

March 6, 2019

## Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy released February 13, 2019

### Executive Summary

1. We are writing in response to the request of the Centre for Tax Policy and Administration of the OECD for comments on the February 13, 2019 Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy (the “2019 Public Consultation Document”). Our comments are principally directed to the impact of the proposals on the international tax framework, including fundamental changes to the existing profit allocation (transfer pricing) and nexus (permanent establishment) rules.
2. The 2019 Public Consultation Document was released under the mandate of studying the tax challenges of the digitalisation of the economy. While there are separate proposals for taxing the digital economy in the 2019 Public Consultation Document, the document also includes proposals to curb continued profit shifting to entities subject to no or very low taxation through an income inclusion rule and a tax on eroding payments. These additional proposals are described in the 2019 Public Consultation Document as addressing unresolved base erosion and profit shifting (“BEPS”) issues.
3. This public consultation follows nearly two years of work by the Task Force on the Digital Economy (“TFDE”). The OECD initially only provided a 17 day window for stakeholders to submit comments before the upcoming public consultation scheduled for March 13-14, 2019 in Paris. This deadline was extended to March 6, 2019, providing only a three-week period to comment on proposals that could radically overhaul the existing international taxation system, pending the development of a consensus view. By incorporating proposals addressing unresolved BEPS issues under the banner of digitalisation, and providing a relatively short timeline to comment, the OECD has effectively hamstrung the process, potentially pushing through major proposals without meaningful public consultation.
4. We are also providing comments on a number of practical issues that will arise under the proposals for taxing the digital economy in the 2019 Public Consultation Document. The OECD should not move forward with the proposals without addressing these issues, providing clear guidance and examples along with meaningful opportunities for public consultation to ensure that there are no anomalous results. In order for the proposals in the 2019 Public Consultation Document to work effectively, countries must, as a minimum standard, agree to (i) abandon any unilateral measures targeting similar activities that may have been adopted prior to adopting a

consensus approach, and (ii) share losses (either prospectively or retrospectively) resulting from similar activities. The OECD should ensure that countries take into account aggregate taxation levels (including taxes arising under the proposals and all other forms of taxation including VAT and other indirect taxes) when assessing the negative impact that the proposals will have on investment and the economy. In addition, countries should not be allowed to cherry pick when extending their nexus to tax digital activities – and must provide relief for resulting losses (including start-up losses) rather than simply taxing resulting income.

## Background to the 2019 Public Consultation Document

5. The background to the 2019 Public Consultation Document makes it clear that the OECD has taken a step towards advocating for a global minimum tax in a discussion draft on the digitalisation of the economy. Digitalisation has been at the centre of OECD discussions about international tax and the curtailment of tax planning strategies that artificially shift profits to low or no-tax jurisdictions where there is little or no economic activity. The final package of BEPS measures included Action 1 Addressing the Tax Challenges of the Digital Economy. The Report on Action 1 acknowledged that it would be difficult, if not impossible, to “ring-fence” the digital economy from the rest of the economy for tax purposes, further concluding that digitalisation presents no unique BEPS issues, but that some highly digitalised business models exacerbate BEPS concerns.
6. The OECD has remained committed to studying digitalisation following the final package of BEPS measures and the TFDE has been tasked with studying the tax challenges of the digitalisation of the economy, with a final report due on the topic in 2020. The OECD is seeking a longer-term solution, pending the development of a consensus view. However, there remains no generally accepted solution and countries have started to implement unilateral measures to address their own concerns. There is a real need to develop consensus in this area given the patchwork of unilateral measures currently in place. Such unilateral measures include proposed measures for taxing the digital economy as well as measures to address unresolved BEPS concerns, including the United Kingdom’s Diverted Profits Tax and the GILTI (Global Intangible Low-taxed Income) and BEAT (Base Erosion and Anti-Abuse Tax) regimes in the United States.
7. The TFDE delivered an Interim Report on the Tax Challenges Arising from Digitalisation on March 16, 2018 and signalled that the OECD was looking at two key aspects of the existing international tax framework in the context of the digital economy – the profit allocation (transfer pricing) and nexus (permanent establishment) rules. The January 29, 2019 Policy Note approved by the 127 members of the OECD Inclusive Framework on BEPS noted that the proposals would go beyond the arm’s length principle and would expand taxing rights in the source jurisdiction where there is no physical presence. Notwithstanding the progress made through the final BEPS measures, the OECD acknowledges that there are unresolved BEPS concerns.
8. The Policy Note also indicated that this work would be expanded to two “pillars” that will form the basis of the final year of the OECD’s work in this area:
  - (a) taxing the digital economy, focussing on the allocation of taxing rights among countries through one or more of three separate proposals – user participation, marketing intangibles and significant economic presence; and
  - (b) unresolved BEPS issues, including an income inclusion rule including consideration of global minimum rates and a tax on eroding payments (i.e., a backup deduction denial rule).
9. The proposals in the 2019 Public Consultation Document regarding the first pillar, taxing the digital economy, are set out in section 2 of the document. The trend is towards allocating taxing rights to the source jurisdiction based on the principle of aligning profits with underlying economic activities and value creation. There are three separate proposals in this regard:

