "digital" and "non-digital" categories. The potential tax issues presented by the digital economy, especially in the direct tax area, are not new and can be addressed by applying the existing international tax framework in the digital context with little or no modification.

<u>The Digital Economy Generally</u>

Overall, the Discussion Draft seemingly proceeds from the view that businesses with a heavy information and communication technology (ICT) component can more easily relocate business assets and resources (*e.g.*, tangible and intangible assets, and workforce), have much lower costs, and benefit from utilising fewer employees as compared with traditional businesses. Businesses with a heavier reliance on ICT, however, generally have different costs, not lower costs, and often must make significant investments in infrastructure and other assets necessary to their operations. This is true even for "pure play" digital businesses, *i.e.*, those that appear to operate only digitally.

With respect to mobility, the Draft overlooks is that ICT-heavy businesses face the same challenges in moving assets and people between jurisdictions as other businesses. Digital business asset movement, whether of intellectual property or other assets, is subject to the same legal, regulatory, and tax costs as traditional businesses that choose to relocate assets or functions. Further, employees are no more mobile in a business that happens to be heavily digital or dependent on intellectual property than a traditional brick-and-mortar business. The same hurdles must be overcome if employees move across, and conduct business in, different jurisdictions. ICT does give businesses greater flexibility to place operations where it makes the

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[1] *See, e.g.*, Discussion Draft, page 6, referencing the principles of the Ottawa Taxation Framework Conditions regarding electronic commerce, issued in 1998.

[2] *Id*. at 24.

[3] *Id*. at 63.

most sense for the business model (*e.g.*, next to research universities, or in close proximity to other needed resources), among other things.

The business models of companies that heavily utilise ICT have the same operational focus as companies in existence prior to ICT advances – to manufacture, produce, or create their products and services and deliver them to customers. What has changed is how the consumer – whether an individual or a business – accesses and receives delivery of the product or service. Changes to how a product or service makes its way into the hands of the consumer is not cause for re-writing the rules of international taxation or writing specific rules for new delivery mechanisms. The OECD's mission is to promote economic and social well-being, not to erect additional barriers to trade and capital or people mobility through the introduction of complicated and sector-specific rules.

<u>Specific Measures to Address Digital Economy Issues</u>

TEI opposes the potential options set forth in Section VII of the Discussion Draft to address the direct tax issues presented by the digital economy. These are: (i) modifications to the exemptions from permanent establishment (PE) status; (ii) a new nexus standard based on significant digital presence; (iii) a virtual PE; and (iv) creation of a withholding tax regime on digital transactions. These options are all generally unworkable. They would impose high administrative costs on businesses conducting digital operations as they would have to register for tax purposes in every country where they sell their goods and services, which would require hiring local advisors to ensure compliance. In addition, determining the country of the relevant activity or of a "virtual PE" or applying and remitting the correct withholding tax may be difficult or impossible. For example, a sale may involve a customer that resides in one country, uses a credit card from a second country, and effects the purchase through an IP address from yet a third country. More important, these options are inconsistent with the Discussion Draft's conclusion that "ring-fencing" the digital economy is not viable.

In addition, the Discussion Draft begins by quoting from the statement by the leaders of the G20 on the BEPS Action Plan at their meeting in September 2013. The statement reads in part that "[p]rofits should be taxed where economic activities deriving the profits are performed and where value is created . . . ."[4] The options and measures suggested by the Draft, however, would have the opposite effect. For example, the Discussion Draft suggests a potential new nexus standard based on significant digital presence and also creating a virtual PE.[5] These options would impose a tax in the jurisdiction of consumption rather than where the activities of a business take place or where value is created (*e.g.*, the jurisdictions where a product is designed and manufactured). A similar result would flow from the imposition of a withholding

[4] *Id*. at 4.

[5] *Id*. at 64-65.

tax on digital transactions as suggested by the Draft. These options do not comport with the statement of the G20 that profits should be taxed where they are located.

Further, it appears that these options are included in the Discussion Draft for Member States to choose selectively when implementing domestic anti-base erosion and profit shifting measures. TEI urges the OECD to address digital economy issues through its work on the other BEPS actions, rather than encouraging Members States to pick and choose from a menu of options. Giving countries the option to select their measure will only result in a greater patchwork of inconsistent international tax rules. Indeed, the best action to curb BEPS is to promote greater uniformity of international rules so that rules of one country cannot be played against the rules of another.

Section V of the Draft addresses digital economy issues through the OECD's work on the other BEPS actions. This approach properly focuses on targeted legal issues of general applicability (*e.g.*, treaty abuse, transfer pricing), rather than cordoning off or "ring fencing" a section of the economy for unique treatment. Notwithstanding our preference for a single set of uniform rules, TEI does not necessarily agree with all of the specific options discussed in Section V.

