COMMENTS RECEIVED ON PUBLIC DISCUSSION DRAFT

BEPS ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY

16 April 2014
Summary/Action

This note contains a compilation of the comments received with respect to the public discussion draft on BEPS Action 1 (Address the Tax Challenges of the Digital Economy).

An invitation for comments was published on the OECD Website on 24 March 2014, with a deadline of 14 April 2014.
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Dear Sirs,

On 24 March 2014, the OECD Center for Tax Policy released a *Discussion Draft on Action 1 (Tax Challenges of the Digital Economy) of the BEPS Action Plan*, for interested parties to provide written comments.

*A3F* is pleased to respond to the OECD's request for comments on this discussion draft.

**A3F** background

*A3F* (French Women Tax Experts Association - Association Française des Femmes Fiscalistes) was founded in 2005. *A3F* is a French-based network of professional women from diverse horizons representing most players of the French and international tax system (experienced tax executives and expert tax advisors from a wide range of French and foreign companies and law firms, University professors, etc). The ever changing and rapidly evolving corporate and individual tax policies in France and around the world are a major concern for businesses. *A3F* provides its members with opportunities to exchange ideas and best practices, and to contribute to the shaping of tax policy through participation in public debates. *A3F* currently counts 115 members (of which two thirds are business representatives), all with a recognized work experience.

The president of *A3F* is Ms Eva Memran, Tax Director for a large French MNC. Ms Memran can be reached at +33 6 77 76 90 76 or evamemran@gmail.com.

**Conclusion**

*A3F* appreciates this opportunity to provide its views on OECD Discussion Draft on Action 1 Tax Challenges of the Digital Economy of the BEPS Action Plan, (outlined in the following pages). These comments were prepared by an ad-hoc *A3F* working group chaired by Ms Odile Courjon (Tax Lawyer, VAT specialist) and Ms Laurence Delorme (Tax Lawyer, Transfer Pricing specialist). We will welcome an opportunity to participate in the subsequent public consultations and related discussions.

Respectfully submitted,

For *Association Française des Femmes Fiscalistes*
1. KEY MESSAGES

- **A3F** fully supports the work done by OECD to address the tax challenges of the digital economy under Action 1 of the OECD. **A3F** main concern is that the evolution of Information and Communication Technology, although contributing to the rapid development of digital economy, may also cause some unfair competition between key players of the digital economy and others (be it with regard to collection of VAT from end-consumer or with regard to payment of corporate income tax on business profits).

- **Definition of the digital economy**: it could be necessary to have a broad definition of the digital economy in the DD: lots of businesses do confuse e-commerce and digital economy, and the digital economy itself also has evolved.

Although this is mentioned here and there in the DD report, we believe, it is of critical importance that concepts be defined. As an example:

- Under OECD definitions, e-commerce covers “the sale and purchase of goods and services, conducted over computer networks [...]” (cf Para 61 of the DD).
- Under EU standards for VAT/customs purposes, the e-commerce rules only cover B to C supplies of telecom, broadcasting and electronic services (from non-EU vendors, and also from EU vendors as from January 1, 2015). But B to C sales of goods remain regulated by the distance selling rules when made within the EU or by the low value import scheme, which are all rules resulting from the single market of 1993.

We understand that the DD report covers both goods and services, potentially both in B to B and B to C transactions (and also eventually C to C transactions), but always in a dematerialized order processing and through an internet transaction.

**For the sake of clarity and understanding, we believe this is should be outlined in a clearer way because we see lots of confusion around those concepts.**

- Work on corporate tax aspects of the digital economy cannot be treated in isolation of work on CFC rules. BEPS Action 3 "Strengthen CFC rules" aims at providing some "recommendations regarding the design of domestic [CFC] rules" which are due by September 2015. **Fixing well-known holes in specific country’s local CFC regulations would resolve the perceived issue with international tax and digital economy much better than adding new measures specific to the digital economy, at the risk of increasing uncertainty and risk of double taxation for businesses.**
• We are not in favor of introducing new characterization of income specific to digital economy for the purpose of withholding income tax in the source country. Independently of the difficulty in setting a proper and precise definition of such income, it would in practice translate into tax being withheld by the source country on a basis equal to consumer sales by a foreign MNE in such source country - such basis would have no bearing with that share of business profits possibly attributable under Treaty to the source country (contrary to interest or royalties). The corresponding tax withheld at source (irrespective of total business profits generated by MNE) would therefore most likely be hard to credit in the residence country, leading to double taxation for businesses. Article 5 of OECD Model Convention (and related commentaries) could be reviewed and updated in order to take into account the evolution of the economy and business models of MNEs, especially (but not only) with regard to the impact of the digital economy, as analysed in the DD. We also recommend reviewing the list of exceptions to Permanent Establishment in particular, so as to avoid/limit cases where a substantial share of an MNE’s activity is carried out in a foreign country through direct (internet) sales to customers, but with no reported tax presence (e.g. no subsidiary or branch) in the said foreign country. The PE definition could possibly be reviewed by introducing some materiality threshold based on the level of business of an MNE in a foreign country in which it has no reported corporate tax presence (subsidiary or branch). As an example, if more than x% of consolidated sales of an MNE headquartered in country A is realized in a foreign country B, and subject to meeting other criteria as per (revised) Article 5 of the OECD Model Convention, the MNE headquartered in country A could be deemed to have a permanent establishment in country B. This would form the starting point of the analysis, based on facts (e.g. actual substance of functions, assets and risks located in country B), as to whether such MNE effectively operates a PE subject to corporate tax in country B (based on Article 5 of OECD MC), and if so, which amount of business profits should be attributed to such PE.

• As to VAT, the n°1 issue lies with the location of a non-resident vendor (or supplier) in a B to C transaction. Failure for the non-resident vendors to VAT register creates harmful an unintended competition to bona fide taxpayers. We believe that the OECD should have a firm political commitment for a “civic tax attitude” by all digital players: this is a quest in favor of a fair tax concept.
2. COMMENTS ON SPECIFIC ISSUES AND QUESTIONS HIGHLIGHTED IN DD

Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules;

- We believe that is not appropriate trying to ring-fence the digital economy from the rest of the economy for the purpose of defining specific corporate income tax rules, nor should specific types of digital transactions be identified and addressed through specific corporate tax rules. It is however necessary to review and update Article 5 (and related commentaries) of the OECD Model Convention.

  The initial digital players, which are all mainly US multinationals with a very specific business model (made extremely effective through favorable US CFC rules allowing them to retain untaxed foreign profits in low-tax jurisdictions without being subject to US tax) now share the digital model with the traditional economy which is now converting itself to digital processing and offerings.

- Specific types of digital transactions (or forms of payment by the end-consumer) could possibly be identified and addressed through specific rules when they create specific issues with collection of indirect tax from the end-consumer and offer possibilities of unfair competition for non-resident Vendors (see below).

The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account;

We believe the identification of opportunities for BEPS in the digital economy (para 119 et sq) has mainly focused on the traditional GAFA scenarios. For other players, it has relied on a simplistic scenario of a non-resident company interacting with customers in a remote country (cf Para 123). Although this direct B to C transaction is a given, it is far from true to represent the actual digital world.

In practice, the digital economy entails complex structures with many intermediaries: very often, a content owner, a data provider, an integrator, and App-store, a mobile operator, a bank collecting the cash, a web-portal operator, just to name a few.

The DD report currently addresses none of these scenarios where intermediaries are involved. We believe the DD report should address the case of these intermediaries and should determine to what extent they are deemed to intervene in the digital transaction. Because failing to do that, any non-resident vendor could easily “hide behind” one of those intermediaries which would hold the BEPS actions ineffective but also which would cause harmful and unfair competition to other bona fide players in the local market.

The EU has set forth presumptions to help operators determine which entity is deemed engaged in the digital transaction vis-à-vis the end-customer (B to C) or not. This piece of work has not been reflected in
the OECD DD report. We believe it should be taken into consideration. Indeed, this is a matter of legal security for the businesses to understand what entity is deemed engaged in the B to C digital transaction and thus becomes liable to all the BEPS consequences (direct and indirect tax).

The examples of new business models in the digital economy and whether (and if so which) other business models should be considered;

We wish to draw your attention on the fact that it is quite urgent to deal with non-resident Vendors (suppliers) which fail to register (for VAT purposes) in the country of their customers’ residence. Particularly, we believe that this results from:

(i) yet legal but unfair practices which create harmful competition to bona fide traders;

(ii) the increase of fraud schemes, both on import VAT and customs duties: indeed, many operators create an activity, develop sales and then disappear after a few months and then recreate the same activity under a new name or brand. This raises the issue of registration thresholds, should they be very high or instead very low

The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy;

In our view, the main opportunity for BEPS with respect to VAT lies with the location of a non-resident Vendor (or supplier) in a B to C transaction: as a particular illustration in the EU, which has implemented a declaring platform for B to C transactions for non-EU vendors, it appears that only very few of the existing non-EU suppliers have effectively registered on this platform and declared their VAT accordingly on sales to EU consumers (less than 1000 non-EU companies in the world have spontaneously registered on the EU portal). This is “THE” major concern of BEPS in a VAT environment.

Of course, the main ones (GAFA and others) have registered further to previous OECD reports, the political pressure and their marketing image. But many others, less big, less equipped, less organized, but also less diligent fail to register. These small ones of today may be the big players of tomorrow!

Failure to register by the non-resident suppliers invalidates the VAT collection mechanism and creates harmful and unintended VAT competition.

Only the OECD can address that issue because of its eminence and its International role. Regional platforms (like the EU one) can only provide technical rules and business friendly tools. But they have no impediment to force non-resident vendors to register otherwise than voluntarily.

Therefore, we strongly believe that the OECD should voice out very loud this political commitment: it is a matter of “civic tax attitude”: we could call it as participating to a “fair tax concept”. We believe only OECD can and should take this on-board.
In our view, this issue should be presented as the N°1 source of Digital BEPS with respect to VAT, which should be addressed under the BEPs action plan as it creates unfair competition in addition to loss of tax revenues for governments.

Paragraphs 136 and 170 address BEPS VAT issues for the exempt sector: but this is a sectorial business issue. In our view, this is NOT the N°1 issue for the Digital economy in a BEPS environment: this is rather an “abuse of law” scheme on some B to B practices implemented by some banks. This is already dealt with by the OECD B to B VAT/GST Guidelines. Moreover, the described scheme is quite old, has circulated a lot in a non-digital business transactions environment: it is not specific to digital business although it can be accelerated in a digital business context. Therefore, this should not come as the first opportunity for Digital BEPS in the VAT area.

Most of the MNEs tend to be 100 % VAT payers so that VAT is not their major tax concern: rather, transfer pricing and corporate tax basis and liability are their concern with regard to their international operations. VAT is due along the recharged invoices: VAT cascades down the value chain of services, with no final impact for businesses (other than cash). This issue, although important comes after the non-resident vendor issue described above.

Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones;

VAT measures

Distance selling should be included in paragraphs 220 and 221 pretty much as the low value imports scheme (just like also in sub paragraph 189); indeed, it may happen that some countries have set a customs Union or have no customs due because of free trade agreements in place where goods are basically no longer subject to customs duties. Still the VAT/GST scenarios need be addressed as a result of the “on-line shopping” habits from consumers in a cross-border transaction. Most of the import value scheme addresses the customers as being the importer of records, rather than the supplier. Thus, it is important that the distance selling is also mentioned together with the import of low value goods.

Any facilitation set up for the import of low value goods should also apply to distance selling with the same VAT territory.

The existence of VAT number, the access to centralized electronic clearances, or access to electronic platforms (for direct or indirect tax) should not create Virtual Permanent establishment issues.

Corporate Income Tax

Regarding corporate income tax, the key issue is effectiveness of CFC rules preventing accumulation by MNEs of foreign business profits never subject to tax. This is not specific to digital economy, although the major players (GAFAM - which are all US corporations) have focused the debate on digital economy over the recent years. But as the whole traditional economy is now converting itself to digital processing and offerings, the BEPS issue with regard to corporate income tax is more global.

Setting-up a special corporate income tax for digital economy only is not a good option, since it would generate the risk of double taxation for business.
The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation;

On paragraph 224, OECD should propose specific enforcement agreements and dispute resolution mechanisms (bilateral or multilateral) to cover also VAT. Those could be clauses to be included in existing tax treaties or in newly negotiated ones. Businesses often suffer from the double taxation on VAT, resulting from mismatches of qualification by the authorities or from diverging interpretations by the authorities. Indeed the likelihood that "Virtual PE" (if retained further to BEPS actions, or if assessed by tax authorities) will end up with VAT collection reassessments is quite high.

The options to address these broader tax challenges discussed by the Task Force and summarized in the discussion draft;

The draft report suggests various options to fight against the VAT and customs harmful competition from non-resident vendors/suppliers. We believe this is a good ultimate goal.

But amongst the various options proposed, the creation of a digital withholding tax (VAT) by intermediaries in charge of digital payments (para 218, Creation of a withholding tax on digital transactions), seems the most suitable solution, due to its simplicity.

Please note however that the EU has not chosen that route as banks are explicitly considered NOT as an intermediary engaged in a digital transaction (and therefore never liable for VAT on it).

The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives;

It is quite critical that any proposed compliance tool be on electronic format, secured and business friendly, including for small and medium sized business organizations.

Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented

Yes.
14 April 2014

By email to: CTP.BEPS@oecd.org

Dear Sir,

Discussion draft on addressing the tax challenges of the digital economy

AFME\(^1\) and the BBA\(^2\) welcome the opportunity to respond to the OECD’s discussion draft entitled “BEPS Action 1: Address the tax challenges of the digital economy” published on 24 March 2014 (the discussion draft). We wish to make clear that while AFME and the BBA have separate and distinct memberships, for the purposes of the OECD discussion draft, both organisations have decided to submit a single, combined response since our respective members share some concerns with the OECD’s proposals in the discussion draft.

We welcome that the OECD is consulting with business on its proposals. We believe that this approach is to the benefit of both policymakers and business and helps to avoid any unintended consequences arising from the OECD’s initial proposals. We believe that it is also valuable for the OECD to take account of the views of business on the practical aspects of operating the intended policy.

Given the relatively short time available it has been hard to consider all aspects of the discussion draft and we are therefore providing a few comments on the most important

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\(^1\) The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

\(^2\) The British Bankers’ Association (BBA) is the leading association for the UK banking and financial services sector, speaking for 180 banking members, headquartered in 50 jurisdictions and operating in over 180 territories worldwide jurisdictions, on the full range of UK or international banking issues. Collectively providing the full range of services, our member banks make up the world’s largest international banking centre.
issues of concern to us. We may write to you again with further comments once we have had a chance to consider the proposals in greater detail.

**General comments**

We welcome the statement that there should not be a separate tax regime for the digital economy and the recognition that businesses are generally part of both the digital and “more traditional” economies. While this is equally true for the banking and financial sector, it should be noted that the regulatory environment for the provision of services applies regardless of how the service is delivered.

We note that the discussion draft appears to consider aspects of the international tax system which were not previously understood to be within the scope of Action 1 of the OECD’s Action Plan on BEPS (the *Action Plan*). We would observe that any recommendations under Action 1 of the Action Plan should not prejudice discussions still to take place within the BEPS framework and we would urge the OECD to ensure co-ordination between the different work streams.

Digital services are a significant source of economic activity across all economies and we would urge the OECD to ensure that any recommendations to the resolve some of the tax challenges for the digital economy do not disproportionately limit the potential for future growth.

**Permanent Establishment**

Paragraphs 211 to 217 of the discussion draft propose a new nexus for the establishment of a permanent establishment (PE) based on there being a “significant digital presence” for an enterprise engaged in “fully dematerialised digital activity”. We do not think that it is appropriate for there to be a different threshold for the establishment of a PE for goods and services sold digitally rather than by any other method. We note the extensive legal and regulatory environment which already governs the activities which may be undertaken by banks and financial institutions in any jurisdiction and where activities are taxed. We do not believe that this should be altered by an additional rule relating specifically to cross-border digital supplies.

We note that when a supplier registers for VAT/GST purposes in the country of consumption and does not hold any human or technical resources in that country, the VAT/GST registration serves a collection purpose only and should not constitute a PE in the country. Whether an establishment is seen as a provider or recipient for VAT purposes will be governed by implementing regulations. We urge that this be made clear and that the obligation to account for VAT is not seen to amount to the creation of a PE for other purposes.
Digital transactions

Paragraph 218 of the discussion draft suggests the creation of a withholding tax on digital transactions. Furthermore, paragraph 218 suggests that since international payments for digital economy transactions are generally made using credit cards or electronic payments an option to be considered would be to require withholding by the financial institutions involved with those payments. We are concerned that such a proposal would be impractical for financial institutions as they will not be able to analyse easily which payments are for digital supplies. Such a proposal is of particular concern for the financial services sector which already has already invested heavily to meet the onerous information reporting obligations imposed by FATCA, and will need to do so again to fulfil its obligations under the OECD model Common Reporting Standard.

Supply of digital services

In relation to the concerns set out at paragraphs 137 to 139 of the discussion draft regarding remote digital supplies to exempt businesses, we note that the concerns are not specific to supplies of digital services. For example, whilst paragraph 138 refers to the acquisition of data processing services by an exempt business, we note that the same concern would arise from the supply of any cross-border service, digital or otherwise. Furthermore, we note that the concerns set out in paragraphs 137 to 139 are not the result of supplies to exempt businesses, but rather they arise from the lack of a uniform international tax collection mechanism.

Paragraph 136 of the discussion draft states that “to the extent that guidelines 2 and 4 of the OECD’s “Guidelines on place of taxation for B2B supplies of services and intangibles” are not implemented, under certain conditions opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT may arise with respect to (i) remote digital supplies to exempt businesses and (ii) remote digital supplies acquired by multi-location enterprises that are engaged in exempt activities.” We note that the work of WP9 on the International VAT/GST Guidelines is already addressing some of these issues and we recommend that governments should be encouraged to implement the proposed recommendations set out in guidelines 2 and 4 of the OECD’s “Guidelines on the place of taxation for B2B supplies of services and intangibles” rather than seeking alternative solutions.

Multi-location enterprise

In relation to the tax avoidance concerns set out in paragraphs 140 to 142 of the discussion draft regarding remote digital supplies to a multi-location enterprise (MLE), we note that the recharge method is a straightforward method – for both taxpayers and tax authorities - for ensuring the taxation of supplies in the place of consumption. We
would encourage the OECD to develop further its work on the use of the recharge method. We would also point out that it is unlikely that the main factor for a multinational bank – or indeed any MLE – structuring its cross-border business is the avoidance of VAT – as is suggested in paragraph 142 of the discussion draft.