- (a) The “user contribution” proposal, which would require revisions to the existing profit allocation and nexus rules based on active user participation. This proposal focuses on the value created by highly digitalised businesses through developing an active and engaged user base and would only target social media platforms, search engines and businesses operating in the gig economy.
- (b) The “marketing intangibles” proposal, which allocates intangibles to market jurisdictions, together with a proportionate share of income. This proposal would require changes to the existing nexus rules that would go beyond the requirement of having a physical presence in the jurisdiction. This proposal would also have a broader scope of application than the user participation model discussed above and would target all industries and not only highly digitalised business models.
- (c) “Significant economic presence”, which we understand to establish a taxable presence or a virtual permanent establishment where revenues are generated in a jurisdiction combined with other factors such as a large user base and billing and collection in local currency, among others. The significant economic presence proposal is premised on the idea that the existing international tax framework is not fit for purpose.

### **Practical Issues with User Contribution, Marketing Intangibles and Significant Economic Presence Proposals**

10. There are a number of practical issues arising in respect of the three proposals in the 2019 Public Consultation Document for taxing the digital economy. The following list is not exhaustive, but gives an indication of some of the additional work that must be done in this area to achieve certainty, predictability and fairness in the international tax framework going forward:

- The proposals refer to a “significant”, “active” and “engaged” user base without defining what those terms mean. Each of these terms should be clearly defined and objectively identifiable across businesses and industries.
- Will countries agree to reallocate taxing rights retroactively if the user base is subsequently determined to have been inaccurate (such as due to the use of bots and/or duplicate or fictitious user accounts)? Similarly, will countries agree to reallocate taxing rights retroactively if the MNE group’s revenues are subsequently adjusted?
- The user contribution proposal only applies to business models that benefit from an active participatory user base, and there is no change for businesses that have more traditional customer relationships. The OECD should ensure that these thresholds are well understood and clearly defined.
- The proposals do not appear to acknowledge the fact that data from one user could be far more valuable than data from another (e.g., one user may be significantly more active and engaged than another). This is jointly relevant to the user contribution proposal and the significant economic presence proposal as a large user base is one of the secondary factors suggested, in addition to revenue, for determining whether a significant economic presence exists.
- The OECD should consider how the sale of user data to third parties could impact the valuation of user data under both the user contribution proposal and the significant economic presence proposal.
- How does the OECD propose to address virtual private networks, which could disguise the location of a user in a jurisdiction? How should taxing rights be allocated for digital services provided on mobile devices that are used in multiple jurisdictions?

