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4 March 2019

David Bradbury, Head
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Via email: TFDE@oecd.org

RE: Comments on Digitalisation of the Economy Consultation

Dear Mr. Bradbury:

The OECD launched its base erosion and profit shifting (BEPS) project in 2013. Action 1 of the BEPS project was entitled *Addressing the Tax Challenges of the Digital Economy* and the OECD published a final report under that action on 5 October 2015 (the Final Report). Among the conclusions of the Final Report was that "because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes."[1] The Final Report noted that the OECD would continue to monitor developments in this area, along with implementation of the other BEPS actions, with a view toward producing a follow-up report on the digital economy in 2020.[2]

Subsequent developments and political pressure, however, have overtaken this "wait and see" approach. As a result, the OECD issued an interim report entitled *Tax Challenges Arising from Digitalisation* in March 2018 (the Interim Report), two years earlier than anticipated in the Final Report. The Interim Report was followed by a policy note, published on 23 January 2019 (the Policy Note), and a public consultation document, published on 13 February 2019 (the Consultation Document), each entitled *Addressing the Tax Challenges of the Digitalisation of the Economy*. The

1 Final Report at 11 & 54.
2 *Id*. at 138.

Consultation Document sets forth a number of proposals to address the tax challenges of the digitalization of the economy, some of which would reach beyond "digitalization" to all sectors of the economy. The OECD asked for input from interested stakeholders no later than 6 March 2019 in preparation for a public consultation to be held on 13-14 March 2019 in Paris.

On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for input. TEI also requests the opportunity to speak in support of these comments at the upcoming public consultation.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 57 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting sound tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies in the world.[3]

TEI Comments

General Comments

TEI commends the OECD for its work on the BEPS project over the past nearly six years and the work of its Task Force on the Digital Economy (TFDE) regarding digitalization. The Final Report, Interim Report, Policy Note, and Consultation Document represent substantial effort in this area with broad implications for both highly digitalized and more traditional businesses. As outlined in the Policy Note, the work in this area is now encapsulated in two groups of proposals referred to as "pillars," each of which, if implemented, would represent substantial changes to the current international tax regime – in addition to the changes already wrought by the BEPS project. The first pillar (Pillar I), focuses on the allocation of taxing rights and nexus issues with an eye toward allocating more taxing rights toward "user" or market jurisdictions. The second pillar (Pillar II), would "strengthen the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective rate of tax to those profits" through a global anti-base erosion rule.[4]

Given the sweeping changes contemplated by the two pillars, as further delineated in the Consultation Document, it is unfortunate that the OECD is under political pressure to have its Inclusive Framework on BEPS (the Inclusive Framework) agree on a solution by May of this year, followed by a report to the G20 Finance Ministers in June, and a final recommendation to be publicly delivered in 2020.[5]

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3 TEI is a corporation organized in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

4 Policy Note at 2.

5 *See id*. at 3.

A mere three-week comment period on these potentially sweeping changes to the international tax system is simply insufficient for interested stakeholders to fully consider the options set forth in the Consultation Document and to formulate and provide informed input to the OECD. While we understand this extremely accelerated timeframe is in part intended to head off additional unilateral actions by individual countries with respect to tax issues exacerbated by the digitalization of the economy, in TEI's view the timeframe will likely result in final guidance full of generalities that will likely lead to disputes and controversy between taxpayers and tax authorities down the road.

Similarly, the relatively sparse detail in the document regarding the three options for modifying the profit allocation and nexus rules, as well as the global anti-base erosion proposal, makes it difficult to provide informed input on the Consultation Document. For the same reason it is difficult to formulate a view as to which of the three profit allocation and nexus options is preferable. With respect to the global anti-base erosion proposal, it is also disconcerting that the Consultation Document spends only a single paragraph discussing "rule co-ordination" to avoid overlap across jurisdictions – and thus double taxation – and merely notes that "further technical work" is needed to explore these approaches.[6] This is especially troubling as the rules outlined in the Consultation Document, if finalized, would add to the already voluminous complexity of the BEPS project, materially increasing the compliance burden of multinational taxpayers and further complicating their ordinary business affairs.