We note that paragraph 140 of the discussion draft refers to an MLE which has establishments in different jurisdictions. We believe – and we should be grateful if any recommendations would make clear - that the intention is to refer only to branches – rather than subsidiaries - of MLEs.

**VAT administration**

With respect to the collection of VAT in the digital economy, the discussion draft – in paragraphs 190 to 201 - focuses on the exemption for imports of low-value goods and on remote digital services supplied B2C. In this context it is clear that the key question is how to ensure compliance, particularly by non-resident businesses, in a way that is easy and efficient for government and business so that the ends (revenue collected) justify the means (cost of collection). We note that two points are critical to resolving this question: (i) the implementation at a global level of consistent place of taxation rules, and, (ii) simplified VAT registration and payment procedures in all countries, together with flexible proxies for identifying customer location. Again, we note that WP9 on the International VAT/GST Guidelines addresses a number of these issues, focusing on the destination principle whereby tax is levied in the place of consumption via means of the reverse charge mechanism (B2B) or via a local supplier registration (B2C). We think that it would also make sense for the OECD to examine and explore good practices which already exist in some jurisdictions. For example, the EU approach (both B2B and B2C) in respect of the forthcoming 2015 VAT changes on electronic, broadcasting and telecom services might serve as a useful framework for consideration.

We would be happy to discuss any of the above in greater detail with the OECD and would be pleased to contribute further as the OECD’s work develops.

Yours faithfully,

Richard Middleton                 Sarah Wulff-Cochrane
Managing Director Tax and Accounting Policy        Director Tax Policy
AFME                                       BBA
AmCham EU’s response to the OECD’s discussion draft on the Tax Challenges of the Digital Economy of the BEPS Action Plan

Executive summary

This document highlights the views of the American Chamber of Commerce (AmCham EU) on taxation of the digital economy and provides a response to the OECD’s discussion draft on Tax Challenges of the Digital Economy of the BEPS Action Plan. Last year, the G20 countries and the European Commission asked the OECD to tackle base erosion and profit sharing (BEPS). In July 2013, the OECD published its Action Plan on Base Erosion and Profit Shifting. The Action Plan identified 15 actions to address BEPS in a comprehensive manner and sets deadlines to implement these actions. Action 1 refers to tax challenges of the digital economy.

AmCham EU appreciates the opportunity to provide input to the public consultation and in this paper outlines the key issues it believes the OECD should consider in discussions on taxation of the digital economy. The response builds on the earlier AmCham EU’s position on tax challenges of the digital economy.

* * *

AmCham EU speaks for American companies committed to Europe on trade, investment and competitiveness issues. It aims to ensure a growth-orientated business and investment climate in Europe. AmCham EU facilitates the resolution of transatlantic issues that impact business and plays a role in creating better understanding of EU and US positions on business matters. Aggregate US investment in Europe totalled €2 trillion in 2013 and directly supports more than 4.3 million jobs in Europe.
General observations

The OECD is the best venue for discussions about international tax policy

Against the backdrop of debates on taxation policy in some EU Member States and the work of the EU Expert Group on Taxation of the Digital Economy, the need for a multilateral approach to changes in international tax-policy makes the OECD the best venue for coordinated discussions about taxation for multinational companies.

The OECD has a long track record as an effective venue for multilateral tax coordination, both in the development of its Model Tax Convention and in its more recent work targeting tax havens. The OECD’s work in this area is crucial to maintaining tax equilibrium both among OECD members and non-OECD countries that closely follow OECD developments. A proposal that might raise taxes in one country or region could give rise to unexpected and contentious shifts in other states' corporate tax revenue and also create concerns about double taxation. The goal of multilateral tax coordination is not to see one country gain revenue at the expense of another, but rather to ensure a consistent rules-based approach to taxation, creating certainty for companies operating across borders and predictable revenue streams for government budgets.

AmCham EU commends the efforts of the OECD to ensure a coordinated and coherent global approach to the taxation of multinational companies.

Broadly defined, all businesses in the global economy are digital in one way or another, so any sectoral approach to digital taxation would affect companies across the board

BEPS Action 1 addresses the tax challenges of the digital economy. But what defines the digital economy? What are the criteria that determine if a company is considered ‘digital’? Are all companies that adopt new technologies like the Internet, sophisticated software tools and data-driven business methods actually digital companies?

The OECD has found that digital technologies are enmeshed in all aspects of the economy, with firms across all sectors using the Internet, data analysis and other new technologies to redefine traditional business methods (see ‘Measuring the Internet Economy: A Contribution to the Research Agenda,’ 2013).

A closer look at specific sectors shows how pervasive digital tools have become, blurring the lines between different parts of the economy. The music, film and publishing industries, for example, have migrated to digital production and distribution methods. Newspapers transmit articles on the Internet, derive an increasing share of revenue from online advertising and use web-specific tools and formats to attract readers. Financial firms, including banks and insurers, use network technologies as the backbone of their businesses and to which the appropriate regulatory environment still applies. Credit card transactions, car insurance quotes and the trading of shares are conducted online or via sophisticated technology platforms. The pharmaceutical and medical sectors are also digital, using data analysis and advanced robots to create new chemical compounds, modelling their efficacy long before drug trials begin. Hospital networks store and share patient data electronically and use data analysis in areas such as tracking equipment and facilities to drive better patient care. The industrial sector also uses digital tools to gather and analyse data in order to improve the utilisation and
efficiency of equipment and manufacturing processes.

Even the parts of the economy that might seem unlikely to be described as ‘digital’ have been transformed by new network technologies. Mining, manufacturing and agriculture have become digital industries, using networked trading platforms to buy and sell commodities and finished goods in a global marketplace. Energy companies can now monitor and maintain their generators remotely in real time. Even the automotive sector has incorporated advanced technologies like global-positioning devices, Internet radio and computers that analyse and regulate performance and aid maintenance. These are not just add-on features. Car companies that have been in business for over a century are currently developing vehicles that can drive themselves, using sophisticated software, data analysis and real-time communication tools. These ‘computers on wheels’ show how new technologies are deeply integrated in all aspects of our economy.

There is an international consensus that the wider economy has transformed into a digital economy, adopting new technologies, new communication tools and new ways of analysing and employing data to create innovative business models and better business methods. As it becomes less and less possible to distinguish the digital economy from the larger economy, any sectoral approach to digital taxation would in fact affect companies across the board.

**Specific observations**

AmCham EU commends the OECD for proposing a principle of non-discrimination between economies, thereby acknowledging that the digital economy cannot be separated from the broader economy and that the BEPS concerns that arise in the digital economy must be addressed through overall BEPS Action Plan.

However, AmCham EU believes that some options proposed by the OECD draft report raise concerns that could hurt the economy itself or reflect a fundamental misunderstanding of the digitalised economy. These include:

- **A proposal that would identify a new taxable nexus based on ‘significant digital presence,’ which is based on the incorrect assumption that some businesses are conducted wholly digitally.** This runs contrary to one of the principal conclusions of the draft position, which states that the whole economy incorporates digital methods. Companies in all sectors still need people, assets and functions that will create some tax presence in many jurisdictions. In addition, such a narrow proposal would require a change in the attribution rules for companies across all the sectors of the economy.

- **A concept of imposing a taxable nexus based on the concept of a ‘virtual permanent establishment’ could in fact cause double-taxation for all digitalised firms** - as a firm would have, for the same activity, a permanent establishment and a virtual one located in another country. This could in turn raise conflicts of law between the current definition of permanent establishment and this new virtual one, and not satisfy some of the principles of the Ottawa Framework (such as efficiency, certainty and simplicity).

- **A proposal of introducing a new withholding tax on digital transactions collected by financial institutions involved in those payments stands in contrast to the conclusion of the report that the digital economy cannot be ring fenced.**
● The consumption tax challenges identified by the OECD must be addressed without introducing additional complexity or burdens on taxpayers.

In most consumption tax systems, businesses, as the collectors of Value Added Tax (VAT), are a key partner for governments. In light of this role, AmCham EU believes that the lack of an easy and efficient collection mechanism in B2C transactions leads to a distortion of competition for businesses and consumption tax shortfall for governments. AmCham EU shares the view of the OECD that the introduction of a simplified registration regime (such as the EU’s mini one-stop-shop framework), accompanied by registration thresholds, is probably the most viable option today as it would lead to taxation in the country of consumption while trying to mitigate the burden on businesses. This would require parallel work and continuous development of an international VAT/GST framework to ensure certainty and consistency in the VAT treatment of digital transactions, in particular uniform application of ‘place of taxation’ rules.

Finally, it is important to keep in mind that when a registration is required for businesses to participate in the collection of consumption taxes, such registration does not, by itself constitute permanent establishment in the country in which the consumption tax is due. Increasingly, the requirement to register for foreign VAT registrations is being used to derive corporate tax; in addition to the fact that it does not cohere with the international corporate income tax framework, such requirements create the potential for discrimination and could, if continued, undermine the efficient collection of consumption taxes.

● Proposals on taxation of data or the use of data to determine a taxable nexus that would stifle innovation and negatively affect the whole economy.

Some proposals on the taxation of the digital economy have focused on the value of data and have considered whether a ‘data tax’ would be desirable. Recent proposals assume that raw data has an intrinsic value while ignoring the longstanding use of customer data, for instance, in traditional industries.

The examples cited in the previous sections demonstrate the wide range of scenarios in which data is transferred across borders. None of the examples suggest that data has an intrinsic value – rather the value is created when data is transformed into information, knowledge and action; not where data is collected. Even if it were accepted that raw data has a value in and of itself, it is clear that this value cannot be determined with reference to the number of bits that storing or transmitting the data consumes – some raw data sources may be very large in size, but of very little value, whereas other data sources may be very smaller in size, but of significant value. Indeed, using software, the same data could be compressed into a smaller number of bits without diminishing its value. Equally, firms may not be able to, or simply may not benefit from, the possession of such data, so that no income is generated by it. Consequently, a ‘data tax’ would be inequitable and be highly subjective, undermining the faith in and relative predictability of the tax system.

Further, as can also be seen from the examples above, the use of data to build new businesses (such as app development) and drive efficiency (e.g. the industrial internet and smart meters) is pervasive and a tax on data would raise the cost of a critical business input and impede data flows, potentially slowing the pace of innovation and data-supported commerce. This would have a negative effect on the wider economy and SMEs, not just a few multinational
companies.

Against this backdrop, data localisation is not a way to address the taxation of intangible assets or to create a taxable nexus or virtual permanent establishment. The location in which data is stored is not relevant to the economic activity that occurs as a result of that data. We would reiterate that economic value is located where intangibles are created and developed, not performed. In addition, using location as the key criterion could have the unintended consequence of generating a wave of forced data localisation.

AmCham EU is concerned that proposals to erect national barriers or ring fence data flows (which have been discussed as potential means to implement a data tax) would create barriers to crossborder commerce. Such a tax would stifle innovation and negatively affect economic activity across the board. Similarly, the use of data to determine a taxable nexus would be both problematic and illogical. There is no clear connection between the value of data and its location. Additionally, the effective forced localisation of firm's data will have unintended consequences, particularly for small businesses that lack the scale to adapt.
The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country’s major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

The Association of British Insurers (ABI) is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI’s role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

ABI response to the Discussion Draft

1. The ABI supports the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment. Our comments reflect our desire to ensure that any measures are workable, well targeted, and proportionate in the context of the efficiency of commercial insurance operations. In the spirit of working constructively with the OECD and member governments, we offer information and suggestions as to how proposals could be improved to help achieve objectives whilst at the same time avoiding inadvertent consequences impacting on the normal conduct of insurance business models.
2. As the Discussion Draft acknowledges in paragraph 54, digital technology has “….become embedded in and central to the business models of firms operating across the economy”. The extent to which digital technology is used varies depending on the business sector and even varies within sectors. For example, business of some insurers is placed through platforms, whilst the business models of other insurers do not include platform services. In view of this the ABI fully agrees with the decision reached by the Task Force on the Digital Economy (“the Task Force”) that ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible (referred to in paragraph 205 of the Discussion Draft).

3. The ABI believe that the tax challenges of the digital economy should be taken into account in the development of the other measures envisaged in the BEPS Action Plan. If this is done those measures should substantially address the BEPS concerns that arise in the digital economy. So, whilst the ABI can understand the desire of the Task Force to consider possible options now, we do not believe decisions on the options should be made until work on the other relevant BEPS actions, referred to in Section V, is completed. It is only where it is clear that the measures identified under other BEPS actions do not address the challenges raised by the digital economy that the potential options to address them, which are described in section VII of the Discussion Draft, should be considered. Otherwise, it is likely there will be unnecessary complication which may have inadvertent negative impact on business.

4. An example of where unnecessary complications could arise for insurance groups, which may result in an inadvertent negative impact, is the interaction of the work being undertaken on permanent establishment as part of Working Party 1 and the options being considered by the Task Force. As such any consideration of permanent establishment should look holistically at the issues for all businesses without being constrained by the options being considered by the Task Force.

5. The ABI agrees that the Ottawa taxation framework principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility continue to be an appropriate framework for evaluating the potential options.

ABI

14 April 2014
Vienna, 14 April 2014

COMMENT ON BEPS ACTION 1:
ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY

It is a big challenge for the Austrian economy that e-commerce sales of global acting international groups increase worldwide. Even in Austria the market share of Internet trading companies increases visibly.

Because of the use of tax loopholes and the non- or very moderate taxation in low-tax countries or tax havens there is on the one hand the problem that the Austrian tax authority is confronted with the missing of tax base of such companies and on the other hand it causes distortion within the Austrian market and distortion of competition. The Austrian advertisers, domestic media, advertising executives and the whole market of trading companies are affected thereof.

The Austrian Federal Economic Chamber asks for consideration of its opinion.
Dear Sir, Dear Madam,

Comments on the Discussion Draft on BEPS Action 1: Address the tax challenges of the digital economy

We welcome the opportunity to give some comments on the taxation of the digital economy. Determine an appropriate set of rules to tax digital economy is crucial to maintain balanced allocation of taxing rights at worldwide level.

Because traditional economy is evolving into digital economy, ring-fencing the digital economy is not an option. In addition, we strongly object to any tax on data’s collection or data’s use. Citizens are more mobile than ever and should never be considered as resources of their respective States, the use of which (e.g. use of their personal data’s) should be remunerated.

Taxing the digital economy requires the combination of (i) existing tax rules, (ii) current OECD work to tackle BEPS (e.g. on treaty abuse) and (iii) new taxes. We recommend the following:

1. tax websites’ bandwidth use;

2. tax commissions, including e-marketing fees at source and adapt double tax treaties accordingly. If required, a new definition of e-service could be included in the model tax convention¹;

3. require VAT to be paid in the country of consumption²; and

4. support digital economy with strong tax incentives³.

¹ This proposal is already mentioned in the Discussion Draft on BEPS Action 1. See §218.
² We did not analyze thoroughly indirect tax aspects. A lot of efforts are already being done a.o. at European level on this matter.
³ Fair and efficient tax system does not imply high taxes.
Additional comments on tax websites’ bandwidth use

This option is often subject to high criticism though it is definitely worth discussing. Some could argue that it is contrary to the US Internet Tax Freedom Act but it all depends on how you consider such a tax. It is merely a supplementary way to levy corporate income tax on enterprises with web presence.

These are our thoughts / recommendations on bandwidth tax:

- It is easy to implement. ISP’s can provide the information about bandwidth use to tax authorities in order to collect tax (compare this role to the role of financial institutions e.g. in collecting withholding tax on financial income).

- The tax should only apply as from a certain annual threshold of bandwidth used in order to avoid administrative nightmare.

- States should grant a corporate income tax credit to enterprises to the extent they pay bandwidth tax. This would maintain equality between digital enterprises and traditional enterprises, leveling the playing field a little. Such a tax credit system would boost the competitiveness in the digital sector. It would also encourage Tech giants to increase their physical presence in their actual markets to use 100% of the tax credit.

- Determine the tax based on each enterprise’s turnover or another financial ratio would be ideal but seems unrealistic, absent harmonized accounting GAAP. Our recommendation would be to start with a fixed tax calculated based on the quantity of octets used by the website. There should be some progressivity e.g. applying different tax levels depending on the enterprise size or the turnover.

- The tax should be paid per installment with a compensation adjustment at year end based on effective use of bandwidth.

- Coordinate the efforts at OECD / European level with respect to data’s collection and control.

- Have some exemptions available for non-profit websites.

New Business Models in a digital economy

We believe the combined application of bandwidth tax, corporate income tax and withholding tax will ensure fair taxation of the new business models identified in the Discussion Draft namely: e-commerce, app stores, online advertising, cloud computing, payment services, high frequency trading and participative network platform.

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4 The 1998 Internet Tax Freedom Act was signed into law as title XI of Public Law 105-277 on October 21, 1998.
In addition, we developed our own classification with 4 different business models: participative content, delivery of content based goods, delivery of tangible goods and intermediation. Note that one enterprise can combine multiples business models.

- **Participative content (e.g. Facebook, Twitter)**

  The main income stream for these enterprises is the e-marketing. The use of the services is free for the final consumer.

- **Delivery of content based goods (Google Play, AppStore, etc.)**

  The consumer buys digital/intangible content for a physical device (music, movie, book, app) at a specific price.

- **Delivery of tangible goods (Amazon)**

  The consumer buys tangible goods which are physically delivered to an address. The difference with a traditional purchase is that the vendor can be located anywhere in the world.

- **Intermediation (Booking, Google, SkyScanner)**

  The enterprise is an intermediary or a search engine. Its main purpose is to facilitate consumers’ access to information. In this category, a distinction is necessary between enterprises receiving commissions or fees such as Booking.com and enterprises rendering the service for free while targeting on other sources of income such as e-marketing (Google).

No matter the category, e-marketing is usually an important source of income.

We classified the 100 top websites (Alexa ranking\(^5\)) according to these categories.