- The OECD should ensure that “routine” and “non-routine” activities are well understood and clearly defined for both the user contribution proposal and the marketing intangibles proposal, as this is the taxing threshold for allocating residual profits under both proposals.
- The OECD should clearly define the “intrinsic functional link” and “substantial contribution” threshold for the marketing intangibles proposal.
- The 2019 Public Consultation Document suggests that certain industries could be excluded, or size or profitability thresholds could be set, for the marketing intangibles proposal, without providing a reason for such exclusions or thresholds if the “value creation” thresholds are otherwise met.
- The proposals suggest that taxing rights may be allocated on an MNE group basis, rather than on the basis of separate legal entities. Detailed rules will be required to (i) define the scope of the MNE group – including across multiple jurisdictions and taking into account multiple forms of entities and joint ventures, (ii) address the tax consequences arising where the MNE group changes – including through acquisitions, divestitures and spin-offs, or arising from sales or dispositions of assets (iii) address differences in taxation periods between MNE group members (including across multiple jurisdictions), (iv) address intra-group compensation payments for the use of losses or taxes paid by one member of an MNE group that are economically attributable to another, (v) address the impact of currency fluctuations, (vi) address the manner in which revenues are to be calculated across jurisdictions (including with respect to both timing and quantum), (vii) eliminate the double counting that could otherwise arise through intra-group revenue or resales, and (viii) address the circumstances and consequences that may arise if the manner in which revenue is computed is revised (such as may occur when relevant accounting rules change) – and ensure that countries accept a common method of computing revenue without ceding their rights to compute tax liabilities to an accounting body or other third party.
- The OECD should clarify whether the proposals are intended to be applied for federal, state and local income tax purposes, or whether their intention is to force companies to allocate income for federal income tax purposes under the proposals while simultaneously being required to compute income under traditional principles (including through the use of the arm’s length standard and permanent establishment concepts applied on a legal entity basis) for all relevant state and local tax purposes – which would obviously compound the resulting complexity and inevitable disputes exponentially.

## **The OECD Must Facilitate Meaningful Public Consultation for Fundamental Changes to International Tax Framework**

11. The proposals in the 2019 Public Consultation Document would fundamentally change the international tax framework. The three separate proposals for taxing the digital economy all require fundamental changes to the existing transfer pricing rules (which are based on the arm’s length principle) and the long-standing permanent establishment threshold for determining the allocation of taxing rights between source and residence states. The proposals trend toward strengthening taxing rights in market jurisdictions where goods and services (digital or otherwise) are being consumed and away from jurisdictions where multinational enterprises are headquartered. For such fundamental changes to the international tax framework, broad and meaningful public consultation is critical.
12. Moreover, the proposals in the 2019 Public Consultation Document are not restricted to considerations of digitalisation. The OECD also introduced two interrelated rules, namely an income inclusion rule and a tax on base eroding payments, to address unresolved BEPS issues, which appear to risk infringing the sovereignty of jurisdictions to set their own tax rates. The significance of these changes, which would consist of introducing what is effectively a global minimum tax rate, cannot be understated. The OECD should be more upfront with stakeholders about the alleged deficiencies in the arm’s length principle and the existing permanent establishment rules. In our view, the OECD should provide meaningful opportunities for public consultation and should not proceed with such significant revisions without a strong consensus from a clear majority of stakeholders, as well as specific proposals to prevent or resolve resulting tax disputes.

13. The inclusion of the OECD's work on unresolved BEPS issues under the banner of digitalisation, with only a three-week comment period, is wholly inappropriate when the OECD has acknowledged that the answer to multinational enterprises paying their fair share is not implementing a digital tax. Pascal Saint-Amans, director of the OECD Centre for Tax Policy and Administration, linked the two pillars by stating, "In addition, the features of the digitalised economy exacerbate risks, enabling structures that shift profits to entities that escape taxation or are taxed at only very low rates" further indicating "We are now exploring this issue and possible solutions".

### **Importance of Mandatory Binding Arbitration**

14. We were comforted to see numerous references to dispute resolution in the 2019 Public Consultation Document. We understand that members of the Inclusive Framework are committed to ensuring that new rules do not result in taxation where there is no economic activity nor instances of double taxation, and the OECD appears to have listened to concerns and past comments on the importance of dispute resolution in this regard. However, if the proposals were to move forward, much more work would need to be done to assist in preventing instances of double taxation, particularly due to the possibility of retaining the arm's length principle and established permanent establishment thresholds for some (but not all) purposes. The trend in the proposals towards strengthening taxing rights in the source jurisdiction means that the resident jurisdiction where a multinational enterprise is headquartered would need to provide relief from double taxation. In our view, this would be best achieved through mandatory binding arbitration.
15. While the Report on Action 14 Dispute Resolution readily admits the OECD's failure to achieve consensus on binding arbitration, and not all countries have signed on to mandatory binding arbitration in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, the OECD should commit to binding arbitration if it proceeds with overhauling the international tax system. Binding arbitration provides a cost-effective alternative to litigation for the resolution of most disputes in a timely manner. And even more importantly, the mere existence of that remedy has been hugely effective in making the Mutual Agreement Procedure more successful.