More broadly, the Consultation Document describes countries as aligning into three groups when it comes to making changes to the profit allocation and nexus rules subsequent to the BEPS project. Overall, TEI is aligned with the third group, as countries "which [are] supportive of the existing . . . international tax system and [do] not see the need for any significant reform of the profit allocation and nexus rules."[7] The bulk of the BEPS project was only finalized in October of 2015. Further, many of the action items required additional work through 2016, 2017 and 2018. Indeed, the multilateral instrument only entered into force on 1 July 2018 and country-by-country reports under Action 13 have only been shared across jurisdictions for a single taxable year. Further, the profit allocation work under Action 7 is still not final. Thus, while it is obviously too early to fully assess the impact of all the BEPS measures, it also seems too soon to embark on a reallocation of taxing rights between source and residence countries, especially on such an accelerated timeframe. It is TEI's view that the BEPS project, once fully implemented, will largely address the underlying concern of double non-taxation (also known as "stateless income").

Moreover, in addition to the BEPS project, other recent significant actions undercut the need to implement the approaches described in the Consultation Document. For example, to the extent that Action 1 of the BEPS project (and the BEPS project generally) was driven by concerns regarding ability of U.S. based technology companies to supposedly earn significant amounts of low-taxed income outside of the United States, such concerns should be substantially addressed by the U.S. tax reform legislation

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6 Consultation Document at 29.

7 *See id*. at footnote 3; *see also* Interim Report at 172.

passed in 2017, colloquially known as the "Tax Cuts and Jobs Act," which includes many of the aspects of the global anti-base erosion proposal set forth in the Consultation Document (as discussed further below), as well as anti-hybrid rules and a limitation on interest expense. Similarly, the European Union's Anti-Tax Avoidance Directives (ATAD I and II), when fully in place, should also alleviate many of the concerns falling within the scope of the digitalization of the economy and the other issues outline in the Consultation Document. In sum, from a pure tax policy perspective, TEI does not see the need to revise the profit allocation or nexus rules or recommend a global anti-base erosion proposal.

Nevertheless, despite the many drawbacks of proceeding in this direction with such haste, given current political realities it appears some near-term revision to the profit allocation and nexus rules is likely. It also seems likely, if unfortunate, that the OECD will recommend countries adopt some form of a global anti-base erosion rule. In light of these realities, set forth below are TEI's comments on the two sections of the Consultation Document, along with answers to the specific questions posed by the OECD therein.

<u>Comments on Revised Profit Allocation and Nexus Rules</u>

The Consultation Document describes three proposals that would revise the current OECD approach to profit allocation and nexus: (i) a "user participation" proposal; (ii) a "marketing intangibles" proposal; and (iii) a "significant economic presence" proposal (in combination, the Proposals). The user participation proposal would largely be confined to "certain highly digitalised businesses" that have developed "an active and engaged user base" and that have solicited "data and content contributions" from those users.[8] The marketing intangibles proposal would not be so confined, and would apply broadly to any business with non-routine or residual income in a jurisdiction attributable to marketing intangibles.[9] Finally, the significant economic presence proposal would attribute a taxable presence in a jurisdiction to a business "on the basis of factors that evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means" whether or not the business has any physical presence in the jurisdiction.[10]

Set forth below are TEI's responses to the specific questions posed in the Consultation Document (the questions are in italics) with respect to the Proposals.

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

General Comments on the Proposals

As a threshold matter, an unstated assumption of the Proposals seems to be that "residual profits" of multinational businesses currently go untaxed. This is generally not the case and to the extent that it

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8 Consultation Document at 9.
9 *Id*. at 14.
10 *Id*. at 16.

has been the case in the past it should be substantially addressed by the changes to the international tax regime proposed by the BEPS project, and other recent developments such as the Tax Cuts and Jobs Act in the United States and ATAD I and II. Indeed, the Proposals would reallocate profits currently taxed in one country to be taxed in some other country, which would lead to controversy. Similarly, it may be the case that one market country increases its share of tax revenue at the expense of multiple other countries, which may also cause controversy. The Consultation Document only briefly addresses how such a multi-jurisdictional dispute could be settled.[11] While we applaud the OECD for recognizing the possibility of disputes between and among countries in its repeated call for a "strong dispute resolution component" to some of the proposals, we view it likely that countries on the "losing" end of any revision to the profit allocation and nexus rules will not give up their current taxing jurisdiction so easily.

Another preliminary matter common to the Proposals is that the Consultation Document speaks in terms of allocating non-routine or residual profits. Defining "residual profits" on a consensus basis would seem to be a difficult task and that is before addressing situations where there are non-routine or residual losses, or, indeed, to situations where a multinational business may earn a profit in one jurisdiction and a loss in another jurisdiction, regardless of whether the multinational as a whole makes a profit or loss.[12] Similar issues may arise where a multinational operates multiple separate business lines and one line earns a profit while the other suffers a loss. In addition to defining residual profits on a consensus basis, TEI recommends the OECD address the issue of residual losses, both for the multinational as a whole and in specific jurisdictions/business lines, in its final 2020 report on the digitalization of the economy.