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\(^5\). Tentative, most relevant sites only. January 2014’s list; source: [http://www.alexa.com/topsites](http://www.alexa.com/topsites). The sites in the top sites lists are ordered by their 1 month Alexa traffic rank. The 1 month rank is calculated using a combination of average daily visitors and page views over the past month. The site with the highest combination of visitors and page views is ranked #1.
No matter how you look at it, the application of a withholding tax on commissions and e-marketing income together with tax on bandwidth use is an appropriate answer to the tax challenges of the digital economy. These tools combined with current international tax rules will help make sure that “digitally active” MNE’s pay their fair share of tax. It is important however to keep in mind that this notion of fairness is open to criticism and highly dependent on time, location and perspective. Therefore, we highly recommend relying on other Ottawa Taxation Framework principles to further analyze options to tax the digital economy, namely: efficiency, simplicity, neutrality and flexibility.

We appreciate this opportunity to provide comments to the OECD on the discussion draft and we hope our thoughts will be useful. We would be happy to discuss any of the above in greater detail (redaction@bananafric.com).

Yours faithfully,

Caroline Dooms
Founder & Writer
Banana Fric

About Banana Fric
Banana Fric is an independent website on international tax challenges. Its founder believes in simple, low and efficient taxation and uses this website to share ideas and thoughts on current tax debates. In addition, the author offers specialized services in tax writing, translation and research. More information is available at the following webpage: http://bananafric.com/tax-writing-research/.
Tax Challenges of the Digital Economy

Comments by the Banking and Finance Company Working Group on BEPS

1. Introduction and Summary of Comments

These comments are being submitted to the OECD by the Banking and Finance Company Working Group on Base Erosion and Profit Shifting (BEPS), which consists of banks and finance companies conducting international business, in response to the OECD’s Public Discussion Draft, *BEPS Action 1: Address the Tax Challenges of the Digital Economy* (March 24, 2014).

Our comments on the Discussion Draft may be summarized as follows:

- We believe that it is important for the OECD to refrain from making any recommendations that are specific to the digital economy until all stakeholders can evaluate, at a future time, the effectiveness of the recommended measures developed in the course of the BEPS Project, as well as recommendations stemming from work currently being done on VAT/GST.

- Recommendations in the digital economy area should focus on business practices that raise the kinds of concerns that inspired the BEPS Action Plan—the use of artificial measures to transfer profits to affiliates based in low-tax jurisdictions in amounts that are disproportionate to the real contribution of those affiliates to a global business, and the ability to conduct very profitable activities with customers in high-tax jurisdictions without creating a physical presence in those jurisdictions.

- If those recommendations are targeted appropriately, they should have limited application to regulated financial services businesses, because our digital activities are either predominantly local (such as consumer online banking and similar businesses involving retail customers) or involve the realization of profits in business units located in high-taxed jurisdictions (such as electronic trading or credit card issuing).

- We are concerned about the potential option of a new, alternative type of permanent establishment based on a “significant digital presence” in a jurisdiction. Such a change would be a radical departure from longstanding
principles of international taxation, and we believe if pursued it must be done in a way that fully considers the theoretical and practical challenges, does not disproportionately impact financial services businesses, and is confined to the abusive situations that are within the scope of the BEPS Action Plan.

- We are also very concerned about the suggestion that a potential option is to require financial institutions to withhold a final tax from payments made to foreign e-commerce providers. Such a requirement would impose an unreasonable burden on the affected financial institutions, due to the practical difficulties in implementing such a proposal.

- We agree that there may be cases in which a consumption tax would represent an appropriate means of dealing with digital sales by foreign sellers, or at least would be preferable to income tax options that would involve the abandonment of traditional nexus standards. However, a consumption tax would not be an appropriate or practical option in the financial services context. For example, the practical difficulty of identifying and accounting separately for the services component of interest on a bank deposit is widely recognized. As noted above, it is important to wait for recommendations in this regard that will result from existing work being done in this area.

- All of the potential measures discussed in Section V of the Discussion Draft (“Tackling BEPS in the Digital Economy”) would create a greater need for improvements in dispute resolution procedures. This highlights the importance of Action 14 of the OECD’s Action Plan on BEPS (“Make dispute resolution mechanisms more effective”).

2. Need for future evaluation of the effectiveness of anti-BEPS measures

The Discussion Draft acknowledges that the tax issues related to the sale of digitized products and services by nonresident sellers are not essentially different from the tax issues arising from sales of physical goods and other transactions between nonresident providers and consumers located in a jurisdiction where the provider has no physical presence. Advances in information and communication technology have simply made direct interactions between providers and consumers in different jurisdictions more efficient, while enabling the delivery of a variety of products and services in digitized form through telecommunications. From an income tax perspective, therefore, the digital economy does not appear to raise new issues. Rather, it has raised the stakes regarding BEPS and the various elements of the existing international tax regime that permit BEPS to occur.
As suggested in Section V, paragraph 146, of the Discussion Draft, the overall aim of the BEPS Action Plan is to “ensure that, once the different measures are implemented in a coordinated manner, taxation is more aligned with where economic activities take place.” Indeed, all of Section V is devoted to a discussion of “how the work on the implementation of the BEPS Action Plan, as well as the work on consumption taxes, is expected to address” the BEPS concerns that are enlarged by key features of the digital economy such as mobility of functions, assets and people. The discussion covers measures designed to restore taxation in market jurisdictions, measures aimed at restoring taxation in both market and ultimate parent jurisdictions, measures that will restore taxation in the jurisdiction of the ultimate parent, and measures to address BEPS in the consumption tax area.

In paragraph 208 of the Discussion Draft, it is noted, appropriately, that “it is expected that as described in Section V, the development of the measures envisaged in the BEPS Action Plan will effectively address the BEPS concerns that arise in the digital economy”. Given this expectation, it seems clear that the OECD should not, at this stage, make any recommendations pursuant to Action 1, which relates only to the digital economy. Instead, all stakeholders should have the opportunity to evaluate the effectiveness of the measures implemented as a result of the BEPS project before any decision is made to develop recommendations that are specific to the digital economy.

**Digital transactions in the financial services industry**

The vast majority of online business conducted by financial services companies does not implicate the concerns raised in the Discussion Draft, such as the creation of stateless income and the shifting of profits to low-tax jurisdictions.

For example, for retail banks, a significant proportion of customers now conduct consumer banking activities online. However, in virtually every case the account relationship is associated with a regulated entity (a branch or subsidiary) that is located in the customer’s home country. Income derived from the conduct of a retail banking business is subject to taxation in the countries where the customers are based, without regard to whether those transactions are effected online or face to face. The advent of the digital economy has not enabled banks to situate retail banking businesses away from their customers, or to do business with customers in high-tax jurisdictions remotely from a low-taxed hub; for regulatory reasons, it never will.

For different reasons, the advent of the digital economy hasn’t resulted in fundamental changes in the manner in which wholesale and institutional banking businesses are conducted, and has not created planning opportunities of the kind that the BEPS Action Plan is intended to address. For example, the globalization of the financial markets, in combination with advances in computer technology and communications infrastructure,
has led to the development of electronic trading that is intended to facilitate effective hedging, capture price differentials and enhance liquidity. Trades are effected automatically through the use of servers and internally-created algorithms that generate market prices. To effect trades efficiently, the technology infrastructure is typically located in close proximity to the principal financial centers around the world where the majority of trades occur, such as New York, London and Tokyo. Income derived from those activities is attributable to factors including the staff who developed the algorithms; risk managers who oversee the positions; the regulated entities that effect the transactions; and the technological infrastructure. The OECD has previously identified these activities as “key entrepreneurial risk-taking” (“KERT”) functions, used by the financial services industry for capital attribution and transfer pricing analysis. Those activities are situated exclusively or almost exclusively in high-tax jurisdictions. There is no need for BEPS Action 1 to deal with technological advances that merely facilitate the efficient conduct of business in high-tax jurisdictions, and don’t create opportunities for base erosion or profit shifting.

Similar to wholesale and institutional banks, credit card companies may lack a permanent establishment in countries where card holders and merchants are located. Historically, such “destination market” business has been conducted from outside the card holders’ and merchants’ country via phone, mail and limited use of local independent contractors, and it has been done for reasons unrelated to the tax avoidance concerns targeted by the BEPS Action Plan. To begin taxing destination market credit card business in countries where the customers are located merely because companies choose, for sound business reasons, to take advantage of emerging digital technology would be outside the scope of the BEPS Action Plan.

3. “Significant digital presence”

The Discussion Draft discusses, as a potential option, an alternative standard of taxable nexus, namely that an enterprise engaged in “fully dematerialized digital activities” would be deemed to have a permanent establishment in a jurisdiction for tax purposes if the enterprise had a “significant digital presence” in the jurisdiction.

Examples given in the Discussion Draft of what might give rise to such a presence include:

- The existence of a significant number of contracts for digital goods or services that were remotely signed between the enterprise and customers resident in the jurisdiction;
- Widespread consumption of digital goods or services of the enterprise within the jurisdiction;
Substantial payments by customers resident in the jurisdiction for digital goods or services delivered as part of the enterprise’s core business;

- The performance of secondary functions such as marketing and consulting in the jurisdiction by a branch of the enterprise; and

- The enterprise’s use of personal data, obtained by systematic monitoring of internet users in the jurisdiction, to do a substantial amount of business.

Financial services such as the destination market credit card business described above could easily fall into the category of dematerialized digital activities that maintain a significant digital presence in the jurisdiction where the customer is located. There is, however, no discernible principle of tax policy to subject such enterprises to taxation in a jurisdiction where it has no employees, agents, or tangible assets while at the same time apparently continuing to exclude from taxation enterprises that sell physical products into the jurisdiction without a physical presence there. In addition, it would most likely be very difficult to administer as a practical matter, both for taxpayers required to comply with it and for tax administrators attempting to audit it.

Expanding the concept of nexus in this manner would be a radical departure from longstanding principles of international taxation found in treaties and the internal tax laws of most countries, and we believe if pursued it must be done in a way that fully considers the numerous challenges from both a theoretical and practical perspective, does not disproportionately impact financial services businesses, and is confined to the abusive situations that are within the scope of the BEPS Action Plan.

4. **Final withholding tax on outbound payments for digital goods or services**

The potential option of imposing a final withholding tax on payments to a foreign e-commerce provider is similarly flawed. A foreign seller of physical goods to purchasers resident in a country where the seller has no physical presence or dependent agent is not taxed by way of withholding on the purchaser’s payments. The Discussion Draft does not make a case for imposing a withholding tax on outbound payments for digital products or services.

Moreover, we emphatically reject the suggestion made in the Discussion Draft that withholding tax should be payable by financial institutions involved in the making of outbound payments for digital goods or services. A financial institution providing payment services cannot be expected to determine whether a payment made under a contract to which the financial institution is not a party is being made for a digitized product or a physical product. A compliance requirement of this nature would be unreasonable and impractical.
5. **Consumption tax options**

Given that established tax policy principles allow a foreign seller of physical goods to make an unlimited number of sales, free of income tax, to residents of a jurisdiction where the seller has no physical presence or dependent agent, it appears that for some industries, a consumption tax, rather than income tax, may be the appropriate area for the OECD to focus on in developing potential options for addressing tax challenges posed by the digital economy. We would note, however, that this would not represent an effective or practical option in the financial services context, in light of the extraordinary and widely recognized difficulty of disaggregating the services component of conventional financial transactions.

We understand that work is ongoing within the OECD and elsewhere with regard to improving the administration of consumption taxes on cross-border transactions. We suggest that it would be appropriate to await the results of that work and evaluate any relevant recommendations that may be made before proceeding to formulate specific options under Action 1 of the BEPS Action Plan.

6. **Importance of dispute resolution improvement**

Section V of the Discussion Draft (“Tackling BEPS in the Digital Economy”) discusses various measures that may be recommended under several of the action items in the OECD’s Action Plan on BEPS. We note that the recommendations will increase the importance of improvements to existing dispute resolution procedures regarding double taxation. In this regard, we urge the OECD to devote at least as much time and effort to making recommendations under Action 14 of the BEPS Action Plan (Make dispute resolution mechanisms more effective) as under other action items.
BEPS MONITORING GROUP

Address the Tax Challenges of the Digital Economy

This response is submitted by the BEPS Monitoring Group (BMG). The BMG is a group of specialists on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Tax Justice Network, Christian Aid, Action Aid, Oxfam, Tax Research UK. This response has not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This response has been prepared by Erika Dayle Siu and Sol Picciotto, with comments and input from Jeffery Kadet, Attiya Waris and other members of the Group.

We welcome the opportunity to comment on the Discussion Draft (DD) on Addressing the Tax Challenges of the Digital Economy published by the OECD on 24th March 2014, under Action 1 of the BEPS Action Plan.

Our comments will address the questions on p.7 of the DD.

1. Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules.

We agree with the evidence and analysis in the DD, that digital technologies are a feature of many if not all sectors of the economy. Hence, we would go further than the conclusion in para. 59 that it would be difficult or impossible to ring-fence the DE as a separate sector, or to apply distinct rules to digital transactions. We agree with the stronger conclusion in para. 205 that ‘ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible’. Indeed, we consider that it is more appropriate to refer to the ‘digitalised economy’. We believe that segregating specific types of digital transactions, so-called ‘fully dematerialized digital activities’ as introduced in para. 212, constitutes ring-fencing and thus, is neither appropriate nor feasible.

In addition, applying different rules to such transactions would violate the principle of Neutrality of the Ottawa Taxation Framework, because businesses which engage only in digital transactions often compete with other businesses in the digitalised economy which are less than fully-dematerialized.

In our view, the shift to a digitalised economy has made it starkly apparent that the traditional test of taxable presence, the concept of Permanent Establishment, must be revised. We explain the reasons for this in more detail in our discussion of the following points. Without such a change the BEPS project would not comply with its mandate from the G20 that ‘the existing international tax rules on tax treaties, permanent establishment, and transfer pricing ...[must...] ensure that profits are taxed where economic activities occur and value is created’. Our proposals for such changes are given under point 7 below.
2. The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account;

In our view, the analysis put forward in the DD astutely describes the changing dynamics and impacts of the DE on value creation and globalisation. In our view these aspects are best understood in terms of (i) dematerialisation, (ii) connectivity and (iii) changing relations between suppliers and customers.

Dematerialisation.

Although dematerialisation is not referred to in the DD’s analysis of the nature of the DE, it emerges in the discussion of potential options in Part VII. It is therefore important to clarify and understand this aspect as it relates to the key features of the digitalised economy. First, it is important to clarify what dematerialisation does not mean. Dematerialisation does not mean that people, both in the form of producers and consumers are eliminated from the business activity. As indicated in Figure 4.A, in the Layered View of ICT, both producers and consumers as users interact with each other via the information which passes through the ICT’s respective layers, which include both hardware and software, and both tangible and intangible services and goods. In other words, there is no ‘purely digital’ transaction. Even the most remote, intangible, digitised thing of value requires a physical server (asset) somewhere and physical developer (person) somewhere to design, improve and maintain inputs along a chain of value as well as a physical consumer (person), who accesses (and adds to) the thing of value through the use of a physical device (asset). Hence, the term ‘dematerialised’ should be understood more in terms of (i) the ability to deliver some products or services digitally (although through physical devices), and (ii) the decreased quantities of physical people and property required to carry out business activities due to the substantially greater capacity for volume and reach in the digitalised economy. Hence, there is no basis for the term ‘fully dematerialised’.

Connectivity.

Connectivity refers to the substantially greater capacity for volume and reach in the digitalised economy. As rightly observed in the DD, paras. 178-179, digital technology has enhanced ‘the ability to carry out activities remotely, increasing the speed at which information can be processed, analysed and utilised, and because distance forms less of a barrier to trade, expanding the number of potential customers that can be targeted and reached’. This ‘connectivity’ ‘increases the flexibility of businesses to choose where substantial business activities take place’ and ‘[a]s a result, it is increasingly possible for a business’s personnel, IT infrastructure (e.g., servers), and customers each to be spread among multiple jurisdictions, away from the market jurisdictions.’ Thus, it is rightly observed in para. 99 that the digitalised economy has increased the pace of globalisation.

Changing relations between suppliers and customers.

In our view, the DE is part of the wider shift to the knowledge or cognitive economy, in which economic transactions are less focused on discrete sales of physical commodities from active producers to passive consumers. Instead, economic transactions increasingly involve the formation and maintenance of longer-term symbiotic relationships which create economic value. On one hand, digital technologies enable businesses to maintain continuous relationships with customers, and supply them with hardware as well as a stream of services, and new products or enhancements. The largest firms, such as Amazon, Apple or Google, have been able to develop
strategies of bundling a range of products and services, including sales of hardware devices as well as digital products and services.¹

On the other hand, as noted in para. 24, digital technologies provide gatekeepers with the capacity to collect substantial amounts of data from users for market research and to `customise user experience’. Further, as stated in para. 31, ‘the processing of this data can be used automatically to change the behaviour of those devices in real time.’ This collected and analysed data, as described in para. 52, further enables developers to power even more applications (and collect even more data), or market the data to other companies (advertising). Moreover, due to the increased collection and processing capacity of digital technologies (paras. 105-107) `big data’ from consumers creates value for businesses in better business models, product and service development, improved decision-making, segmenting of target populations for customised products and services, managing performance and creating data transparency for greater adaptability to market conditions.

Digital technologies also enable participative networked platforms (para. 90), which allow users to generate user-created content, such as product reviews, creative or how-to videos, and social media sharing, which adds value by attracting an audience and provoking interactions between users and with the business (para. 22). Other positive externalities of consumer activity are present in value chains, such as network effects (paras. 108-111), evidenced in social/professional networking sites, consumer reporting sites, and other participative networked platforms.

Hence, the resulting value chain is a product of the symbiotic relationship between ICT users—both businesses and consumers. In the DE, the traditional paradigm of the business transaction breaks down. The sale of a physical commodity such as a tablet computer or a smartphone is much more than a one-off transaction between an active supplier and a receiving consumer. Instead, transactions in the DE bind the business and customer into an ecosystem (para. 52), enabling a continuous, symbiotic and reciprocal relationship of value exchange.

It must be recognised that customers now make a significant contribution to value creation and thus, add more to the business transaction than mere payment for goods and/or services.

Taken together, the three aspects of dematerialisation, connectivity and changing supplier-customer relationships in the DE change our traditional understandings of both value creation between businesses and consumers as well as the business transactions between them. In our view, in accordance with the astute analysis of sections II and III, yet contrary to the conclusion of section IV, para. 178, the DE has indeed changed the fundamental nature of the core activities that businesses carry out as part of a business model to generate profits.