### **Residual Profit Allocation for User Participation and Marketing Intangibles Proposal**

16. The first two proposals for taxing the digital economy contain a mechanism to allocate residual profit after the application of the arm's length principle based on the concepts of "user participation" and "marketing intangibles". Both proposals contemplate applying the arm's length principle to what is described as "routine activities" such that the residual profit would be attributable to "non-routine activities". If a consensus view emerges in support of either approach, the OECD should ensure that "routine" and "non-routine" activities are well understood and clearly defined and ambiguity in their application should be resolved in favour of taxpayers and not revenue authorities.
17. The OECD should carefully study the interaction between the arm's length principle and the proposal to allocate residual profit based on economic activities and value creation. In our view, embedding tax avoidance principles into transfer pricing or otherwise layering them on top of the existing profit allocation rules will conflate the arm's length principle (which is cited in the Commentary to both the OECD and United Nations Model Tax Conventions) and anti-avoidance, and will further undermine reliance by courts and others on the OECD Transfer Pricing Guidelines.
18. The 2019 Public Consultation Document focuses on allocating residual profit. The marketing intangibles proposal is the only alternative that explicitly recognizes sharing losses. In our view, if some kind of formulaic apportionment is going to apply, countries should agree in advance to adopt a similar formulaic sharing of losses. If a country is willing to forego established international tax norms with a view to taxing additional profits, it must also be willing to share in the burden of any resulting losses, particularly those which may arise in the early stages of business development. By way of an example, consider the case of an enterprise that incurs all initial start-up costs in the United States and, over time, expands into different markets. The enterprise would

ultimately recognize revenues in those additional markets, but, at the time that losses were incurred, was not operating in the user or market jurisdictions. This underscores the importance of sharing losses prospectively as well as retrospectively.

19. In addition, while formulary apportionment is used domestically within certain countries, like Canada, to allocate profit to local taxing jurisdictions, it has not been used on a broad international scale. Examining how formulary apportionment is used domestically identifies certain practical, administrative and compliance issues for the OECD to consider. In Canada, a single currency is used. There are also similar tax systems between provinces, generally confirming to a common tax base. The OECD should carefully study and provide a mechanism to address foreign exchange differences, possibly by adopting the currency and fiscal period used for purposes of determining the consolidated groups' financial results. The OECD should also consider how this proposed allocation would be administered when there is huge disparity in taxation systems and accounting standards globally.
20. Looking at the Canadian approach also sheds light on a gap or mismatch in the OECD proposals. Provincial taxes are payable in a Canadian province where the taxpayer carries on a business through a permanent establishment in that province. If a taxpayer maintains a permanent establishment in a particular province and one or more permanent establishments outside the province, its taxable income is allocated to the various permanent establishments according to the gross revenue and salaries and wages attributable to each province with a permanent establishment. In the 2019 Public Consultation Document, the OECD appears to only be looking at revenues and not the associated costs (e.g., salary and wages from the Canadian approach). In our view, while it may be appropriate to focus on revenue only for indirect tax purposes, allocations of income taxing rights should focus on both revenue and related costs (such as salary and wages).
21. We note that there is no discussion in the 2019 Public Consultation Document regarding VAT, sales tax or other indirect taxes. In the context of the proposals for taxing the digital economy, the OECD should have a cohesive framework that considers all forms of taxation and that takes steps to ensure that aggregate levels of taxation are not excessive. In particular, the OECD should acknowledge the adverse effects that uncertainty and taxation may have on the global economy, perhaps establishing maximum (rather than minimum) levels of taxation beyond which countries agree not to exceed. Moreover, the OECD could suggest that participating countries must agree to abandon the unilateral measures that they have implemented in response to the digital economy as a pre-condition to their participation in any new global standards.