The Proposals also regrettably depart from the arm's length principle, as the OECD notes in the Consultation Document, in favor of an approach akin to global formulary apportionment. Because the arm's length principle attempts to recreate prices between unrelated third parties in a market economy, departing from the arm's length principle would distort market dynamics. If the OECD proposes to include global apportionment into a part of the OECD's approach to arm's length principle, it is unclear why there should be both the arm's length principle and global apportionment operating in parallel, which would create a double level of administrative complexity. Further, it is unclear how one would apply the arm's length principle to allocate profits among jurisdictions or associated enterprises after part of that profit has been allocated under a formulary apportionment approach.

TEI also notes the Consultation Document mostly omits discussing the significant benefits provided to users and consumers by some of the business models addressed in the Proposals. This is hinted at on page 18, where the Consultation Document states:

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11 *See id*. at 22 (noting the possibility of using the International Compliance Assurance Programme, multilateral advance pricing agreement programmes, as well as joint audits).

12 Paragraph 76 of the Consultation Document notes the need to allocate non-routine losses but does not go into any detail on how this should be done.

> Under the user participation model, it could be argued that the value created by the contribution and engagement of users does not constitute value created by the business, and instead constitutes value created by third-parties, that are more akin to suppliers than employees, and are remunerated at arm's length through the provision of a free service.

If this view is correct, then the users in such a model are, as a whole, obtaining substantial services from a third-party in a tax-free barter transaction.[13] It is unclear why only the business side of this barter transaction is proposed to be taxed in the user/market country. Indeed, if the "value created by the contribution and engagement of users" is remunerated at arm's length via free services, then the conundrum of how to tax such value creation could conceivably be solved by imposing a tax on the income received by the users from such free services, although this is impractical for several reasons. In TEI's view, this is a reason why the user participation approach to profit allocation and nexus may be unworkable.

Also omitted by the Consultation Document are consumption taxes such as the VAT, which was the one area taken up by the OECD in the Final Report. TEI recommends the OECD again address consumption taxes in the final 2020 report as part of a holistic approach to the digitalization of the economy, rather than solely focusing on direct tax issues as set forth in the Consultation Document. If the Inclusive Framework wishes to tax the value created by users or customers a simple way to do so is to modify indirect taxes to cover the barter transactions approach discussed above, instead of adding another level of complexity and administrative burden to the corporate income tax system. This would derive the same result as increasing taxes on business via one of the options set forth in the Consultation Document as the users or customers would likely bear a material part of burden of any increased corporate tax collections. Of course, any proposed changes to indirect taxes in this regard should be consistent with the cost neutrality principle of such taxes for businesses.[14]

Finally, the Proposals purport to apply to a multinational group as a whole rather than to just the legal entity (or entities) that conduct the activities deemed to have a nexus with the local jurisdiction. In that case, it is critical that a single set of financial statements or tax returns be used to allocate income, otherwise differences in local financial accounting standards or tax laws will almost certainly result in double taxation (or perhaps double non-taxation). A second critical point is that if a group-wide approach is used, there needs to be a process to determine the member of the group that is deemed to have the presence in the country, otherwise it is unclear which tax treaty to apply.[15]

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[13] The Interim Report discusses user participation as a barter transaction in more detail. *See* Interim Report at paragraphs 39, 54, 87 and 159.

[14] In addition, to the extent indirect taxes give rise to double taxation, in TEI's view such double taxation disputes should be resolvable under the dispute resolution procedures noted in the Consultation Document.

[15] *See* Consultation Document at 22 ("The taxation of the reallocated income in the user or market jurisdiction would require the determination of the identity of the taxpayer who bears the tax liability and filing obligations.").

Specific Comments on the Proposals

Any modifications to the profit allocation and nexus rules should take into account that the digitalization of the economy impacts all businesses and any changes to the profit allocation and nexus rules should apply to all businesses. While today the impact on certain businesses may be more pronounced, as the digital economy evolves, the impact on all businesses will increase. Should a significant change to the profit allocation and nexus rules be introduced, it should be a "future-proof" solution that does not require modification for future technological changes and the tax challenges such changes might produce. Limiting taxation to income from advertising or online marketplaces or the "digital economy" as we see them today is shortsighted given that digital products and services are evolving at an accelerated pace and will continue to do so in the future in a myriad of ways not currently contemplated. Targeted approaches can become obsolete very quickly and it would be a better use of limited resources to adopt a broader approach not dependent on current "digital" businesses.