3. The examples of new business models in the digital economy and whether (and if so which) other business models should be considered;

In our view, the discussion of multi-sided business models (MSBMs) found in paras. 112-118 is very relevant as MSBMs are central to the understanding of value creation in the DE. In the DE,

¹ Although Google has developed by offering digital services, mainly its search engine, and its principle revenue stream has come from digital advertising, it is now moving to tie these activities to hardware sales, e.g. through the Nexus range of tablet computers, manufactured under licence by third parties, and most recently Google Glass.
there are ‘multiple distinct groups of persons [who] interact’ and their decisions affect each other through positive or negative externalities. Moreover, in a MSBM, ‘the prices charged to the members of each group reflect the effects of these externalities.’ In other words, the value of the business activity is generated by both the business and the consumer.

In our view, the discussion of MSBMs should not be an afterthought but should be included with the central description of business models, e.g., B2B, B2C, C2C, because in the DE, all of these traditional business models converge in MSBMs and challenge the traditional understandings of value creation as well as the business transaction paradigm.

4. The ability of measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy;

The measures outlined in section 5 are viable options in addressing BEPS concerns in the DE. In our view, two main action areas in particular could go a long way in preventing BEPS in the DE. First, the artificial avoidance of PE status (Action 7), will require all three measures listed: revising the PE definition (para. 150); treatment of sales of affiliates within a multinational group as effectively concluded by dependent agents (para. 151); and revising the exemptions in Article 5(4) of the Model Convention (para. 152). Due to the ability to circumvent PE status through (often artificial) contractual arrangements and the segmentation of legal entities, as well as the changing nature of what it means to do business in the DE, each of these measures is essential in preventing BEPS.

Secondly, in assuring that transfer pricing outcomes are in line with value creation (Actions 8-10), the key issues listed in para. 160 are highly relevant. Our perspectives on each of these key issues is as follows:

(i) Intangibles: Below value and hidden transfers of intangibles are key agents in the shifting of income from parent, market and other operational jurisdictions to low or no-tax jurisdictions. Both types of transfers are enabled by core informational deficits on valuation of comparable prices and informational asymmetries between taxpayers and tax administrations. Moreover, with a more nuanced understanding of the changing paradigms of business models and transactions due to the interplay of businesses and consumers in value creation, the concept of consumer value as an intangible also comes into play. Similar intangible concepts are not new - both goodwill and brands, which involve customer perception and recognition, are intangible assets under traditional business accounting. However, in the DE, the interaction between consumers and businesses creates value above and beyond brand recognition and goodwill. As described in sections II and III of the DD and summarized above, the value contributed by customers generates data for building and expanding market reach, product development, advertising, network effects, and direct user-generated content. This value can be monetised (see paras. 50-51) and hence, should be incorporated into business value as an intangible asset.

(ii) Business risks: The transfer of risk can easily be accomplished through contractual arrangement and it is often difficult for tax administrations to determine which legal entity of an MNE group actually bears this risk. In these considerations, the location of people and actual business functions should be used to allocate risk among the MNE group and not mere contractual arrangements.

(iii) Characterisation of transactions: In the area of identifying and in some cases, recharacterising, the specific nature of transactions, clear rules and guidance are necessary to
create certainty for taxpayers and administrable rules for tax administrations. In setting these rules, it is important to recognise asymmetries of information between taxpayers and tax administrations. It should also be recognised that business structures and relationships will inevitably continue to change, so that rules and guidance must include flexibility for taxpayers and administrators to make new characterisations when appropriate. The more information is provided to the tax administration through a country by country report and transfer pricing master file and country file, the more accuracy there will be in determining the fair amount of tax that should be paid.

(iv) Base eroding payments: Excessive cross-border payments are a prime driver of base erosion and profit-shifting. Inadequate data on comparables (especially in the DE); a lack of tax administration enforcement resources; complex fact patterns; questionable attribution of risk are endemic aspects of international corporate taxation.

Although para. 165 states that “transfer pricing rules based on the arm’s length principle (ALP) are theoretically equipped to address the proper amount of [cross-border] payments”, these rules were conceived to function in a reality that, quite simply, no longer exists. It is high time to acknowledge this core deficiency of the ALP and adopt tax solutions for the present. The impact of digitalisation of the whole economy means that the future is now.

(v) Global value chains and profit split methods: Increased integration of MNEs has been demonstrated both theoretically and empirically, and is accurately summarised in para. 166 of the DD: ‘With the advent of the development in ICT, reductions in many currency and custom barriers, and the move to digital products and a service based economy, the barriers to integration broke down and MNE groups began to operate much more as single global firms. Corporate legal structures and individual legal entities became less important and MNE groups moved closer to the economist’s conception of a single firm operating in a coordinated fashion to maximise opportunities in a global economy’.

However, what is also important to note is that this has made corporate legal structures less of a business decision and much more of a tax decision. According to the Ottawa Taxation Framework, the principle of neutrality requires that business decisions be motivated by economic rather than tax considerations. Due to the impact of digitalisation on the economy, global value chains as well as the changing dynamics between customers and suppliers, should be examined in the allocation of taxable profit.

This entails a move to the use of profit-split or other profit apportionment methods based on actual economic actors (people as consumers and producers) and not legal constructions.

As we have argued in previous submissions, for the BEPS project to be successful, it is essential to replace the separate-entity principle with one which enables tax authorities to examine multinational companies as what they are, unitary entities. There are a number of ways in which this could be done, and we hope that the OECD will seriously consider them as work on the Action Plan develops further.

If clear rules and guidance were given, taxpayers would have much more certainty than in the current situation, where the lack of data on comparable prices forces taxpayers and tax

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administrations into negotiations and time-consuming dispute resolution proceedings. And even where there is a negotiation, MNEs often face the problem of ‘public licence’ when decisions by Competent Authorities are viewed by citizens of the market jurisdiction as invalid due to an imbalance of expertise and information possessed by parties to the negotiations. Therefore, this work on global value chain analysis and profit split methods should be pursued deliberately and seriously so as to avoid a tragic and colossal expenditure of political will and global resources in making the international tax system function effectively.

5. Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones;

In our view, the measures described in section V should be guided by fundamental examination of the changing business models resulting from the impact of digitalisation, which permeates almost every aspect of today’s economy. Further, while the measures outlined in section V are valuable in curbing base erosion and profit shifting, without a systemic analysis of how the international tax system can better align with business model paradigms of the present economy, the BEPS project will fail in the central purpose mandated by the G20: that of ensuring that ‘profits are taxed where economic activities occur and value is created’.

6. The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation;

The tax challenges identified by the Task Force are in our view characterised accurately on the whole. From our perspective the main challenges are those identified in sections VI.3 and VI.4: the ability to have a significant presence in a jurisdiction without meeting the threshold under current tax rules for a taxable presence or nexus; and the value created by consumers. Discussion on both aspects follows:

(i) Nexus and the Ability to have a Significant Presence without Being Liable to Tax:

There are two components to this. On the one hand, as mentioned above, an important characteristic of the DE is the closer and more continuing nature of relationships and interaction with customers. Customers are no longer passive purchasers of discrete products, and businesses aim to maintain long-term and interactive relationships with their customers in an exchange of value. This includes systematic collection of data from and about customers or users, but extends also to active contribution of information and content by those customers or users as outlined above. This two-way relationship goes well beyond traditional functions of marketing, although digital technologies have also transformed those.

At the same time, digital technologies provide the connectivity which enable these closer relationships to be established and maintained at a distance, and hence across borders. We therefore agree with the concerns expressed in para. 181 that this requires a reconsideration of the treaty definition of what constitutes a permanent establishment (PE), and for attribution of profits to a PE. The BEPS Action Plan stated that the reforms it envisaged were ‘not directly aimed at changing the existing international standards on the allocation of taxing rights’.

However, it also accepted that Action 1 should ‘examine closely how enterprises of the digitalised economy add value and make their profits in order to determine whether and to what
extent it may be necessary to adapt the current rules order to take into account the specific features of that industry and to prevent BEPS’.

In our view, the features of the DE we have stressed, the closer interaction with customers and the ability to maintain this at a distance, inescapably require a re-evaluation of the concept of a PE and of attribution of profits to it. Traditionally, the claim of the source jurisdiction to taxing rights based only on access to its market was not considered sufficient. This reflected the perception that a customer was simply a passive purchaser of a physical commodity manufactured elsewhere. Today, however, the business engages much more closely and dynamically with the customer, and this interaction is essential to value creation. At the same time, the connectivity facilitated by digital technologies makes it much easier to locate the source of supply so as to facilitate BEPS.

It is not only a matter of recognising that it is now possible to serve customers with a lower physical footprint. It must be accepted that the claim of the source jurisdiction now also rests on the contribution of active users and customers to value added.

(ii) Data and the Attribution of Value Created from the Generation of Marketable Location-Relevant Data through the Use of Digital Products and Services.

As described in sections II and III and outlined above, consumer data and activity is one of the twin engines of ICT innovation and marketing. Unfortunately, the discussion in VI.4 neglects to mention that in addition to data, active customers and users make significant contributions to value added. Hence, the consumer is not merely a passive element, from which businesses collect data. To the contrary, consumers often contribute personal data, product reviews, instructional videos on the use of products, and generate network effects which add value to the business. Thus, the changing role of consumer means that the business model is no longer B2C but is now B2C2B on a continual basis. The value of these externalities is monetised by business and should be reflected in tax system design.

7. The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft

In light of these considerations, we first support the option mentioned in section VII.3.1, the complete elimination of para. 4 from article 5 of the model convention. The concept of activities of a purely preparatory and auxiliary character belongs in a much earlier era of export trade. If a firm considers that it needs to own or lease the facilities listed in para. 4 (a) to (e), it must be recognised as having a close connection with customers in that market. At the very least, if para. 4 of article 5 is not to be completely eliminated, then it should be made crystal clear that para. 4 activities will only be covered if they are truly preparatory and auxiliary in light of the business of the taxpayer. The language in the Commentary on article 5, especially paras. 42.8 and 42.9, should be made considerably stronger and expanded to reflect at least the current characteristics of the DE.

Much more important, however, is the option discussed in section VII.3.2.

In our view, it is time to replace the concept of a PE with a new one of Significant Presence. For the reasons explained under point 1 above, we consider that it cannot and should not be limited to ‘fully dematerialised digital activities’. In our view it is inappropriate to introduce a special rule only for ‘fully dematerialised digital activities’, based on the criteria in para. 213. It seems to
us that this would violate the Ottawa Taxation Framework principle of neutrality. The criteria would also be very hard to apply objectively.

Instead, we suggest that the new concept of Significant Presence should be an extension of the ideas which lay behind that of the older concept of a PE. A degree of physical presence is clearly relevant in deciding the extent of involvement of an enterprise with the host economy, and it remains so. In any case, it would be difficult or even impossible for a host state to effectively enforce a claim to tax firms with absolutely no physical presence in the jurisdiction. The problem is caused by the outmoded concept of a physical place of business with a minimum of twelve months of presence.

The criteria which we suggest for a Significant Presence should reflect the contribution to value added resulting from the closer and interactive relationships with customers. These should include:

(a) relationships with customers or users extending over six months, combined with some physical presence in the country, directly or via a dependent agent;

(b) sale of goods or services by means involving a close relationship with customers in the country, including (i) through a website in the local language, (ii) offering delivery from suppliers in the jurisdiction, (iii) using banking and other facilities from suppliers in the country, or (iv) offering goods or services sourced from suppliers in the country;

(c) supplying goods or services to customers in the country resulting from or involving systematic data–gathering or contributions of content from persons in the country.

Although broad, these criteria would still exclude many businesses involved in the digitalized economy. For example, a software designer which supplies a program in digital form to customers all over the world from a single website in the language of its residence country would not be covered. The aim of the definitions is to capture situations where the firm has a significant presence in the host country although digitally, and to include the element of value added from systematic collection of data and contributions of content from persons in the host country.

8. The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives;

On the administrative challenges of the DE following para. 201, which include identification of business structures, the extent of business activities, information collection and verification and identification of customers, we provide two suggestions:

(i) Identifying customers is possible through tracing of IP addresses to devices used by the customers, the servers accessed, ISP services provided as well as customer information from modes of payment. In situations where public devices are used, customers could be required to log in with an address; and where mobile phone payment systems are used, companies could be required to register customer information including an address when adding value to the payment cards. Regulations requiring service addresses are required in the credit card industry and should likewise be instituted for other modes of payment.
(ii) Identifying businesses information may be made possible through a central registration system shared by national governments. Systems such as the Legal Entity Identifier would provide useful models.

The digitalised economy also obviously enhances the techniques available to public administrations. However, it should not be forgotten that there is also a `digital divide’, and that a number of tax administrations in developing countries are still inadequately computerised, or indeed not computerised at all. Remedying this should be a high priority if the BEPS project is to meet the requirement of the G20 that `Developing countries must reap the benefits of the G20 tax agenda’.

9. Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

In our view, the Ottawa Taxation Framework should be amended to include the Principle of Profit-Value Alignment. This Principle should be drawn from the St. Petersburg G20 Leaders Declaration, particularly, that `international tax rules on tax treaties, permanent establishment, and transfer pricing will be examined to ensure that profits are taxed where economic activities occur and value is created’. Such a Principle should provide:

**Profit-Value Alignment:** International tax rules should ensure that profits are taxed where economic activities occur and value is created; in particular, the location of real activities should take precedence over legal constructions.

All the reports and other details of the BEPS Monitoring Group are available at [http://bepsmonitoringgroup.wordpress.com/](http://bepsmonitoringgroup.wordpress.com/)
Dear Jesse,

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

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

General comments

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

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

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

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

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

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

Sincerely,

Will Morris
Chair, BIAC Tax Committee

Mr Jesse Eggert
Senior Advisor, BEPS Project
Centre for Tax Policy and Administration
OECD

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

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

General comments

2. BIAC appreciates the opportunity to have input at this stage of the process, and we strongly support the OECD’s conclusion that there should not be a separate taxation regime for the “digital economy”. We strongly agree that the proposals to be developed under the other Actions of the BEPS Action Plan will address the challenges posed by the digital economy.

3. Parts of the Discussion Draft range far beyond the Digital Economy, with some aspects impacting other BEPS Action items and others touching upon issues explicitly excluded from the BEPS project. We believe that fundamental issues – such as source vs. residence taxation, which are beyond the scope of the BEPS project – should be addressed, if at all, directly and separately, rather than tangentially in this paper. With those BEPS issues beyond the Digital Economy we believe the best place to undertake that analysis is in work being undertaken on those substantive Action Items.

4. Arguments have been made that a market jurisdiction should have an entitlement to tax some part of the profits of sales into the jurisdiction, based on the demand created by the market place, even where an enterprise has no physical presence. We strongly believe that a combination of an origin-based income tax and a destination-based VAT appropriately divides the jurisdiction to tax between the countries where income producing activities occur and the countries where consumption of goods and services occur. We are also concerned that a number of proposals described in Chapter V, if adopted, would reflect a clear move a towards formulary apportionment. The development of a hybrid tax system would feed uncertainty, drive double taxation, and discourage investment. Deviations from well-established principles of taxation should therefore be very carefully considered before being acted upon. BIAC believes that this work should include an analysis of the purpose and economic burden of the corporate income tax versus the VAT.

5. We believe there are some potential contradictions in recent OECD proposals with respect to the importance of people functions and the location of business activities. For example, the Discussion Draft seems to consider tax nexus for enterprises delivering digital goods or services based on the place where those good and services are supplied to, rather than where functions are performed, risks are assumed and assets are used. These inconsistencies must be resolved to provide a stable tax system that encourages cross-border investment.

6. BIAC appreciates the extreme time pressure under which the OECD has been required to develop these proposals and we appreciate the opportunity to comment on what is explicitly identified as a non-consensus draft. We also understand the political imperative driving this project. Nevertheless, the proposals raised in this draft are complex issues which require time and care to work through the analysis and study the expected repercussions.
Specific Comments

Information and communication technology and its impact on the economy

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

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

8. BIAC strongly agrees with the Task Force that it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy. BIAC also notes that it is equally difficult to distinguish the digital economy from the larger economy. With the ever increasing digitalization of commercial activity, it is difficult to distinguish “pure play” digital/internet companies from other companies. The Discussion Draft implicitly acknowledges this point in its treatment of the internet of things, virtual currencies, and 3D printing, all of which create a business convergence between digital/internet service providers and providers of manufacturing, design, development, and financial services.

9. BIAC nevertheless acknowledges that digital/internet companies distinguish themselves from low-technology enterprises through the positive contributions that digital/internet companies make to the economies in which they are based. Academic studies demonstrate that an economy in which a high-technology enterprise, such as a digital/internet company, is based enjoys positive externalities in the form of increased employment in the local service sector that exceed those associated with the presence of a low-technology enterprise.

Identifying opportunities for BEPS in the digital economy

10. The Discussion Draft acknowledges that the nature of the strategies used to achieve BEPS in digital businesses is similar to the nature of strategies used to achieve BEPS in more traditional businesses.

11. Detailed comments are provided in section 3 on opportunities for BEPS with respect to VAT, avoiding withholding tax and eliminating or reducing tax in the market country.

Tackling BEPS in the digital economy

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

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

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

14. BIAC strongly supports the Discussion Draft's reference to the Ottawa Taxation Framework (from 1998) principles – neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. We endorse the view that these principles are still relevant and, supplemented as necessary; can constitute the basis to evaluate both direct and indirect tax options to address the tax challenges of the digital economy.

15. We also believe that options should not contradict the sovereign choice of jurisdictions to determine how tax is imposed on properly attributable income. With the exception of appropriate CFC rules, countries should not be able to assert a claim to tax another’s income.

Modifications to the exemptions from permanent establishment status

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

A new nexus based on significant digital presence

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

18. This option would result in significant controversy and double taxation and would discourage the expansion of digital goods and services into remote economies, which will adversely affect economic growth.

Virtual permanent establishment options

19. BIAC opposes the adoption of any of these virtual PE options because adoption would violate the Ottawa Principles. Such options would create compliance difficulties and would add uncertainty in many ways.
Creation of a withholding tax on digital transactions

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

Consumption Tax Issues and options

21. VAT issues should be addressed by the ongoing work of the OECD and WP9 and the OECD/Business Technical Advisory Group (TAG) to the WP9.

22. We note that many VAT issues in the Discussion Draft are not specific to the digital economy. Instead, they are conceptual issues related to the design and the application of the VAT system. All stakeholders agree that conceptually, a broad based VAT system, with ideally no or very few exemptions, and one standard VAT rate, would represent the most efficient and effective structure for all relevant parties. It would take substantial complexity out of the VAT system, would ensure neutrality for business, and would ease both compliance for business and administration for governments.