For example, one suggestion made with respect to BEPS Action 7 "Prevent the artificial avoidance of PE status" is to "ensure that where essential business activities of an enterprise are carried on at a given location in a country, the enterprise cannot benefit from the list of exceptions usually found in the definition of permanent establishment (see, e.g., Art. 5(4) of the OECD Model Tax Convention)."[6] The Draft's concern is that, through the fragmentation of business activities and changing business models, previously "auxiliary" activities may now constitute the core activities of an enterprise. To address changes in business activities, the Discussion Draft suggests modifications to Art. 5(4) may be necessary. It is important to recognise, however, that fragmentation (or business restructuring) concerns are not new and any modifications to Art. 5(4) will have broader implications beyond companies using digital resources to conduct their business.

One example of such implications is the Discussion Draft's focus on the maintenance of a local warehouse. The maintenance of a local warehouse is not the core activity of a seller – sales to the seller's customers is the core activity. Today, as in the past, sellers based in one jurisdiction use warehousing and delivery facilities in other jurisdictions to deliver goods to customers (*e.g.*, companies selling over the telephone or through mail-order catalogs). This business model has not changed merely because these businesses have moved to digital means for interacting with and advertising to customers. The core activities of these businesses have always been, and continue to be, selling products to consumers, not warehousing or advertising. Minimising or right sizing the breadth of a company's operational footprint and

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6 *Id*. at 49.

costs, including administrative costs associated with creating a taxable presence in a jurisdiction, is just one of the many factors a company evaluates when determining where to place functions and processes. Such realignments are not "artificial" in the vast majority of circumstances.

The Discussion Draft also sets forth other measures that would restore taxation in the market (source) jurisdiction where it may be lacking due to the features of the digital economy.[7] These measures fall under BEPS Actions 6 (Prevent Treaty Abuse) and 7 (Prevent the Artificial Avoidance of PE Status). Such measures would address multi-national enterprise (MNE) operating structures that centralise risks in a low-tax jurisdiction and may be viewed by tax authorities as inappropriately tax motivated. However, the OECD should recognise that these structures have legitimate business purposes, including: (i) the centralisation of functions to extract efficiencies; (ii) the hedging of the risk of losses in a single location; and (iii) a constant and regular (albeit lower) income flow in most countries to the satisfaction of tax authorities worldwide.

Other measures noted in the Discussion Draft would aim to restore taxation in both the market country and the country of the ultimate MNE parent. These measures fall under BEPS Actions 2 (regarding hybrid mismatch arrangements), 4 (regarding limiting base erosion), 5 (regarding harmful tax practices) and 8-10 (regarding transfer pricing). TEI notes that many of the issues that these measures are designed to address are the result of deliberate tax policy choices of the OECD's Member States. MNEs take into account these policy choices when structuring their operations to legally minimise their tax burden, in many cases in full accord with the underlying policy to encourage business activity of one form or another in the policymaker's jurisdiction. It is these policies, and not the MNEs, that create the low effective tax rates.

Paragraph 166 of the Discussion Draft notes the increasingly integrated nature of MNEs, which is facilitated in part through the utilisation of ICT. For transfer pricing purposes, this paragraph of the Draft foreshadows the need for greater reliance on "value chain analysis and profit split methods." TEI looks forward to the OECD's work in this area. We note, however, that profit splits may appear simple in concept, but are fraught with difficulties in application. TEI urges the OECD to tread carefully when reviewing these aspects of its BEPS project and avoid implicitly endorsing a global formulary apportionment approach.

In paragraphs 189-201 (and the immediately following commentary on pages 61-62) and in paragraphs 219-224, the Discussion Draft seems to suggest eliminating or reducing VAT exemptions on low value imports and addressing issues with the supply of digital goods and services. Such exemptions, however, are in many cases highly utilised by small enterprises like software developers and marketers and not large MNEs. Removing the exemptions for low

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[7] *Id*. at 48-49.

value imports must be accomplished in a measured fashion to avoid hindering innovation or imposing unreasonable administrative costs on small and medium sized enterprises, which are a driver of future growth.

On the other side of the spectrum, the OECD should recognise that the additional personal mobility created by ICT puts MNEs at risk of having taxable jurisdictions all across the world for *de minimis* activities. TEI recommends that PE rules be adjusted to reduce the substantial administrative burden this is likely to create for both tax authorities and taxpayers alike by introducing a *de minimis* safe harbor.

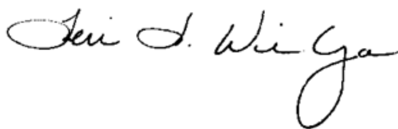
With respect to indirect tax issues, TEI emphasises that the approach to such issues should be guided by the Ottawa Taxation Framework Conditions, including taking into account the administrative and compliance burdens imposed on non-resident suppliers and ensuring the neutrality of VAT. Any new approach to the administration of indirect taxes should ensure a level playing field for all businesses, no matter their jurisdiction of residence.

Section V of the Discussion Draft sets forth several other options to address potential tax issues presented by the digital economy. TEI will comment on these options when addressed by the OECD in its work product under the other BEPS actions.

Conclusion

TEI appreciates the opportunity to comment on the OECD's Discussion Draft on *BEPS Action 1: Address the Tax Challenges of the Digital Economy*. These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +352 26 20 77 46, nickha@herbalife.com, or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

Sincerely yours,
TAX EXECUTIVES INSTITUTE, INC.



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