This concern is particularly acute for the "user participation" proposal as it focuses on three highly digitalized business models: social media platforms, search engines, and online marketplaces. However, the proposal would likely have significant impacts on businesses beyond these highly digitalized ones as the use of connected products and the internet of things continues to grow. This raises the question of how, in practice, tax authorities would draw the line between a business where user participation is viewed as a significant contribution and other businesses, and when a business crosses the line from one category to another. The Consultation Document does not attempt to answer this question. This is another reason not to adopt a narrowly targeted approach to changing the profit allocation and nexus rules.

Moreover, it is not clear that all users are created equal. For example, is it more valuable to have a large number of users in a less developed (and thus poorer) country, or a small number of users in a developed (and thus richer) country? Similarly, is it more valuable to have a large number of "low intensity" users (i.e., users who spend a brief amount of time on one's website), or a low number of "high intensity" users? Factors that might be useful in valuing user participation include: (i) the number of users; (ii) hours/time spent by users; (iii) the degree of user involvement (e.g., posting links, writing reviews, etc.) (iv) whether a website is available in the local language; (v) whether a website is tailored to the local culture; (vi) the percentage of total server capacity dedicated to a particular country; and (vii) the number of employees dedicated to serve a particular country, among others.[16] This, of course, assumes multinational companies collect this kind of information (if it is even collectable in the first instance and that collection is permissible under local laws regarding user privacy).

A final issue regarding the user participation model is that the Consultation Document focuses its attention on the "value" of user participation but ignores the large corporate investment necessary for

[16] The Interim Report discusses some of the differences among users on pages 53-59.

user participation to take place.[17] That is, large social media platforms (for example) spend a tremendous amount of time and effort developing, improving, and maintaining their platforms to enable consumers to use them and yet it appears the user participation model in the Consultation Document would attribute most, if not all, of the value of these businesses to user jurisdictions despite the location of these value creation efforts.

Fundamental questions also afflict the marketing intangibles proposal. The proposal appears to assume that the value of marketing intangibles must be automatically attributed to the jurisdictions where products or services are sold/used, irrespective of the actual activities that created or increased the value of such intangibles, which seems economically incorrect. For example, activities associated with brand awareness and brand strategy are generally conducted in a centralized manner, whereas it is only the deployment of the strategy which is localized. Moreover, in many industries, the brand value is closely related to the performance of the product itself, *i.e.*, the technical research and development and intellectual property, or the product design, which are not connected with the markets where products or services are sold.

Similarly, the marketing intangibles proposal also ignores the performance of development, enhancement, maintenance, protection and exploitation (DEMPE) functions, which is a significant departure from the arm's length principle and its application. This creates a significant risk for arbitrary allocation of the tax base and a disconnect between the tax base and value creation.

Further, for the marketing intangibles proposal to work properly, there needs to be a clear and agreed definition of what constitutes a marketing intangible and how it is remunerated. The Consultation Document references the definition in the OECD Transfer Pricing Guidelines, which defines such intangibles to include "customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers."[18] Will this be used for purposes of the final guidance issued by the OECD? What constitutes a "customer list" or "customer relationship" in the context of, for example, a massive social media platforms or online marketplace?

One possible approach for this proposal would be for the multinational group's parent jurisdiction to determine the group's marketing intangibles based upon the agreed definition. The parent jurisdiction's tax authorities could then determine the group's non-routine or residual profit attributable to such intangibles and apportion such profit among the countries in which the group does business according to the agreed upon marketing intangible allocation formula and the group would pay the resulting tax. If the market country tax authority disagreed with the parent jurisdiction's allocation, the dispute could be settled via the mutual agreement procedure.

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[17] This fact is briefly noted in the Interim Report on page 54 ("it has to be recognised that it is the platform developed through investment in information technology (IT) and intangibles such as algorithms that attracts the users.").

[18] *See* Consultation Document at footnote 6.

Paragraph 39 discusses the digital needs of consumer facing businesses, raising the question of the scope of the application of the Proposals – will they apply only to business to consumer business, or to all business models (i.e., also business to business models)? The OECD should address the scope of the proposals in the final 2020 guidance.