23. BIAC agrees that the most effective and efficient option to ensure appropriate VAT collection on cross-border B2C services is to require the non-resident supplier to register and account for these supplies in the jurisdiction of the consumer. We support the adoption of consistent 'place of taxation' and simplified procedures/mechanisms to allow easy and efficient collection. Registration thresholds should apply where necessary to minimise the compliance burden on business and the administrative burden for governments.
Detailed comments

General Comments

1. BIAC appreciates the opportunity to have input at this stage of the process. We understand that this is a report on the digital economy that identifies options for further discussion rather than makes recommendations. Keeping this in mind, we have the following general comments.

2. First, we endorse wholeheartedly the conclusion that there should not be a separate taxation regime for the "digital economy", however defined.

3. Second, we are concerned that parts of the Discussion Draft range far beyond the Digital Economy. Some of this discussion impacts other BEPS Action items, but other parts touch upon issues explicitly excluded from the BEPS project – in particular "source" vs. "residence" taxation. In relation to the latter we believe that these fundamental issues should be addressed directly and separately, rather than tangentially in this paper, for the reasons briefly set out below. It is only by squarely facing the issues and doing the difficult analytical and political work that these foundational questions can be properly resolved. In relation to the discussion in the Discussion Draft of proposals affecting other Action Items, we believe that rather than trying to resolve them in this document, the best place to undertake that analysis is in work being undertaken on those substantive Action Items. So, we comment briefly on the suggestions made with respect to other BEPS areas, but without proposing courses for action. We do, however, comment in more detail on the proposals in Chapter VII on specific rules for the digital economy.

4. As an overall matter, the Discussion Draft raises the issue of whether a market jurisdiction should have the jurisdictional basis to impose a net income tax based solely on the fact that an enterprise may be able to make sales of goods or services (digital or otherwise) into the jurisdiction. We understand that arguments have been made that a market jurisdiction should have an entitlement to tax the profits of sales into the jurisdiction, based on the value of the market place, even if the enterprise may have no actual presence in the market jurisdiction. It may well be that this is an appropriate discussion to have in relation to, for example, comparability factors under Transfer Pricing rules (as has, indeed, been occurring in relation to the ongoing project on intangibles). However, BIAC believes that the appropriate tax to impose by reference to the place of consumption is a VAT. BIAC believes that the further work on this Action Item would be clarified by an explicit analysis of whether current business models or practices (digital or otherwise) warrant a deviation from the principle that the right to impose an income tax should be based on the presence of actual business operations in a state. For completeness, we would further suggest that this work include an analysis of the purpose and economic burden of the corporate income tax versus the VAT.

5. We also think it important to resolve an apparent important inconsistency between certain of the proposals in this Discussion Draft and other recent OECD/G20 work on the role of business substance to determine the right to tax and the measure of taxable income. The draft revisions to Chapter VI of the Transfer Pricing Guidelines ("TPG") specify that the returns to intangibles should be allocated by reference to the location of personnel who perform or control the development, enhancement, maintenance, and protection of the intangible, and not by reference solely to ownership, funding and bearing risk. In contrast, this digital economy Discussion Draft expresses concern that taxpayers control the location of functions and assets, and thereby suggests that the location of the actual business activities giving rise to the development, delivery and support of digital products and services may not be the
determinants of the jurisdiction to tax income arising from those activities. We believe this apparent inconsistency needs to be resolved. Either the place of performance of profit producing activities is a key factor or it is not. Uncertainty and unpredictability would be greatly increased if place of performance were used to determine the entitlement to returns on intangibles, but not to determine tax nexus for enterprises delivering digital goods or services.

6. We note with approval the many recent statements by OECD representatives that the OECD continues to endorse the arm’s length principle (“ALP”). We also strongly support the conclusion in this Discussion Draft that the proposals to be developed under the other Actions of the BEPS Action Plan will address the challenges posed by the digital economy. As noted above, however, Chapter V of the Discussion Draft describes how some of the ideas now being developed under those other Action Items would address the tax challenges of the digital economy. We are concerned, however, that a number of proposals described in Chapter V (discussed in more detail below) if adopted would move the OECD’s application of the ALP substantially in the direction of formulary apportionment. BIAC believes that the OECD should assess all capital allocation, interest expense allowance, and similar proposals by the criterion of whether the proposal is consistent with the purpose of the ALP. A hybrid tax system would allow countries to assert the ALP selectively (and almost certainly, inconsistently with the practices of other countries), or to adopt elements of formulary when it enhances tax revenue. Businesses would be caught in the middle and subjected to a high risk of double taxation. Further, a hybrid system will substantially increase the administrative burden associated with an either/or approach. Taxpayers will still be producing transfer pricing studies, but will also be required to produce information that will support apportionment in some cases. The current proposals for Transfer Pricing Documentation and the Country-by-Country Reporting template illustrate this tension.

7. BIAC sympathizes with OECD executives and staff for the extreme time pressure under which the OECD has been required to develop these proposals, and thanks them for already taking into account many comments made by business in consultations. We appreciate the opportunity to comment on what is explicitly identified as a non-consensus draft, and hope that our comments will be useful to allow the OECD to complete the next steps of this project with efficiency. We also understand the political imperatives under which the OECD believes it is operating. Nevertheless, the proposals raised in this draft are complex issues which require time and care to work through the analysis and study the expected repercussions. We believe that decisions on significant changes to the international tax law should not be made in haste. We, therefore, stand to help the Working Party and Secretariat in any way we can so that they can produce consensus comments which enhance the OECD’s reputation for careful, analytical work that supports the foundation of sound tax policy. We look forward to contributing to a productive dialogue with the OECD as it continues this important work.
Specific Comments

I. INTRODUCTION AND BACKGROUND

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

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

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

III. THE DIGITAL ECONOMY, ITS KEY FEATURES AND THE EMERGENCE OF NEW BUSINESS MODELS

10. BIAC strongly agrees with the Task Force that, “because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy.” (Para. 59) As a corollary to this statement, BIAC notes that it is equally difficult to distinguish the digital economy from the larger economy. Moreover, with the ever increasing digitalization of commercial activity, BIAC notes that it is difficult to distinguish “pure play” digital/internet companies - i.e., companies that use the internet as their principal method to deliver goods and services, including communicating with users and suppliers through hosted web pages - from other companies. The Discussion Draft implicitly acknowledges this point in its treatment in Chapter II of the Discussion Draft of the internet of things, virtual currencies, and 3D printing, all of which create a business convergence between digital/internet service providers and providers of manufacturing, design, development, and financial services.

11. BIAC nevertheless acknowledges that digital/internet companies distinguish themselves from low-technology enterprises through the positive contributions that digital/internet companies make to the economies in which they are based. BIAC reaches this conclusion because academic studies demonstrate that an economy in which a high-technology enterprise, such as a digital/internet company, is based enjoys positive externalities in the form of increased employment in the local service sector that exceed those associated with the presence of a low-technology enterprise.

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

2 As the OECD proceeds with this topic, it might want to include a definitional section. One of the issues with the Discussion Draft is that the definition of important terms is frequently unclear.
The Digital Economy Is Indistinguishable from the Economy

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

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

13. The Discussion Draft states that “[t]he digital economy has given rise to a number of new business models” (Para. 60) and notes that examples of such “new” business models include auction solutions, logistics services, online sales, the development and sale of applications, online advertising, cloud computing, and payment services. BIAC respectfully submits that the activities that the Discussion Draft identifies are not examples of “new” business models. Rather, these activities are examples of the use of information and communication technology (ICT) to operate existing business models more efficiently and to extend these business models through opportunities for new products and services. This conclusion follows because, as the Discussion Draft acknowledges, these “new” business models have offline analogues, through which marketplace, payment, logistics, auction, and other services have been provided since the 19th century. For example, in more traditional companies digital activity generally flows from existing sale and supply chains and the digital component is used to enhance capabilities within those flows.

14. Technology (ICT) to operate existing business models more efficiently and to extend these business models through opportunities for new products and services. This conclusion follows because, as the Discussion Draft acknowledges, these “new” business models have offline analogues, through which marketplace, payment, logistics, auction, and other services have been provided since the 19th century. For example, in more traditional companies digital activity generally flows from existing sale and supply chains and the digital component is used to enhance capabilities within those flows.

15. The Discussion Draft observes correctly that ICT enables enterprises to conduct “many types of business at substantially greater scale and over longer distances than was previously possible.” (Para. 60) BIAC considers this feature of ICT to be one of its key virtues. With ICT, small- to medium-size enterprises are able to reach discrete and specialized markets at earlier stages in their development than was previously possible. This creates considerable economic efficiencies, and goods and services can reach even these specialized markets with much greater efficiency than before. As a result, businesses and consumers around the world have access to a greater variety of goods and services, and more opportunities for economic advancement, than ever before. We would also note that the ability to monitor and apply standards remotely has actually led to the localization of production in some cases. Communications enhancements have reduced the need to keep development and production in close proximity.

16. ICT does not change the fundamentals of business models, however. A retailer of LPs once shipped LPs to consumers using the postal service. An online provider of song downloads now uses ICT to deliver songs to consumers over the internet. The fundamental business model of finding and developing artistic talent, marketing, and delivering musical content to consumers remains the same. Similarly, a software developer and manufacturer once shipped software on disk or CD directly to consumers or retailers. This same developer and manufacturer may now provide access to this software online. The fundamental business model of developing, delivering and supporting software for use by consumers remains the same.

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

17. The Discussion Draft suggests that e-commerce companies enjoy a competitive advantage over their offline counterparts because e-commerce companies are able to “eliminate the need for many of the wholesalers, distributors, retailers, and other intermediaries that were traditionally used in businesses involving tangible goods.” (Para. 64) BIAC notes that the
The digitalization of certain forms of commerce has not resulted in a net reduction of costs. Instead, digitalization has shifted these costs to new operational areas. In place of costs associated with renting and operating retail space and transacting with intermediaries, e-commerce companies bear significant costs associated with developing, hosting, and operating websites that are accessible to consumers around the world every day of the year. These websites require ongoing R&D to ensure that they retain the right level of functionality to provide consumers with the interactive experience that consumers expect from a virtual marketplace. In some cases functions are shifted to third parties. For example, a digital economy enterprise which sells tangible goods still needs to develop logistics systems to deliver the goods to its customers, just as a department store needs to handle its inventory. In many cases for enterprises operating in the digital economy, these non-core functions are outsourced to third parties. The statement in the Discussion Draft also fails to sufficiently acknowledge how more traditional companies operate. Digital distribution functions may be an adjunct to rather than a replacement for traditional distribution networks.

Moreover, costs associated with activities such as product development, marketing, and customer support persist in the businesses of digital/internet companies, just as they do in other businesses. In many cases, these costs may be higher for digital/internet companies that must contend with short product cycles, the rapid obsolescence of technology, and low barriers to entry into markets. As the Discussion Draft acknowledges, this competitive pressure drives some digital/internet companies to give away hardware, and to treat this hardware as an operational cost, in an effort to expand the market of customers for their goods and services. (Para. 15) In addition, the use of technology and data in business brings with it specific legal costs, such as costs of complying with local country export controls and data privacy rules. More traditional companies that are expanding their capabilities in the digital sphere are expending significant amounts of capital in the development of new products and have applied an impressive amount of resources in educating their customers as to the benefits of these capabilities. The Discussion Draft underestimates the financial commitment that companies must make and the significant risks they incur in order to become successful within the digital economy.

The Discussion Draft states that technological advances make it possible for businesses to carry on economic activity with minimal need for personnel to be present. The Discussion Draft notes that businesses can increase in size and reach with minimal increases in the number of personnel required, so-called scale-without-mass. (Para. 98) While some start-up companies certainly have succeeded in developing valuable businesses at an early stage in their development, we believe this point is greatly exaggerated as a description of the industry as a whole. Well-known “digital economy” companies have tens of thousands of employees. Business cannot effectively scale without human and asset resources.³ This misimpression of the amount of business substance actually required to operate a significant “digital economy” enterprise distorts discussions on the appropriate nexus rule for such companies through the false implication that such enterprises lack substance outside the market jurisdiction.

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

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

³ One major digital economy company, for example, has 99,000 employees worldwide with 41,000 outside the U.S. Many of its foreign marketing subsidiaries have over 1000 employees. Another digital economy company has around 30,000 people of which around half are in the US. There is “mass” behind this scale.
For example, the Discussion Draft characterizes “[r]eliance on data” as a key feature of the digital economy. BIAC notes that all enterprises, including digital/internet companies, “collect data about their customers, suppliers, and operations.” (Para. 103) Moreover, this practice is not new. By way of illustration, customer-facing enterprises used mailers, loyalty cards, and contests to collect and analyse data about customer behaviour long before the internet came into being. What digital has provided is the ability to collect such data in a faster and more accurate manner. For example, data regarding engine performance was historically collected by airline mechanics, pilots and flight reports. Much more accurate data is now collected from the engines themselves. The collection of data is not a new development and does not require sweeping changes to the rules regarding nexus and tax base.

21. BIAC respectfully questions whether the digital economy can properly be characterized as having a tendency toward monopoly/oligopoly if volatility is also a key feature of the digital economy. (Paras 117 – 118) With low barriers to entry, the digital economy is consistently witness to rapid ascents and declines. The now-defunct Friendster was considered “the hottest thing in social networking”4 in 2003, one year before the founding of Facebook. Although Facebook arguably dominates the English-language social networking space today, its successor could be founded tomorrow. The trajectory of digital/internet companies thus stands in contrast to historic monopolies, like that enjoyed by the United Fruit Company, which dominated the banana trade virtually unchallenged for much of the 20th century.

22. BIAC respectfully submits that the Discussion Draft overstates concerns about the mobility of intangible assets, users, and business functions in the digital economy. Enterprises in all areas of the economy, including pharmaceutical, biotechnology, semiconductor, and natural resources enterprises, develop, acquire, and exploit intangible assets. These enterprises transfer intangible assets just as they transfer other, tangible assets, such as equipment. Transfers of both tangible and intangible assets may constitute gain recognition events and result in direct tax at the level of the transferor. In addition, in many cases, the physical ease with which an enterprise may transfer an intangible asset as opposed to a tangible asset is offset by IP protection and other compliance burdens associated with intangible asset transfers. Most OECD/G20 countries have developed rules that create significant tax costs upon the cross-border transfer of intangibles. These rules should generally provide a proper framework for addressing the issue of intangible transfers.

23. BIAC also observes that users are generally not mobile because users live and work in one place. Situations in which users reside in one country and purchase and/or access applications while located in a second country are less common. Similarly, business functions are generally not mobile. Personnel who perform R&D, IT, logistics, marketing, management, and other functions remain situated in a particular location. These personnel have always been able to move among different locations and are no less rooted to a single location now than before. BIAC nevertheless acknowledges that ICT enables enterprises to centralize certain functions, such as finance, legal, management, and customer support functions, in a single location to reduce costs and improve efficiency. This location might (or might not) be remote from market jurisdictions. By definition, centralizing such functions means that the centralized activity will be remote from the majority of market jurisdictions. Centralizing functions does not entail the mobility of functions, however. Instead, centralizing functions requires that these functions remain fixed at a single location. Current transfer pricing rules can be used to address the issue of mobility with respect to services that are used internally.

24. In its treatment of the mobility of business functions, the Discussion Draft suggests that digital/internet companies are able to “carry on economic activity with minimal need for personnel to be present.” (Para. 98) BIAC respectfully disagrees with this contention. BIAC observes that all enterprises, including digital/internet companies, require human resources to scale, as evidenced by the tens of thousands of employees of the leading digital/internet companies. Although digital/internet companies may retain fewer salespeople as compared to their offline counterparts, these same companies employ significant numbers of development, marketing, operations, IT, and other personnel. Put differently, digital/internet companies have reallocated the responsibilities of their employees but have not eliminated the need for employees. This statement also reflects a potential misunderstanding by the OECD of how companies operate in the digital sphere. Technology is developed by engineers, scientists and other sophisticated professionals that have the ability to innovate. The technology is developed where these people are located and can be both labour and capital intensive. Most of these people are located in countries which are hardly thought of as tax havens and there is not a tremendous amount of mobility within this population.

25. BIAC also respectfully questions the utility of Figure 8, which appears below paragraph 98 of the Discussion Draft and which depicts the “[a]verage revenue per employee of the top 250 ICT Firms.” As a threshold matter, BIAC notes that revenue generally does not translate into profits for digital/internet companies and thus represents a false metric for the productive capacity of employees of these companies. In addition, neither Figure 8 nor the source in which Figure 8 originally appears - i.e., the OECD Internet Economy Outlook 2012 - sets forth the names of the “top 250 ICT Firms.” As a result, BIAC is unable to assess the relationship between the average revenue per employee in Figure 8 and the profitability of the firms in question. Moreover, BIAC respectfully submits that an objective assessment of the relative profitability of ICT employees must take place in the context of other high margin industries, such as financial services, consulting services, and oil and gas.

Significance of Investment Decisions

26. Paragraph 101 notes that businesses are increasingly able to choose the optimal location for productive activities and assets, even if that location may be distant from the location of customers or the location of other stages of production. The ability of businesses to choose the optimal location for assets and activities is not limited to the “digital economy” and thus cannot be used to justify separate rules for digital enterprises. BIAC believes that this statement reflects concern on the part of some delegates that this ability to choose the optimal location for productive activities and assets will permit taxpayers to locate productive activities and assets where they are subject to little or no tax. BIAC believes that there are four true statements about tax and investment decisions, unrelated to the digital economy:

1. Taxpayers take into account the level of tax they will incur on their productive investment when they make decisions about where to locate these activities.

2. Low taxes or tax incentives will not make up for an unfavourable investment climate.

3. Tax incentives can tip the scales towards a location that has an otherwise favourable investment climate.

4. A difficult tax environment including high rates, lack of clarity and the difficulty of resolving disputes can discourage investment in an otherwise favourable environment.

27. In an open global market place, if countries seek to encourage business to make productive investments in their jurisdictions, then consequences of these factors are clear. Countries
need to focus on making the investment climate favourable. Tax regimes are a part of this, including tax regimes that are clear, predictable, and generally impose lower rates of tax on a broader base.