## **Value Creation in the User and Market Jurisdiction**

22. The 2019 Public Consultation Document adopts the concept of “value creation” introduced in the Report on Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation and incorporated in the 2017 OECD Transfer Pricing Guidelines. More particularly, the three proposals in the 2019 Public Consultation Document for taxing the digital economy (i.e., user participation, marketing intangibles and significant economic presence) all stem from the principle of aligning profits with underlying economic activities and “value creation” across digitalised business models.
23. Our firm submitted comments on the concept of value creation in response to the July 3, 2018 Discussion Draft on Transfer Pricing Aspects of Financial Transactions (the “2018 Financial Transactions Discussion Draft”). The comments we made about “value creation” in that context apply equally to the proposals in the 2019 Public Consultation Document. Paragraphs 24-27 of this submission reproduce our comments on this topic from our September 6, 2018 letter.
24. The new “value creation” criterion, introduced in the 2015 BEPS revisions and incorporated in the 2017 Transfer Pricing Guidelines, is novel and vague, does not necessarily yield the same terms and conditions as those produced under the arm's length principle embodied in Article 9 of the OECD Model Tax Convention, and reflects a shift away from the simple premise that prices charged between non-arm's length parties should be priced the same as they would in a comparable transaction between two arm's length parties.

25. Despite implicit or explicit assumptions by the OECD that the concept of “value creation” accords with or is congruent with the arm’s length principle, “value creation” is a new test and it has no foundation in Article 9 of the OECD Model or the Commentary on Article 9. Nor was this purportedly now self-evident objective of transfer pricing rules mentioned in the 1995 or 2010 Transfer Pricing Guidelines. Yet it is now simply assumed to be the primary objective of transfer pricing. At a conference for the National Association for Business Economics Transfer Pricing Symposium, in response to comments that the Report on Actions 8-10 fail to uphold the arm’s length principle, Andrew Hickman, the then head of the OECD transfer pricing unit, acknowledged that the 2015 Revisions may not accord with the arm’s length principle, stating:

Perhaps [critics] will say we fudged it, but I would say that’s a pragmatic fudge [...] It may be that we haven’t got a pure version of the arm’s-length principle, but perhaps we’re looking for something that is just and equitable and might work.<sup>1</sup>

26. In addition, the concept of “value creation” has no jurisprudential or doctrinal history, at least in Canada. The adoption of such a novel concept without any legal foundation or well-defined meaning can only lead to more disputes and the potential for double taxation. To many observers, the introduction of this concept was simply a device to make the authorized OECD approach (“AOA”), now prescribed for the attribution of income to a permanent establishment under Article 7 of the OECD Model Convention, applicable for Article 9 purposes by focusing on significant people functions (i.e., decision making) and significantly diminishing the importance of the provision of capital, without regard to whether it is consistent with the arm’s length principle.
27. There is also no broad international consensus on what value creation means from a transfer pricing perspective.<sup>2</sup> Jonathan Schwarz, for example, has pointed out that value creation frequently appears in policy documents and new legal instruments as the justification for new international tax rules, but is nowhere explained.<sup>3</sup> Professor Herzfeld pointed out the following flaw in that regard:

In its July report to the G-20 on BEPS implementation, the OECD continued to emphasize value creation, noting that “a key component of ensuring that taxation is aligned with value creation is the ability to tax administrators to understand where Multinational Enterprises have their activities and where the revenues are generated.” But the report on actions 8-10 and the subsequent revisions to the transfer pricing guidelines all suffer from a major flaw: The OECD didn’t say what creates value, nor did it provide guidance for determining where revenues should be considered generated.<sup>4</sup>

As a result, there is no generally accepted legal meaning available to courts and revenue authorities to resolve future disputes.

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1 Ryan Finley, “OECD Took a Pragmatic Approach to Arm’s-Length Principle, Hickman Says” (22 July, 2016) Tax Analysts [emphasis added]. See also Professor Mindy Herzfeld, “Will the OECD’s ‘Pragmatic Fudge Save Transfer Pricing?’” (August 1, 2016) Tax Analysts.

2 Professor Herzfeld, “GDP, Transfer Pricing and Value Creation” (September 3, 2018) Tax Notes Int’l.

3 Jonathan Schwarz, “Value Creation: Old wine in new bottles or new wine in old bottles” (May 21, 2018) Kluwer International Tax Blog. Jonathan Schwarz questioned whether value creation is just a relabeling of the source principle (old wine new bottles) or something different (new wine in old bottles).

4 Professor Herzfeld, “Value Creation, Digital Users, and the History of Things” (August 20, 2018) Tax Notes Int’l.