The allocation of non-routine return from marketing intangibles referenced in the Consultation Document also seems to ignore non-routine return generated from other sources, such as trade intangibles, intellectual property, etc. Is this meant to suggest that marketing intangibles would have the "first bite" at non-routine returns from multinational business activity in a jurisdiction and what was leftover would then be allocated according to traditional transfer pricing principles? Also, if the marketing intangibles return is allocated to Country A, and taken from Countries X, Y and Z, how would the arm's length standard apply to Countries X, Y, and Z with respect to marketing and other non-routine return producing intangibles? We also note that, in practice, the relevance of various countries for an international product may change rapidly over time as the product's popularity waxes and wanes based on consumer tastes. Tax authorities should understand this dynamic and profit and cost allocations should be devised and administered in a manner to allow for this kind of year-to-year fluctuation.

The "significant economic presence" proposal consists of new nexus rules and a formulary apportionment approach. While it may appear simple at first, considering the number of criteria listed in paragraph 51,[19] the test to determine nexus may pose many questions regarding the materiality to apply, in addition to definitional issues as highlighted at the end of the paragraph regarding what types of transactions would be covered. In addition, the nexus test will require changes to domestic laws and tax treaties.

The formulary apportionment approach apparently contemplated by the significant economy presence proposal is obviously a departure from current application of the arm's length principle and will require changes to domestic laws and tax treaties. TEI believes that any significant economic presence proposal requires uniform adoption globally to function properly. If the OECD decides to go down this path, TEI recommends the method clearly apply to all businesses and that the OECD emphasize the need for tax authorities to use a consistent set of financial statements to minimize the risks of double taxation, *i.e.*, that tax authorities use the same accounting financial standards, which is currently not the case.

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[19] In addition to total revenues, the Consultation Document lists the following criteria to be considered when determining whether a business has a significant economic presence in a jurisdiction: (1) the existence of a user base and the associated data input; (2) the volume of digital content derived from the jurisdiction; (3) billing and collection in local currency or with a local form of payment; (4) the maintenance of a website in a local language; (5) responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance; or (6) sustained marketing and sales promotion activities, either online or otherwise, to attract customers.

The use of modified deemed profits methods is mentioned in the Consultation Document as a "simplified" method of allocating profit.[20] Such methods are likely to add more complexity and therefore create controversies for the following reasons: (i) each multinational enterprise has its own cost structure, therefore the use of industry averages does not seem appropriate; (ii) a multinational's cost structure may vary over time and across countries and regions; and (iii) this method is not capable of addressing loss making businesses. This method would only seem a viable option if a multinational enterprise could obtain advance pricing agreements from tax authorities covering the main parameters of the method.

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

As a threshold matter, we note that businesses can have an active presence or participation in a jurisdiction that is not recognized under the current profit allocation and nexus rules, regardless of whether they use digital means. Reaching out to customers/users in paper media, on television or though telemarketing achieves broadly the same goals as using digital platforms, although admittedly it may not be as effective. Those approaches to reach customers/users are many decades old and were never considered as the impetus for sweeping changes to international tax principles. The current transfer pricing rules effectively deal with the traditional approaches to reach customers/users, and align taxation rights with the location where functions, assets and risks are located. It is difficult to see how the advent of digitalization warrants fundamental changes to the existing tax framework. The proposals appear to be entirely driven by the perception that states do not receive their fair share of income to tax in the digital age.

In TEI's view, many of the issues associated with digitalization can be resolved with the application of current transfer pricing rules and concepts, such as an analysis of the value chain, DEMPE functions, and an analysis of risks. This is particularly the case when a multinational enterprise has some kind of physical presence in a country, even if the physical presence is small or indirect.

A key issue with the Proposals is that they ignore contractual relationships, actual functions performed and the risks of the taxpayers in favor of allocating taxes and profits amongst tax jurisdictions via formulary apportionment-like methods. It seems to us that there would be great difficulty getting consensus among tax authorities regarding how to apply formulary allocation methods, subjecting taxpayers to double taxation. Consideration also needs to be given to setting the appropriate thresholds

[20] *See* Consultation Document at 17. Modified deemed profits methods are discussed in Section 7.6.2.3 of the Final Report.

under each of the proposal given the likely substantial costs of complying with any of the alternatives (see also our response to Question 3. below).

Finally, the proposals seem to lean heavily on application of the residual profit split method. We note that the profit split is not a primary transfer pricing method and is typically only used for businesses that are highly integrated and where transactions cannot be evaluated separately and/or with one-sided methods that are significantly less burdensome to document. The Consultation Document seems to endorse this method because it gives the air of using the OECD transfer pricing guidelines to achieve arm's length outcomes. However, the reality of applying the residual profit split method is that it effectively achieves global formulary apportionment: routine functions are rewarded with routine, benchmarkable returns (e.g., cost plus 5 percent), while the residual profit is split between market jurisdictions based on a formula (e.g., relative revenue, number of users). Forcing the use of the residual profit split method in the context of this project effectively overrules the explicit rejection of global formulary apportionment as stated in section 1.32 of the 2017 OECD Transfer Pricing Guidelines.