28. This paragraph also raises concerns that countries wish to have it both ways. The BEPS project generally has a theme of requiring more substance in order to support taxpayers’ allocating income to a particular jurisdiction.\(^5\) This focus on increased substance is inconsistent with the suggestion that income of a MNE can be taxable in a jurisdiction where that MNE has no assets, functions, or employees.\(^6\) That is, if a country wishes to focus on the “people functions” leading to the development of intangible property and assert that the people functions are the principal source of profit creation (in distinction to the contributions of risk and capital), then that country should not at the same time assert that another country where the “people functions” are carried on, which lead to the creation of products that are marketed in the first country, must yield to the first country insofar as the right to tax the full return from those functions is concerned. This point will be discussed in more detail in comments on section VII, but BIAC believes that the Task Force underestimates the need for people and assets in the production of digital economy products.

29. The Discussion Draft does recognize the volatility of the market and notes that the few companies that have managed long-term success typically have done so by investing substantial resources in research and development and in acquiring start-ups with innovative ideas, launching new features and new products and continually evaluating and modifying business models. (Para. 118) BIAC is concerned that although volatility and the resulting need to continuously innovate is acknowledged, it is not taken properly into account for purposes of profit attribution. Particularly in the context of the Discussion Drafts on intangibles, BIAC has been making the point that the OECD is undervaluing the contributions attributable to managing business risk. These fundamental business decisions are generally centralized in one or a few designated MNE group members, and are not decentralized into the market jurisdictions. For example, risk management policies are generally determined at headquarters, but their daily implementation and control are generally decentralized into a few regional management companies.

IV. IDENTIFYING OPPORTUNITIES FOR BEPS IN THE DIGITAL ECONOMY

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

\(^5\) The OECD has identified actions 6 through 10 as directed at ensuring a taxpayer’s transactions have substance. In addition, action 5, relating to harmful tax practices, is directed at ensuring that countries require substantial activity for any preferential regime.

\(^6\) That is, if two men and a dog cannot support the attribution of income to a low-tax jurisdiction, then no men and no dog cannot support the attribution of income to the market jurisdiction.
**BEPS in the Context of Direct Taxation**

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

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

**Avoiding a taxable presence**

32. The domestic laws of most countries require some degree of physical presence before business profits are subject to tax. Articles 5 and 7 require a permanent establishment before a non-resident may be subject to tax. Accordingly, a non-resident company may not be subject to tax in the country solely by reference to the fact that it has customers there. (Para. 123)

33. The Discussion Draft also states that the ability of companies to maintain some level of business connection "within a country" without being subject to tax on business profits from sources within that country is the result of particular policy choices reflected in domestic law and tax treaties, and is not in and of itself a BEPS issue. (Para. 124) However, digital companies may be able to take greater advantage of these opportunities. This combined with the elimination of taxation in the residence state, creates double non-taxation, and does raise BEPS concerns. (Para. 124)

34. First, BIAC believes a distinction needs to be drawn between actual presence "within a country" and sales “to a country”. Activities “within a country” include sales affiliates, customer support operations, and other personnel and assets that actually are established in market jurisdictions by many digital economy companies. This is distinct from making sales to customers located in a country, which should not be considered a business connection “within a country”.

35. BIAC believes that these choices relate to the fundamental jurisdictional issue concerning when it is appropriate to impose income tax on participants in the economic life of a country. A legitimate substantive basis for imposing a tax may arise from different contacts between the country and the person or thing taxed. The location of a person, the situs of property, the performance of an activity, the entry of a person or property into a jurisdiction all can support the jurisdiction to impose a tax. Different contacts support different types of assertions of taxing authority. For example, importation of non-income producing property into a jurisdiction would support the imposition of a customs duty, but not an income tax on the person importing the property. Although all taxes are designed to raise revenue, they legitimately reach different aspects of the economic life of a country. Thus countries use a variety of tax instruments to reach each of these aspects and a country may have a legitimate jurisdictional basis for imposing one tax but not a different tax based on the type of connection between the country and the thing that they wish to tax.

36. The notion of an income tax -- particularly a net income tax -- requires identification of the person receiving the income as a first step in determining the items of income and expense around which the income tax net is drawn. Since that must be the first step in identifying the

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7 Countries should only impose tax if they have a substantive basis for their taxing authority. They may attempt to do so in other cases and may succeed if they have enforcement power, but an exercise of taxing authority in such a situation where there is no substantive basis is illegitimate and the OECD/G20 should not condone such an exercise of taxing jurisdiction.
income tax base, the characteristics of that person seem more relevant than they might for other taxes, for example, excise taxes. Even in the case of a gross basis income tax, the identity of the person receiving the income is relevant to the determination of the amount of tax imposed; bilateral income tax treaties grant benefits on fixed or determinable type income on the basis of the residence of the recipient. So, the status of the recipient of income is a key concept in determining the amount of an income tax. Because of the intrusiveness of the income tax, this status is relevant in a way that is not for other taxes. Thus the basic jurisdictional nexus is between the person earning the income and country with which that person has substantial contacts justifying the imposition of a tax that requires detailed information concerning the person subject to the tax. BIAC believes that this is the fundamental reason that countries have historically adopted an origin based income tax model and refrained from imposing an income tax, particularly a net income tax, in the absence of substantial contacts of the enterprise located in the country. Because of these sound reasons the OECD/G20 should not lightly reject these historical standards.

37. The single fact that may differ in the case of the digital economy is that the scale of remote sales has increased. The policy choice, therefore, is whether this fact justifies a modification to the traditional nexus standards. BIAC believes that this increase in scale does not justify a general change, or a special rule for the digital economy, since over time trade in these goods and services will become more reciprocal among jurisdictions.

38. Traditionally, gross basis withholding taxes may be imposed on certain types of income even in the absence of an actual business presence. For a gross basis withholding tax to be considered appropriate, the income should be of a type the production of which does not require significant expenses. As previously discussed, the Discussion Draft asserts that internet businesses have significantly more revenues per employee. BIAC would like a further explanation of how those figures were derived. We believe that in most cases internet businesses are like any other. That is, it is difficult to move from a good idea to a business profit. Most businesses fail. Even successful businesses may have long periods of start-up losses before becoming profitable such that a model that imposes tax on a gross basis is likely to impose tax in many cases on amounts that do not reflect net profits. Gross revenue per employee, even if high, does not mean that those businesses do not incur significant costs. People may be replaced by technology, but technology costs may be expensive. For example, search revenue per employee may be high but traffic acquisition costs (TAC) may significantly reduce the profit opportunity on that revenue.

39. Historically, there have been two primary bases for imposing income tax: source and residence. Tax treaties generally recognize that a jurisdiction where the source of income is located (the jurisdiction in which the income “arises”) has the primary right to impose an income tax on that income, and the jurisdiction of residence has a secondary right to impose tax. A person’s income is generated by that person’s activity and/or property. Source rules generally are intended to reflect the location of the person’s activity, or the location of the person’s property, that generates the income or the origin of that income. Neither concept focuses on the location of the customer.

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8 See the FATCA rules.
9 The BEPS Action Plan provides: “While actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.” (Action Plan p. 11.) So, while jurisdictions may debate these issues, the BEPS project is not intended to changing the current standards.
Source rules are not universal or immutable, but there are some basic principles that are generally used to determine source. Some of those principles are: place of activity (performance of services, profits attributable to a PE), place of use (rents and royalties\textsuperscript{10} from property), residence of the payor (interest and dividends), and residence of the recipient (capital gains, and business profits, not otherwise dealt with, and not attributable to a PE outside the residence country).

The income tax, at its most basic level, is an origin based tax on income created by activities conducted in a particular place. That is, jurisdictional nexus is created by the location of activities\textsuperscript{11} and assets of the person earning the income. The country or countries that have a substantial nexus to those activities and assets should have the jurisdiction to tax that income.

\textit{Minimizing functions, assets, and risks in market to jurisdictions}

The Discussion Draft asserts “[i]n the context of the digital economy, an enterprise may typically establish a local subsidiary or a PE, with the local activities structured in a way that generates little taxable profit.” (Para. 125) The Discussion Draft acknowledges that this is not a BEPS issue in and of itself, even if the enterprise takes taxes into account in deciding where to locate personnel and functions. (Para. 125) The Discussion Draft asserts, however, that this creates "incentives to purport an allocation of functions for tax purposes in ways that may not correspond to actual business functions performed, and that would not be chosen in the absence of tax considerations.” (Para. 125) How much profit a local entity generates depends on the functions, assets and risks of that entity. There has been a lot of public comment on this issue, but the public comment does not necessarily reflect the actual operations taking place in particular countries. In many cases, “digital economy” companies only locate a small portion of their worldwide labour force in a jurisdiction and those personnel are not responsible for intellectual property. Thus, minimal presence and low value functions are what leads to the low profit attribution.

The Discussion Draft states that authority to conclude contracts is one of the functions that may "purportedly" be in a non-resident entity, while the "effective authority" to conclude contracts is in fact in the local entity.\textsuperscript{12} (Para. 127) The draft continues as follows: "assets, in particular intangibles, and risks related to the activities carried out at the local level may be allocated via contractual arrangements to other group members operating in a low tax environment in a way that does not correspond to actual risks assumed or to functions performed, assets used, or risks assumed related to the intangibles.” (Para. 125) The draft also identifies "undervaluing" intangibles at the time of transfer as a risk. (Para. 126)

Operations in higher tax jurisdictions often are “allegedly” stripped of risk, do not “claim” ownership of intangibles or other valuable assets, and do not hold the capital that funds the core profit making activities of the group.” (Para. 126 internal quotations added.) BIAC has addressed some of these concerns in our comments in our responses to the Discussion Drafts on intangibles. BIAC is very concerned with the tone of

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

\textsuperscript{11} The word “activities” is used broadly here. Activities would include investing, bearing risk, holding title and managing property.

\textsuperscript{12} Contract approval parameters are generally set at the headquarters company or regional management company, not at the local market level. Difficult contract negotiations are generally escalated to the headquarters or regional management company.
this Discussion Draft, that it reflects an assumption that MNCs systematically misrepresent to
tax authorities the actual functions, assets and risks located in a jurisdiction.

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

Maximizing deductions in market jurisdictions

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

Avoiding withholding tax

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

Opportunities for BEPS with respect to VAT

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

V. TACKLING BEPS IN THE DIGITAL ECONOMY

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

Restoring taxation on stateless income

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

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13 The timing on this Action Item may be premature. Action Item 1 should probably have been Action Item 15. That is the
impact of all the other changes should have been considered before taking action of the “digital economy.”
items (Actions 8, 9, and 10). The Discussion Draft also recognizes greater transparency and mandatory disclosure of aggressive tax planning arrangements, uniform transfer pricing documentation requirements, and country-by-country reporting as contributing to this. BIAC has previously submitted comments on these issues. We would like to highlight that the OECD needs to be mindful of the burden created by reporting requirements and ensure that burden is appropriate and proportionate.

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

51. These measures include the prevention of treaty abuse (Action 6). A Discussion Draft on this was published recently. BIAC has submitted separate comments on this topic.

52. On preventing the artificial avoidance of PE status (Action 7 – which is due by September 2015), the Discussion Draft mentions possible changes to the rules concerning the conclusion of contracts and dependent agents (Para. 150) and possible changes to the Article 5(4) preparatory and auxiliary activities. (Para. 151)

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

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

**Neutralize the effects of hybrid mismatch arrangements**

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

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

55. The Discussion Draft points out that “many large and well-established digital economy players are cash rich and they often finance new ventures, the acquisition of start-ups, or other assets with intra-group debt.” (Para. 155) Intra-group financing entities are often established in low tax jurisdictions. The existing rules permit companies to fund profit-generating activities of the group with intercompany debt even though the group as a whole may be much less heavily leveraged. (Para. 156) This issue is not unique to digital economy companies and may be less prevalent in the “digital economy” than in other sectors of the economy.

56. The Discussion Draft identifies this as an area where mechanisms within or beyond the arm’s length principle may be necessary and suggests a formulary approach which ties deductible interest payments to external debt payments which may lead to results that better reflect the business reality of MNE groups. (Para. 157) This would obviously be a significant change from current law and a significant move towards formulary apportionment. BIAC has serious doubts concerning the feasibility of such an approach. In order for this to work, countries would not only deny deductions for intra-party debt, they would also have to permit a deduction for a portion of the external interest expense incurred by an entity located outside of their jurisdiction. Since, these countries are now allowing that deduction presumably they would also want the option to impose a withholding tax on the portion of external interest paid. Instead of actual intra-company debt would there now be deemed intra-company debt that would be subject to withholding tax? That does not seem appropriate since there would be no income in that jurisdiction since the only income is held by unrelated parties who are not necessarily located in the jurisdiction of the entity that incurs the third party debt. Would each
company have a share of the external debt? If so, how would each company determine a share of that in a timely manner such that withholding tax could be imposed without burdening capital markets? Perhaps withholding agents have to determine which treaty applied to some portion of each payment. Perhaps withholding agents would withhold at the highest possible applicable rate and investors would be required to apply for refunds in every jurisdiction to which interest was allocated.

Counter harmful tax practices more effectively

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

Assure that transfer pricing outcomes are in line with value creation

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

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

59. The BEPS work on intangibles will address the below value transfer of intangibles by taking several steps. (Para. 160) These include:

1. A broad definition of intangibles -- this is intended to ensure that any intangible for which unrelated parties would pay compensation must be compensated in a related party transfer;

2. Entities that contribute value by performing or managing development functions or by bearing or controlling risks are appropriately rewarded;

3. Valuation techniques may be used when appropriate comparables cannot be found;

4. In the case of partly developed or hard to value intangibles, post-transfer profitability (commensurate with income) should be taken into account.

60. BIAC has submitted comprehensive comments on the topic of intangibles and stands by those comments.

Business risks

61. The Discussion Draft states that the BEPS work will require the control of risk, the financial capacity to bear the risk, and the management of risk to be more closely aligned. (Para. 163) Even more importantly, the Discussion Draft states “the guidance will also identify risks that, by their nature, are borne by the MNE group as a whole and therefore which cannot readily be assigned to a single group entity.” (Para. 163) The Discussion Draft does not say what would
be done with these risks. Ignoring commercial risk is one of the principal tenets of formulary apportionment (those advocating for formulary approaches basically consider the return from intangibles and risk to be spread over all the activities of the group). So, ignoring risk would be a significant move in the direction of formulary apportionment. As mentioned earlier in this comment letter, the managing of global risk is one of the principal functions of senior management. Management is responsible for identifying the direction of the business, deciding which ventures to pursue and which to abandon, and developing or acquiring new products or businesses which they believe will be successful. These basic decisions determine whether a company will become and remain successful. Even successful businesses must continuously evaluate and manage these risks. These risks are not managed in the contract manufacturing entity or the contract research and development facility, but they are key to the continuing vitality of any business and an approach that either ignored these risks or allocated them on the basis of a formula would fundamentally misallocate business risk. This approach would divorce taxation from business and economic realities; a result that appears contrary to the goals of the OECD. Additionally, formulaic apportionments carry significant risks of creating their own base erosion problems.

**Base eroding payments**

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

**Global value chains and profit methods**

63. The Discussion Draft provides that:

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

64. The output is to be delivered by September 2015.

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

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14 Even companies that have been successful over a long period can fail because they fail to manage business risk and change. Kodak is a prime example of the sort of failure.
Measures that will restore taxation in the jurisdiction of ultimate parent

66. The Discussion Draft provides that to address BEPS in the digital economy, CFC rules must effectively address the taxation of mobile income created by the digital economy. (Para. 168) To address this situation, consideration should be given to CFC rules that target income typically earned in the digital economy, such as income earned from the remote sale of digital goods and services. (Para. 169) Remote selling is neither new nor unique to the digital economy. Internet/cloud technology has made remote selling pervasive in the economy. So it would be difficult and unfair to limit rules on remote selling to digital economy transactions. The draft also says that the work will need to take into account the need for anti-inversion rules. (Para. 169)

67. BIAC believes that the purpose of the corporate income tax and the economic burden of that tax are relevant to whether a CFC approach or another approach is appropriate to reducing the incidence of low or non-taxation. That is, if other BEPS concerns are addressed and yet there is still low-taxed income: does any country have jurisdiction to tax that income? If so what is the basis of that jurisdiction? The corporate income tax ensures a comprehensive income tax; without a corporate income tax, corporate earnings would not be taxed until paid out to individual shareholders. It is also widely acknowledged that corporations do not bear the economic burden of the corporate tax, although it is less clear where that burden falls. Traditionally, the impact of corporate taxation has been believed to borne by the shareholders of the corporation since it reduces the value of their shares. More recently some have argued that the burden of the corporate tax falls on labour or the consumer. The U.S. Congressional Research Service believes the traditional analysis is generally correct. This is relevant to the policy analysis because if the corporate tax functions as a pre-payment of the personal income tax and the economic burden of the tax in fact usually falls on the shareholders of the corporation, then the jurisdiction which ought to be determining whether residual tax should be imposed on a corporation that is earning income subject to a low rate of tax ought to be the jurisdiction in which the shareholders reside. Taxing the ultimate individual shareholders is probably impractical. However, taxing the ultimate parent in the jurisdiction in which it resides is probably a reasonable proxy for taxing the individual shareholders. If that conclusion is correct, is the jurisdiction of the ultimate parent obliged to tax low taxed income or can it make a sovereign choice to tax that income only on repatriation to the ultimate parent or not at all? BIAC believes that countries do have the sovereign right to make these choices and that after appropriate returns are paid based on a FAR analysis, the right to impose an additional tax on corporate profits ought to be reserved to the jurisdiction of the ultimate parent.

68. This issue goes to the origin theory of income taxation vs. the supply/demand theory. Under the supply/origin theory: "profits originate where the factors that produce the profits operate and the source of the “normal” return of equity capital should therefore be identified “to the location in which the actual operation of the capital occurs”", the mere consumer market does not represent a factor contributing to the added value of the company. “[A]ctivity somewhere, as reflected by the entrepreneur’s risk assumption, labour deployment, and property investments, remains a necessary component to an enterprise’s creation of products..."
and services. Nothing in the "new" economy changes the proper justification for a state to impose an income tax on an enterprise.\(^{20}\)

69. The Final Report also says: "No member of the TAG argued that tax rules should be modified to shield countries from the effect of technological developments on their tax base. Countries do not have a right to a particular level of tax revenues regardless of where business profits originate."\(^{21}\) So, if activities have shifted to outside the jurisdiction, countries will lose tax revenue and that is appropriate. BEPS is intended to address artificial profit shifting. If the income is attributable to actual activities that have moved out of the jurisdiction, then the profit shifting is not artificial. We are concerned that the digital economy proposals are inconsistent with the other BEPS action items that strive to attribute more profit to the location where activities take place. We believe that countries cannot have it both ways. If they want to look to the location of people functions in the context of the attribution of income to the development of intangibles, they should also look to the location of people functions in the context of the digital economy.