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?*

TEI's important design considerations in this regard include: (i) a need for simplicity in the implementation and operative rules; (ii) avoiding multiple layers of rules; (iii) global consensus consistency in application across tax authorities; and (iv) avoiding double taxation and controversies. As indicated in the Consultation Document, the rules should allow for sharing residual losses in the same manner as residual profits.

Paragraph 72 states "[m]any aspects of the proposals suggest that they could be applied more appropriately at the business line level rather than at the level of the [multinational] group." TEI recommends that final guidance give taxpayers the flexibility to determine whether to apply the proposals on a business line-by-business line basis or to the entire multinational group given the different organizational approaches across industries and taxpayers.

As noted, taxpayers should be of some minimum size before any of the proposals would apply to account for the likely substantial compliance costs. For example, if the proposals are implemented, businesses may then need to be registered for tax, legal and regulatory purposes in many new jurisdictions, set up new accounting systems and processes to capture information, change the business models/strategies, change their, transfer pricing policies/strategies, hire/engage additional resources to meet compliance requirements, etc. Thus, some threshold to exclude smaller businesses from these rules is warranted.

Another design consideration is how the proposal will apply if the entire multinational group has losses or if some of the entities have losses and others income. For example, would the proposal use accounting concepts for recognition of tax losses or only recognize losses when they are utilized on a tax return? If accounting recognition is used, what happens with changes in accounting estimates that results in a change in the financial statement benefit of tax losses? Further, if temporary differences relating to tax losses are taken into account, should other temporary differences (e.g. interest expenses, depreciation, etc.) also be taken into account? One simplified approach would be to use the tax laws of the parent company's jurisdiction to determine the residual profits for allocation across jurisdictions.

Finally, consideration should be given to the value of the data being sourced in foreign jurisdictions for business models where users do not pay a fee for use of the providers' services. Raw data from foreign users is of relatively little value when sourced, and only gains significant value when categorized, analyzed, and configured for specific customers of the digital services vendor (e.g., for targeted advertising on the website). This high-value analysis, including complex algorithms, generally takes place in home jurisdictions of the vendor, not where data is sourced. Therefore, when allocating profit to be taxed in data sourcing locations, the value to be taxed is in many circumstances necessarily lower than value created in home jurisdictions via these activities.[21]

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

The Proposals depart from current transfer pricing methods, and in TEI's view would increase complexity and uncertainty, and therefore create higher risks of double taxation and controversy. If the arm's length principle is to be abandoned or significantly modified, then it is essential that whatever approach is adopted should be based on a small number of easily measurable criteria, combined with clear profit allocation rules, and coordinated with subsequent modifications to tax treaties to enable multinational enterprises to use existing treaty based competent authority procedures to avoid double taxation. However, this will require consistent changes to domestic tax laws in addition to thousands of tax treaties, which is an enormous effort that will require substantial time. One key question is if the multilateral instrument is to be used for the necessary tax treaty changes, will the changes be a "minimum standard" or optional?

With respect to the use of a profit split method, a critical question is what measure of profit to use? In TEI's view the best answer is the parent company's GAAP profits because using local GAAP or local taxable income will lead to differences across jurisdictions and thus over or under taxation. An additional issue is what to include in income. For example, would it include restructuring costs, foreign exchange, interest expense, one-time gains or losses on the sale of a business, etc.?

In applying the fractional apportionment factor, it is critical that countries use consistent apportionment factors and factor definitions. U.S. state apportionment factors vary and thus taxpayers suffer double taxation. Similarly, factor definitions vary from state to state (e.g., whether contractors are included in definition of employees).

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21 The Interim Report notes the value added by data analytics on pages 53-54.

Conceptually, utilizing processes such as the international compliance assurance programme (ICAP), advanced pricing agreements, competent authority etc., could provide needed certainty and quick resolution of audits and double taxation issues, but in a dynamic business environment these processes are often ineffective as they are expensive and take too long to come to resolution.

Finally, TEI recommends the final 2020 report include de minimis rules, for example, in cases where marketing intangibles are not substantial, where the residual profit is not substantial, and in cases where sectors are not expected to have marketing intangibles, etc. Such de minimis rules could apply to any new nexus standard implemented in the final 2020 report as well as to the conventional nexus rules of the traditional permanent establishment definition. The implementation of Action 7 of the BEPS project through the expansion of the permanent establishment definition as well as the anti-fragmentation rules has created substantial uncertainty for multinational businesses. De minimis exceptions to an expanded nexus concept which exclude the need for filings in multiple jurisdictions in the first place and that apply across the board would greatly reduce compliance costs and improve certainty for taxpayers and tax authorities, especially if there is an international consensus for their implementation.

Comments on the Global Anti-Base Erosion Proposal

The Consultation Document sets forth a global anti-base erosion proposal (the Anti-Base Erosion Proposal) that has two parts: (i) an income inclusion rule, and (ii) a tax on base eroding payments. The tax on base eroding payments is divided into an "undertaxed payments" rule and a "subject to tax" rule. The Anti-Base Erosion Proposal also notes the need for rule coordination among countries to avoid multiple applications of anti-base erosion rules that would result in double taxation. Coordination could be applied on a payment by payment basis or on a more systematic basis depending on the location of a multinational enterprise, although the Consultation Document notes that further technical work is needed in this area.

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.*

The Anti-Base Erosion Proposal is similar to the global intangible low-taxed income (GILTI) regime and base erosion anti-abuse tax (BEAT) introduced in the United States by the Tax Cuts and Jobs Act.[22] The GILTI and BEAT regimes have added a tremendous amount of complexity to the U.S. corporate income tax system and require substantial efforts by multinational enterprises subject to the rules to identify and collect the data necessary to calculate and pay the resulting taxes.

More broadly, the Anti-Base Erosion Proposal seems to indicate that the OECD believes that the BEPS project is ineffective as a whole. In TEI's view this would be a premature conclusion given that, as noted above, implementation of the BEPS project only began recently and is ongoing. Further, the Anti-Base Erosion Proposal would sever the connection between tax and value creation, undermining the

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22 *See* sections 951A and 59A, respectively, of the U.S. Internal Revenue Code of 1986 (as amended).

premise of the BEPS project. Instead, the Anti-Base Erosion Proposal appears to be aimed at ensuring that income is taxed "enough," regardless of where value is created. While this might solve the problem of base erosion and profit shifting, it is a departure from the approach the OECD undertook in its BEPS project. That said, an income inclusion rule combined with a tax on base eroding payments may be a simpler approach to addressing base erosion and profit shifting concerns than the 15 action items that served as the basis for the BEPS project. In case the OECD and the Inclusive Framework consider BEPS ineffective to the point that rules like the Anti-Base Erosion Proposal are needed, TEI would urge the OECD to use this as an opportunity for radical simplification and would support the OECD in identifying BEPS recommendations that can be revoked in favor of such simplification.

With respect to what taxes are considered "paid" for purposes of determining whether income is "low taxed," all taxes paid, accrued, or deemed paid or accrued to a jurisdiction (along with any "gross-up") should be counted in the total. While this may seem obvious, it is not always so clear with respect to certain taxes, especially if an entity is remitting taxes on behalf of other entities in a multinational group and/or remitting taxes that relate to a different time period. Such taxes should be counted toward the total taxes paid.

Another question with respect to the income inclusion rule is whether it would only apply to the group's parent entity and not to lower tier entities who may be the parent of their own groups and located in other jurisdictions. Application of the income inclusion rule at multiple levels of a multinational group would lead to double (or triple, etc.) taxation. TEI recommends the OECD clarify this in the final 2020 report.

Finally, there is some uncertainty whether double taxation relief could be obtained under current tax treaties for taxes imposed under the Anti-Base Erosion Proposals. The OECD should clarify whether in its view such relief would be available, at least under the OECD's Model Convention.

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.*

TEI's important design considerations with respect to these two rules are: (i) to avoid a new layer of rules, if possible; (ii) ensure consistency across jurisdictions; (iii) simplicity of the rules; and (iv) to avoid double, triple or quadruple taxation resulting from multiple inclusions when the corporate legal structure has several tiers. With respect to the last design consideration, in accordance with Action 4 of the BEPS project (Interest Deductions and Other Financial Payments) many countries are already imposing an interest expense limitation of 30 percent of earnings before interest, taxes, depreciation and amortization (EBITDA). The 30 percent limitation is often accompanied by a limited ability to carry forward unused interest expense before it is permanently lost. While this type of limitation may not directly address the concerns of user/market jurisdictions regarding the inability to tax income sourced

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there, it does raise the overall effective tax rates of multinationals and thus addresses base erosion concerns under Pillar II.