70. BIAC also believes that this does not deny a market jurisdiction an appropriate share of taxing jurisdiction because proper application of a destination based VAT will provide an appropriate base for taxing the value attributable to the market.\(^{22}\)

71. In contrast to an income tax, a VAT is intended to impose a broad-based tax on final consumption by households. The central design feature of a VAT is that the tax is collected through a staged process. Each business in the supply chain takes part in the process of controlling and collecting the tax, remitting the portion of the tax corresponding to its margin. That is the VAT of a business is the difference between the VAT on its taxed inputs and the VAT on its taxed outputs. The tax is collected in principle on the "value added" at each stage of the collection process.

72. The economic burden of a VAT is supposed to be borne by the ultimate consumer (in contrast to the corporate income tax). We believe that the OECD should take a careful look at the economic burden of both of these taxes in the context of the digital economy. If companies are competing on price then VAT compliant MNEs may be bearing the burden of the VAT because SME competitors may be less likely to be VAT compliant and will undercut more compliant companies on price. Thus, VAT compliant businesses may be bearing at least a portion of the VAT. Also, companies may want to use a uniform pricing model across jurisdictions and in order to avoid pricing differentials caused by different VAT rates, some VAT may be borne by MNEs (which may mean that it is ultimately borne by shareholders). Business also believes that in determining the economic burden of the VAT compliance costs should be taken into account. These costs are higher than they need to be because governments have not coordinated their rules; compliance is more burdensome than it needs to be; penalties are significant; and there is no process for resolving double taxation disputes.

\(^{20}\) Business Profits TAG final report paragraph 50.
\(^{21}\) Ibid para. 118.
\(^{22}\) There are political reasons that some jurisdictions do not want to rely on a VAT to tax the value attributable to the market. These vary but include the fact that, as discussed, the economic burden of a VAT is supposed to fall on the final consumer. That is, jurisdictions may wish to tax corporate income precisely because the economic burden does not fall on their residents. In some jurisdictions VAT rates are already very high and there is not a lot of scope to raise rates further. Sub-national governments may impose VATs, so revenue from a VAT would have to be shared between national and sub-national governments. Some jurisdictions may have constitutional or other restrictions that limit their ability to impose a VAT. These political concerns of course need to be properly taken into account, but that should be done after the tax policy analysis of the proper scope of the income tax and the VAT, so countries understand that they are making political concessions to achieve a consensus solution.
Precisely because the economic burden is supposed to be borne by the customer, the compliance costs business incurs are an economic burden on the company.  

73. The fundamental policy issue in relation to the international application of the VAT is whether a VAT should be imposed by the jurisdiction of origin or the jurisdiction of destination. Under the destination principle, tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction. If countries adopt a destination based VAT, in the case of a cross-border transaction, the country of origin is ceding its taxing jurisdiction to the country of destination. This may be the right policy, but the economic result is that the country of destination is taxing value added in other jurisdictions.

74. Under the destination principle, exports are not subject to tax (and are entitled to a refund of input tax) and imports are taxed on the same basis as domestic supplies. Thus, the value that was added outside of the jurisdiction of consumption is subject to full VAT in the jurisdiction of final consumption. In other words, the jurisdiction of consumption is able to impose a tax on the value created by activities taking place outside the jurisdiction and assets whose use and value is outside the jurisdiction.

75. Under the origin principle, each jurisdiction would levy VAT on the value created within its own borders. Thus, jurisdictions would tax exports on the same basis and at the same rate as domestic supplies and would tax imports as domestic supplies with a credit for the hypothetical value of its VAT (not the actual VAT paid in the country of export). By imposing tax at the various rates applicable in the jurisdictions where value is added, the origin principle could influence the economic or geographical structure of the value chain and undermine neutrality in international trade.

76. Obviously this is true and could also be true for origin-based income taxes. That is, imposing income tax on the place where value is created can and does influence the economic and geographical structure of the value chain, as discussed above companies take taxes into account in deciding where to locate productive activities. The OECD has recognized that consumption taxes are preferable to income taxes, precisely because consumption is less mobile and does not create distortions. This does not mean that all taxes -- income taxes in this case -- should be imposed on the basis of place of consumption. A distinction between origin based income taxes and destination based consumption taxes allows both the jurisdiction of origin and the jurisdiction of destination to tax value creation in an appropriate way.

77. Although VAT is a tax on final consumption, VAT is not imposed on actual consumption but on proxies that are intended to predict the likely place of consumption. In the context of developing VAT guidelines, the OECD is identifying which proxies work best in certain circumstances. Once proxies are identified, actual consumption is irrelevant to determining the place of taxation. That is, the proxy trumps the place of consumption if they differ. In the context of digital transactions there are four possible proxies being considered. Those proxies are: consumer residence; actual location of the consumer; residence or location of the supplier; and place of performance. It is likely that the only really feasible proxy in the majority of cases will be consumer residence. The residence of the consumer is the proxy (and therefore the deemed place of consumption) for digital transactions. In other words, the place

23 Some have argued that making use of the infrastructure of a country ought to be a sufficient basis for finding a PE and imposing an income tax. We disagree with that view, but note that MNEs not only make use of the infrastructure of a country, but also contribute to it. Serving as the government’s VAT collector is a prime example of such a contribution.
of actual consumption would be irrelevant and the place of consumer residence would generally be the place of consumption.

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

VI. BROADER TAX CHALLENGES RAISED BY THE DIGITAL ECONOMY

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

1. Nexus – the reduced need for physical presence in order to carry on business raises questions as to whether the current rules are appropriate;

2. Data – the use of data raises questions concerning how to attribute value created from the generation of data through digital products and services, and how to characterize a person’s supply of data;

3. Characterization – how should payments attributable to new digital products and services be characterized;

4. VAT collection – particularly with respect to goods and services acquired by private consumers.

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

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

Data and the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services
81. The Discussion Draft provides that data gathered from various sources is a primary input into the process of value creation in the digital economy. (Para. 183) A key challenge is the attribution of value to this data and the extent of value relative to other sources of value—systems, software and people. It may be challenging to assign an objective value to raw data (Para. 183) and determine the ownership of that data. Personal data is generally considered to be owned by the individual to whom it relates, rather than by a company. (Para. 183)

82. BIAC believes that raw data has little or no intrinsic value, especially generally available raw materials such as usage data. Value is created by the aggregation of data and the application of analytics, which is achieved through investment in people and technological resources.

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

83. This section of the Discussion Draft raises the question of whether monetization models utilizing new delivery methods of goods and services challenges the rationale behind existing categorisations of income and consistency of treatment of similar types of transactions. These issues are raised, in particular, with respect to "cloud computing" transactions, including infrastructure as a service, software as service, or platform as a service. (Para. 187)

84. The Discussion Draft includes a lengthy factual description of the nature of cloud computing transactions. (Paras 79 - 84). BIAC generally agrees with that description and the broader factual statements contained in Chapters II and III of the Discussion Draft relating to cloud computing models. To consider the appropriate characterisation for such transactions, the Discussion Draft notes that it will be necessary to examine the rationale behind existing rules in order to determine whether those rules produce appropriate results in the digital economy and whether differences in treatment of substantially similar transactions are justified in policy terms. (Para. 188)

85. With respect to the characterisation of cloud computing transactions, we note the prior OECD work in this area, which produced guidance that remains useful today. In 2001, the OECD published the final report of the Technical Advisory Group on Treaty Characterisation of Electronic Commerce Payments.\(^{24}\) That TAG addressed the characterisation analysis for a variety of e-commerce transactions for purposes of the OECD Model Convention. The TAG discussed general principles which should be applied to the characterisation analysis, then applied those principles to 24 specified transactions. Those 24 transactions included several remote access transactions, including “application hosting”, “web site hosting”, “data warehousing”, and “streamed (real time) web based broadcasting”, which would be described as "cloud computing" transactions today.

86. The TAG evaluated the available precedents for characterising such payments as business profits or royalties, and concluded that the most useful guidance existed under U.S. tax law. Accordingly, the TAG adopted the principles of U.S. Internal Revenue Code section 7701(e) to guide its characterisation analysis. The TAG report states as follows:

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

\(^{24}\) Taxation and Electronic Commerce - Implementing the Ottawa Taxation Framework Conditions (2001).
28. The Group examined various factors used to distinguish rental from service contracts for purposes of section 7701(e) of the U.S. Internal Revenue Code and found these factors to be useful for purposes of determining whether payments are for “the use of, or the right to use, industrial, commercial or scientific equipment”. Once adapted to the transactions examined by the Group, these factors, which indicate a lease rather than the provision of services, can be formulated as follows:

(a) the customer is in physical possession of the property,

(b) the customer controls the property,

(c) the customer has a significant economic or possessory interest in the property,

(d) the provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract,

(e) the provider does not use the property concurrently to provide significant services to entries unrelated to the service recipient, and

(f) the total payment does not substantially exceed the rental value of the computer equipment for the contract period.

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

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

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

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

88. The guidance provided in the TAG continues to be useful today in characterising payments for cloud computing transactions. While the TAG language discussed above has not been formally incorporated into the OECD Commentary, guidance on certain analogous
transactions recently has been incorporated in the Commentary.\textsuperscript{25} In particular, the Commentary discusses how satellite operators and their customers frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilize the capacity of a satellite transponder to transmit over large geographical areas. The Commentary concludes that in most cases, payments for these transactions should be characterised as business profits rather than royalties. This is true even in the context of treaties that include the leasing of industrial, commercial or scientific (ICS) equipment. In reaching its conclusion, the Commentary points to the fact that customers typically obtain access to the transponder's transmission capacity, rather than physical possession of the transponder itself. We believe this analytical approach should apply to cloud computing transactions, and that the current Commentary guidance is consistent with the TAG report and the principles of section 7701(e).

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

90. We would be pleased to work with the OECD to develop language for the Commentary that provides guidance for payments from cloud computing transactions.

Collection of VAT in the digital economy

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

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

Framework for evaluating options

92. The Discussion Draft states that the Ottawa framework of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility continues to be a good starting point. (Para. 204) BIAC strongly endorses the use of the Ottawa framework. The framework will also need to take into account the key features of the digital economy as outlined in section III.

93. The principle of neutrality means that "ring fencing" the digital economy and applying separate tax rules is neither appropriate nor feasible. (Para. 205) BIAC agrees completely with this conclusion.

94. Another key point is that the OECD expects that action on the other action items will raise the effective tax rates of digital economy companies. If that is not the case and effective rates in the digital economy remain extremely low, then “addressing the broader tax challenge of the digital economy becomes a more pressing concern.” (Para. 208) While not surprising, this statement seems somewhat inconsistent with the notion that countries are free to choose to impose low (or no) tax on income properly attributable to that jurisdiction because it implies that a certain level of income tax ought to be paid at the corporate level in all cases. If income is subject to tax in the appropriate jurisdiction, then whether that jurisdiction chooses to impose a low tax or any tax at all, is a sovereign choice for that jurisdiction. If that jurisdiction

\textsuperscript{25} See e.g., OECD Commentary on Article 12, para. 9.1.
does not choose to impose tax, then (apart from appropriate CFC rules) other countries should not be able to assert a claim to tax that income.

**Options proposed to the Task Force**

*Modifications to the exemptions from permanent establishment status*

95. The Discussion Draft raises the question whether the activities described in Article 5 (4) of the OECD Model Convention could constitute core functions of a business. (Para. 210) At least in the case of maintaining a warehouse, that activity normally could be considered a "core" activity only of an enterprise whose principal business function is to provide warehousing services. Warehousing is an activity within almost every industrial supply chain. But it is seldom if ever a core function – indeed it is an area that many companies outsource in full or part and it is a function that is generally acknowledged as being easy to benchmark, given the multitude of third party comparables. It would also be unfair and distortive if companies that outsource their warehousing function are potentially treated differently from those companies who primarily insource. BIAC believes that if Article 5(4) is to be changed, then any such changes should modify the preparatory or auxiliary exception only for those enterprises whose primary source of revenue is an Article 5(4) activity. BIAC supports a policy that all businesses are subject to tax in the jurisdictions in which revenue-generating functions relating to their core competencies take place.

96. Changes to the definition of PE are part of Action Item 7 which is due by September 2015. BIAC will provide comments at the appropriate time on OECD/G20 proposals modifying these rules. Business prefers bright line rules that provide certainty, so to the extent the changes the OECD/G20 is considering move in that direction, that would be a plus. However, as we discuss at length in other parts of this comment letter, PE rules that minimize exposure to local country tax have a sound basis in policy. The OECD/G20 should not make broad changes without careful consideration of the consequences.

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

97. The Discussion Draft includes an option of an alternative nexus test when a business is “fully dematerialized.” (Para. 212) This seems to directly contradict the statement in paragraph 205 that ring-fencing the digital economy is neither appropriate nor feasible. Paragraph 213 provides a potential test for determining whether "fully dematerialized digital activities" are conducted, including the following elements:

- The core business relies completely or in considerable part on digital goods or services;
- No physical elements or activities are involved in the value chain other than the existence use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialization of location-relevant data;\(^{26}\)
- Contracts are concluded exclusively remotely via the Internet or by telephone;
- Payments are made solely through credit cards or other electronic means;

\(^{26}\) This condition is the most difficult to understand how it could apply to any significant enterprise. Assuming that the object of this option is to define a category of digital enterprises that provide valuable services cross-border, it is hard to conceive of such a business that does not include as part of its value chain development, operations, customer support, marketing, management and similar functions which allow the enterprise to identify new services, develop the technologies to perform the services, and deliver the service to the market.
• Websites are the only means used to enter into a relationship with the enterprise; no physical stores exist for the performance of core activities other than offices located in the parent company or operating company countries (emphasis added – BIAC questions why these operations seem to be ignored);

• All or the vast majority of profits are attributable to the provision of digital goods or services;

• The legal or tax residence and physical location of the vendor are disregarded by the customer;

• The actual use of the digital good or the performance of the digital service does not require physical presence.

98. If a fully dematerialized business is considered to exist, then a significant digital presence could be considered to exist in a country, under the following circumstances:

• A significant number of contracts for the provision of fully dematerialized digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country;

• Digital goods or services of the enterprise are widely used or consumed in the country;

• Substantial payments are made from clients in the country to the enterprise; or

• An existing branch of the enterprise in the country offers secondary functions.

99. As a general comment before analysing this under the Ottawa principles, it is interesting to note that the tests do not look to whether the payment by the recipient of the good or service is deductible. BIAC believes that this is because many of the transactions intended to be covered by this option are B2C so a deduction would not be available. It would seem that in order for this to be a base erosion problem, a deductible payment would be necessary. To reiterate, as to profit shifting, the BEPS project should be targeting artificial profit shifting, if profit producing activities shift, profits should move. Countries do not have a right to a particular level of tax revenues regardless of where business profits originate. It seems fundamentally inconsistent for market jurisdictions to argue that income from intangibles should be allocable to people functions (where the research and development takes place) and ignore the people functions when the transaction is digital (where the digital content is created). The digital content ultimately is created by people, so if people functions should trump then there is no basis for a nexus that looks solely at consumption activity. Otherwise, this option is inconsistent with the emphasis on people functions in the draft Chapter VI TPG revisions.

Ottawa Principles:

100. Neutrality: As the Discussion Draft notes in paragraph 205, ring-fencing the “digital economy” would violate the neutrality principle. That is, tax rules and therefore conditions would differ between traditional and electronic commerce. The option of special nexus rules clearly ring-fences some portion of the “digital economy” and therefore violates this principle. Paragraph 216 also raises neutrality issues because it raises the possibility of separate income attribution rules for “fully dematerialized digital businesses.”
101. Efficiency: BIAC believes that the efficiency criterion is also violated. BIAC believes that the nexus based on significant digital presence must be based on taxation of net, not gross, income.\textsuperscript{27} Net basis taxation will require some sort of return and depending on how the many subjective terms – significant number, substantial payments, widely used – are defined this could result in tax returns in many additional countries where the company has no physical presence at all. Establishing the accounting systems necessary to file returns in many additional countries is a significant burden and one of the principal reasons for the historical PE standard.

102. Certainty and Simplicity: The nexus test contains many subjective criteria such that the criterion of certainty will be violated. The test uses terms such as “considerable part”, “significant number”, “widely used or consumed”, “substantial payments”, which are all subjective and probably intended to be subjective. The determination of a "significant number" will vary widely between jurisdictions depending upon factors such as market size.

103. At the same time, however, one of the core elements of the definition would seem to apply only in exceedingly rare cases. One element of the proposed definition of a fully dematerialized digital business is that “no physical elements or activities are involved” in the value chain other than servers, websites and the collection of location-relevant data. Any enterprise of sufficient size to have its goods or services "widely used" in a country will have many employees who perform critical business activities other than “the collection, processing, and commercialization of location-relevant data.” As written, it is hard to conceive of an enterprise to which this element of the definition could apply. This would lead companies to be concerned that the test does not really mean what it says.

104. Effectiveness and Fairness: This criterion is more difficult to judge given that the standard is “that taxes imposed are designed to produce the right amount of tax at the right time, and avoid creating new opportunities to artificially avoid taxation.” The Discussion Draft does not provide details of how profits would be attributed to a taxable presence imposed under this new nexus standard. Accordingly, it is difficult to judge whether the right amount of tax would be imposed at the right time. The nexus rules fail the fairness test depending on whether what appear to be absolute tests are in fact absolute tests.

105. Flexibility: This criterion is difficult to apply; since it is difficult to anticipate which direction technology will take. However, the number of absolute tests proposed likely will make the test less flexible. For example, new technology may make the criterion of “contracts are concluded exclusively remotely via the internet or by telephone” irrelevant.

106. BIAC believes that the proposed option of a new nexus based on a significant digital presence clearly fails the Ottawa principles.

107. Looking at the new nexus test more generally, we believe that the only argument in favour of the adoption would be that it would permit market jurisdictions to impose an income tax on “fully dematerialized digital activities” in certain limited cases. Whether this is appropriate is a political decision for countries. On the other hand, this option would result in significant controversy and double taxation. This option also would discourage the expansion of digital goods and services into remote economies, which will adversely affect economic growth.

\textsuperscript{27} In part, because one of the other alternatives is a gross basis tax.
Accordingly, BIAC recommends that if countries wish to collect more tax from these transactions they should impose VAT on a wider range of deliveries of digital goods and services and not adopt income tax rules that violate the Ottawa principles as described above.