More broadly, TEI recommends the OECD implement clear and straightforward entity ownership thresholds for inclusion in a multinational group that are relatively high. In TEI's view, entities should only be included in a group for purposes of these proposals if (i) a group owns more than 50 percent of an entity, or (ii) if an entity's earnings constitute greater than 10 percent of the group's total income and the group owns more than 25 percent of the entity. Lower ownership thresholds would present problems in obtaining the necessary information from the entity to apply the proposals.

Determining whether an entity's income is subject to a "low" effective tax rate is a more difficult question. In theory, if a multi-year rolling average effective tax rate of a foreign subsidiary was lower than a certain percentage of the subsidiary's parent's statutory rate, then the income of the subsidiary could be said to be subject to a "low" effective rate. However, such a test would ignore the ability of a subsidiary to carryover losses from prior years (or carryback losses from later years) or the progressive nature of the corporate tax rate in the subsidiary's jurisdiction. Moreover, such an approach would not account for the subsidiary's income qualifying for various BEPS-compliant incentive schemes, such as a patent box or research and development credit. TEI urges the OECD to adopt a principled approach in this regard rather than a simple formula that may be both over and under inclusive.

TEI also recommends that when determining whether a multinational group's foreign income is subject to a "low" effective tax rate that this calculation be done on a worldwide basis, rather than on a country-by-country basis. A country-by-country approach would impose substantial complexity, require agreement on expense allocation rules, and put substantial pressure on transfer pricing between foreign affiliates, whereas a worldwide average rate approach avoids most of those problems and would be easier for tax authorities to administer.

The Consultation Document also states "[t]he subject to tax rule could make corresponding adjustments in one contracting state dependent on effective taxation by the state making the primary adjustment under Article 9."[23] This would be a dramatic change in domestic tax enforcement by conditioning corresponding adjustments in one state upon whether the primary state adjustment meets a certain effective tax threshold. In general, assessments are raised by domestic tax authorities when taxpayers do not comply with domestic tax law and are not dependent on the primary adjustment made in some other state. TEI recommends that this suggestion be removed from the final 2020 report.

A clear definition of what constitutes a base eroding payment is necessary and should focus on the areas of concern around payments for intangibles and financing while ensuring that bona fide business expenses/payments are excluded from the rules. The U.S. BEAT regime address this point in part by excluding amounts included in cost of goods sold (COGS). However, this still leaves a significant amount of bona fide business expenses subject to the U.S. BEAT, such as shipping costs that generally

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23 Consultation Document at 28.

fall outside of COGS. For example, for trading businesses that hedge pricing exposure through the use of derivatives, the tax treatment applied to the profit and loss arising from the derivatives should be treated the same as that arising from the associated physical transactions as each is an ordinary cost of conducting business and not motivated by base erosion concerns.

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

TEI recommends limiting income inclusion to abusive situations, *i.e.*, where there is no substance to the payee and the main objective is to obtain a tax benefit, where the arrangement is wholly artificial, and where the relationship is with non-cooperative jurisdictions or the structure is a harmful tax practice identified under BEPS Action 5.

In addition, payments should not be within the scope of both the income inclusion rule and the tax on base eroding payments, which is the case with the U.S. GILTI and BEAT regimes (i.e., under the U.S. regimes, a payment can both be subject to the BEAT of the payor and be considered GILTI of the payee).

See also our answer to Question 2. above regarding thresholds.

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

Applying the rules on a payment by payment basis would be too onerous in cases where there are a substantial number of transactions. Detailed information on a per payment basis is not always readily available, especially in cases where a group owns less than 50 percent of an entity.

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

See our responses to questions 1-4 above.

111. In their responses commentators are invited to draw on experiences from the operation and design of existing rules that they consider would be helpful for this discussion.

See TEI's comments in response to Question 1. above regarding the U.S. GILTI and BEAT regimes.

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TEI appreciates the opportunity to comment on the Consultation Document regarding the tax challenges of the digitalization of the economy. As noted above, TEI requests the opportunity to speak in support of these comments at the public consultation to be held on 13-14 March 2019 in Paris.

TEI's comments were prepared under the aegis of its European Direct Tax Committee, whose chair is Giles Parsons. Should you have any questions about the submission, please contact Mr. Parsons at +44 793 921 5554 or gilesparsons55@gmail.com, or Benjamin R. Shreck of TEI's legal staff at +1 202.464.8353 or bshreck@tei.org.

Sincerely yours,
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