109. The Discussion Draft also proposes the option that a fully dematerialized business could be considered to have a significant digital presence if it uses personal data obtained by the regular and systemic monitoring of Internet users in that country through the use of multi-sided business models. (Para. 215) BIAC believes that this is narrower than the above proposals, but it is not clear who is doing the regular and systemic monitoring of the Internet users: the enterprise itself? If the data is obtained and analysed by another entity, then it would seem the profits from those activities should be attributable to the other entity and therefore should not give rise to a nexus for the business purchasing the data.

110. The Discussion Draft acknowledges that development of these options would “require evaluation of the above elements to determine which combination of factors would result in an appropriate nexus to address the tax challenges of the digital economy effectively, while providing enough clarity to minimize dispute. It would also require consideration of how profits would appropriately be attributed, and whether doing so would require modification of the current rules for the attribution of profits to PEs. The work would also need to consider whether such a change would require a change in the attribution rules for all enterprises or whether the changes could be limited to “fully dematerialized digital business.” (Para. 215)

111. This seems inconsistent with the statement in the Discussion Draft that ring-fencing the digital economy and applying separate rules is neither appropriate nor feasible.

Virtual permanent establishment

112. The Discussion Draft includes “for the sake of completeness” virtual permanent establishment options considered by the Business Profits TAG. (Para 217) It does not seem that these options are being actively considered by the Task Force since the options are merely stated with no assessment of pros and cons as were expressed by the Business Profits TAG. BIAC opposes the adoption of any of these virtual PE options because adoption would violate the Ottawa Principles.

113. Neutrality: A virtual PE establishment is not real; there is, in fact, no place of business in the cases in which the virtual PE options seek to deem a PE to exist. The neutrality principle would be violated to the extent that the options would result in different tax outcomes for conventional and digital forms of commerce.28

114. Efficiency: Extending the PE concept to cover situations where websites are being hosted in a country would create serious compliance difficulties. A business may not even know where a website is hosted. Tax administrations would have to attempt to enforce their tax rules in the absence of physical assets and employees.29

115. Certainty and Simplicity: The virtual PE proposals would add uncertainty to the determination of whether a PE exists. For example, businesses may not know where the servers hosting its operations are located. Businesses may have difficulty identifying where contracts are concluded and to the extent there are thresholds, it may be difficult to have reliable information

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29 Ibid at para. 333.
on whether the thresholds are exceeded and it will be difficult to know at the outset whether the thresholds will be exceeded.

116. Effectiveness and Fairness: The virtual PE options attempt to tax business activities that are not carried on within a country. Thus, creating a PE is “unfair”. It is also likely to be ineffective both because it will be difficult to administer and unless profit attribution rules are fundamentally changed, little or no profit will be attributable to the virtual PE.

117. Flexibility: It is unclear whether these models would be flexible enough to deal with emerging technologies.30

Creation of a withholding tax on digital transactions

118. A further proposed option is a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider. (Para. 218) Presumably, the justification for such a tax is that the provider delivers a substantial amount of goods or services into a jurisdiction but does not maintain a taxable nexus in that jurisdiction. Consistency with trade obligations would need to be considered, as would the difficulties of imposing a withholding tax in the context of B2C transactions. The burden of complying with a withholding tax may be imposed on financial institutions. (Para. 218)

119. A withholding tax would allow the market jurisdiction to collect some revenue without the burden of imposing net income filing requirements and determining the profits attributable to the market jurisdiction. It would likely therefore be simpler in some respects. However, this option raises difficult characterization issues and those issues have caused significant controversy and double taxation in the software and service industries. Revenue is a poor proxy for net income. As discussed above, developing digital products and services may require significant investment in time and money. Many products and services never make any money on a net basis. Because of these concerns any withholding tax should be at a very low rate. India’s High Powered Commission recommended a 3% rate for these reasons.

120. Neutrality: “It would be difficult to justify applying withholding tax only on cross-border e-commerce and not on traditional cross-border trade. Such a tax would violate the neutrality principle as presented in the Ottawa framework principles. The alternative of applying the tax to all forms of cross-border trade would mean, however, the introduction of tariff-like taxation, which might well be against WTO rules and principles.”31

121. Efficiency: There are also administrative concerns many of these transactions will be B2C32 and very low value. It is unlikely that individual consumers will collect and pay over a withholding tax. Imposing a withholding tax on these transactions will create significant burdens for the financial system.

122. Certainty and Simplicity: A withholding tax applicable only to digital transactions would require a definition of the transactions to which it applied. This would likely be a difficult task.33

123. Effectiveness and Fairness: Given the difficulty of imposing a withholding tax on B2C transactions, this option may not be effective. It also appears to fail the fairness test since the

31 Ibid at para. 260.
32 We reiterate that in the case of B2C transactions there should not be a base erosion concern.
withholding tax would be levied regardless of profitability. A tax on gross revenues is a very poor proxy for a tax on net income.

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

Consumption tax issues

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

Exempt sector and multi-location entities

126. The Discussion Draft identifies remote digital supplies to exempt business (Para. 137) and to a multi-location enterprise (MLE) (Para. 140) as aspects which, under certain conditions, create opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT. Concerns particularly relate to the extent that Guidelines 2 and 4 of the OECD’s “Guidelines on place of taxation for B2B supplies of services and intangibles” are not implemented.

127. Before commenting on this aspect in further detail, we would like to first highlight some more conceptual aspects that are not specific to the digital economy.

128. All stakeholders, including governments, business or academia, agree that conceptually, a broad based VAT system, with ideally no or very few exemptions, and one standard VAT rate, would represent the most efficient and effective structure for all relevant parties. It would take substantial complexity out of the VAT system, would ensure neutrality for business, and would ease both compliance for business and administration for governments.

129. Therefore, these issues relating to the exempt sector and MLEs in the exempt sector are not specific to the digital economy. Instead, they are conceptual issues related to the design and the application of the VAT system. As the Discussion Draft points out these issues arise to the extent that Guidelines are not implemented. (Para. 136) Thus, implementation of the Guidelines would alleviate these BEPS concerns. (Para. 171) Business supports the implementation of the Guidelines and urges governments to implement the principles of the Guidelines in a consistent fashion.
BIAC would also like to point out that the imposition of new VAT on exempt purchasers of digital (and non-digital) products and services is a significant issue. Universities, hospitals, governments, local government bodies and many others buy vast quantities of services (digital and otherwise) and do not have the budget to pay additional VAT. Although this is not purely a digital issue, as the OECD examines the application of VAT to the exempt sector, these issues should be taken into account to ensure that the exempt sector is not exposed to significant additional costs whilst also ensuring a level playing field for domestic and foreign providers of goods and services.

Finally, we would like to clarify two editorial aspects of the Discussion Draft to ensure a common understanding:

In paragraph 140, an MLE is referred to as a multinational business that has establishments in different jurisdictions. This could be misunderstood as including subsidiaries of multinationals. However, putting this statement into the context of the relevant example described in the Discussion Draft, and considering the work already done on the VAT Guidelines, it should be clear that it can only mean a multinational business established as a single legal entity with branches of that same entity in different jurisdictions.

Paragraph 171 states that “Guideline 2 recommends that the taxing rights on cross-border supplies of services and intangibles between businesses be allocated to the jurisdiction where the customer has located its main business establishment and that business customers be required to self-assess VAT on remotely delivered services acquired from offshore suppliers according to the rules of the jurisdiction in which they are located”. We agree with the allocation of the taxing rights to the jurisdiction where the customer is located, and with the required self-assessment of VAT by the business customer, but we would like to point out that in context of Guideline 2 of the International VAT Guidelines, which deals with legal entities that are established in one location (Single Location Entity, SLE), the taxing rights will always be allocated to the jurisdiction where this legal entity is located. Therefore, there is no “main” business establishment in this context, as the business is only established in one location.

Consumption tax options

The Discussion Draft states that the main VAT challenges created by the digital economy relate to exemptions for importation of low value parcels (Para. 219) and the increase in direct sales of services to consumers (Para. 222) (not the tax treatment of the exempt sector). Paragraph 189 states that the challenge posed by the digital economy may result “in no VAT being levied at all on these flows, with adverse effects on countries VAT revenues and on the level playing field between resident and non-resident vendors. (Para. 189)

With respect to low value imports and remote digital supplies to consumers, there is a need to find a balance between the need for appropriate revenue protection, avoidance of the distortion of competition and the need to keep the cost of collection proportionate to the small level of VAT collected. (Para. 193)

With respect to remote digital supplies to consumers, the Discussion Draft notes that compliance by non-resident suppliers is essentially voluntary as VAT jurisdictions have limited means to enforce compliance by non-resident non-established suppliers. (Para. 195) Experience suggests that MNEs do comply, in part because of reputational reasons. (Para. 195) We expect that this issue will be returned to Working Party 9 to be dealt with be the VAT/TAG.
137. BIAC agrees that the most effective and efficient option to ensure appropriate VAT collection on cross-border B2C services is to require the non-resident supplier to register and account for these supplies in the jurisdiction of the consumer. (Para. 221) Countries should consider simplified registration regimes to minimize the compliance burden. (Para. 222)

138. Remote digital supplies to consumers are covered by the WP 9 work on B2C as part of the development of the International VAT Guidelines, and are currently being discussed in the VAT/ TAG.

139. To safeguard VAT revenues and to be able to accurately, timely, and efficiently comply with the VAT obligations, clear, consistent and easy to apply rules are of utmost importance for business. This is even more important in the B2C context, both for imports of low-valued goods and for remote digital supplies to consumers, where businesses have to deal with high volume and low value cross-border transactions.

140. Striking the right balance between the VAT at stake and the administrative costs for business and governments related to that collection is crucial. The wrong balance discourages compliance and can lead to a distortion of competition for business. This is a significant concern for the international business community related to cross-border B2C supplies, particularly in the context of e-commerce related supplies. It is important to recognize that VAT revenues are best safeguarded and collected when the administrative costs of collection and compliance are reduced. Nevertheless, thresholds and exemptions will still be necessary. Business should not be forced to deal with compliance burdens in relation to a de minimis level of transactions, especially where the business may have no control over whether the obligation is incurred because customer’s ability to purchase goods and services without regard to borders.

141. The question that therefore arises is how can collection be made as easy and as efficient as possible for business while ensuring enforceability for governments?

142. Two aspects play a vital role here:

   a) Internationally consistent ‘place of taxation’ rules are required that allow business to determine, in an easy and efficient manner, where a transaction should be taxed for VAT purposes.

   b) Internationally consistent simplified procedures/mechanisms are required, particularly for foreign businesses selling digital supplies cross-border, to allow business to collect and pay the VAT in an easy and efficient manner, while at the same time, improving enforceability for governments.

143. In a B2B scenario, the two aspects identified above are covered by the International VAT Guidelines based on the destination principle and the recommendation to apply the reverse charge regime as the collection mechanism. Adoption of the Guidelines by governments would ease the burden of the collection of the VAT for business while ensuring full enforceability for governments.

144. Consistent application of the destination principle by governments around the world, together with the application of a reverse charge regime is vital. It was suggested in the ‘E-commerce Guidelines and the Consumption Tax Guidance’ papers issued in 2003 and has been further explored and reconfirmed again by the VAT Guidelines. In a B2C scenario, it will be more difficult but not impossible to implement consistent place of taxation rules and simplified procedures. Flexibility on the use and evidence of place of taxation proxies, easy access to
information, easily accessible, simplified, and standardized and technology friendly administrative procedures and an effective administrative cooperation between governments are crucial to make this happen.

145. A tax is not worth anything if it cannot be collected. Particularly when it comes to high volume low value transactions, the OECD should aim for place of taxation rules that allow VAT to be collected in an easy and efficient manner.

146. Business needs flexibility both on appropriate proxies for place of consumption and appropriate indicia to determine the application of those proxies. It may, in some cases, be impossible not just burdensome for business to identify the residence of their customers and they therefore may need to rely on appropriate indicia of residence such as the address associated with a credit card. Only if flexibility is ensured will business be able to effectively collect the VAT at stake. Substantial work has already been done on this aspect in some jurisdictions, for example in the EU, which should be considered, learned from and further explored.

147. Procedures/mechanisms need to be as simple as possible. This will enable foreign businesses to collect and pay the VAT in efficient manner, while improving enforcement for governments. Business agrees that vendor collection is the most viable option. (Para. 222) Business also agrees that simplified registration systems and registration thresholds are necessary to minimise the compliance burden on business. (Para. 223) The simplified registrations system should allow business the choice and maximum flexibility (i.e. direct registration, simplified registration, collection by a 3rd party intermediary on behalf of the supplier, etc.).

148. Such a system will only work if business has easy access to information in order to know how to comply and if governments provide easily accessible, simplified, standardized and technology friendly administrative procedures. Technological solutions should be web-based, secure, and should cover remote selling of goods and remote supplies of services. In addition, governments must establish effective administrative cooperation. Without such cooperation, it will be impossible to simplify and standardize the compliance requirements, leading to inefficiencies for business and less compliance with VAT overall. Thus, business supports the notion expressed in paragraph 224 that improved international cooperation between jurisdictions is likely to be required. We would note, however, that this paragraph focuses on cooperation in enforcement actions. While such cooperation is both necessary and appropriate, cooperation needs to begin with designing simple, consistent VAT systems and extend through the cycle to dispute resolution. The issue of double VAT taxation is difficult for two reasons. First, unlike an income tax dispute, it is essentially impossible to split the tax because the issue is always in which jurisdiction did consumption occur? Therefore to reach resolution one jurisdiction has to concede that its VAT will not apply. Second, although VAT is covered by the Mutual Agreement Procedures of income treaties and the MLAT, we believe it is unlikely the Competent Authorities would be willing to deal with VAT issues. If the Competent Authorities were to accept a VAT case, it is unlikely they would have a basis to reach agreement because of the jurisdictional nature of these disputes.

149. Remote B2C digital supplies may involve multiple parties in the supply chain which can make it difficult to determine who the supplier of the service is to the final consumer. Knowing the supplier is key, particularly when aiming at supplier registration as the mechanism to collect the VAT at stake. The OECD must develop clear rules on this. These rules should be informed by EU rules in this area.
150. In some cases business may wish to use third party intermediaries in the collection process. This should be an option for foreign business, not a requirement. Financial intermediaries may not have the relevant information to determine VAT properly. So financial intermediaries can only be a part of the solution if both the supplier and the intermediary agree.

151. All of these aspects need to be further explored and the OECD VAT TAG process is the right platform for governments and business to work together to develop an efficient solution. This solution can only work through effective administrative cooperation between governments.

152. Finally, there is one very important point to highlight when it comes to supplier registration as collection mechanism for VAT purposes. As mentioned in footnote 25 of the VAT Guidelines, a registration for VAT purposes by itself does not constitute a permanent establishment. Business experiences more and more that, by acting as VAT collectors for governments, foreign VAT registrations are misused by governments and are re-qualified as a permanent establishment for corporate tax purposes, forcing business to pay corporate tax in a jurisdiction where, based on international direct tax principles, no corporate tax should be due. In the long term, and if this continues to happen on a larger scale, such developments might undermine an efficient collection of VAT by dissuading businesses from registering for VAT purposes. This would result in VAT revenue losses for governments and distortion of competition for business.

Co-ordination with other digital economy options

153. In section VII, various options unrelated to VAT are proposed to address the broader tax challenges raised by the digital economy. Some of these options could have an impact on VAT. For example, any changes to the current permanent establishment concept may have an effect on the application of the simplified VAT registration procedure. Such changes might also influence the application of the reverse charge mechanism.

154. Therefore when considering these options from a direct tax perspective, adequate time must be dedicated to fully understanding the potential VAT consequences.
Public Discussion Draft
BEPS ACTION 1:
ADDRESS THE TAX CHALLENGES
OF THE DIGITAL ECONOMY (OECD)
24 March 2014 – 14 April 2014

The information supplied below is provided in good faith for your assistance. In accepting this information you acknowledge your agreement that it will not be used against any of the parties referred to, or be disclosed to any third party without our prior agreement

Boku background

Boku is a mobile payment services provider, enabling people across the globe to pay for the things they are interested in using the one device they’re never without, their mobile phone. The company contracts with content providing merchants to collect payments on their behalf. The company then sub-contracts with Mobile Network Operators or “Carriers” – sometimes via other intermediaries – to collect the payments from final consumers. There may also be additional intermediaries in the beginning of the chain between Boku and the content providing merchant. Therefore the longest chain in the payment collection that we tend to see can include five unrelated and separate companies.

Comments:

Based on experience from our role in the payment collection services chain and in response to the particular questions posed we would make the following comments:

• Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules;

• The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account;

Response - the risks of using the current VAT regime to resolve where the liability for paying VAT in cross border e-commerce transactions mean that these can identify a business as supplier where this is not the case and therefore include any other legal obligations belonging to that transaction that should properly belong to the original supplier. Some countries like Italy and Germany take the view that if a business remits the VAT that all other legal obligations accompany the VAT liability. This is an issue that should be taken into account.

• The examples of new business models in the digital economy and whether (and if so which) other business models should be considered;

Response - It should be noted that not all e-commerce services will be subject to VAT at standard rates, for example payment by mobile phone is starting to expand to cover other types of transactions such as online gambling, which is generally VAT exempt in the UK and instead subject to other duties which are applied differently, or services like parking are also effectively arranged and paid for online but again may be subject to different tax treatments. Also confusion arises around various different methods of digital payment methods and whether these fit within Payment Services legislation, for example e-money, or are instead varieties of “VATable” voucher type arrangements. This confuses the issue of
what the tax points are for e-commerce services which also impacts on who is liable to pay the tax. Any resolution of the VAT issue should address these points so that tax is only liable once.

- The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy;

- Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones;

- The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation;

- The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft;

Response - potentially a withholding VAT type system could work on the basis that this would be collected by the payment collection business without any accompanying other legal and product liabilities or other responsibilities. To avoid double taxation it would be suggested that where verified local VAT registration numbers are provided by the relevant supplier withholding VAT would not be applicable. This would have the benefit that it would be clear who would remit the VAT – either the payment collector or the supplier where a local VAT registration number was provided. This could solve the problem of enforcing local registration which in the EU has been found to be extremely difficult.

- The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives;

- Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

Greta Kemper
Global Indirect Tax Manager
Boku

3rd April 2014
The Committee on Fiscal Affairs
OECD
2 rue André Pascal
75775 Paris Cedex 16
France

April 14, 2014

Dear Sirs

RESPONSE OF BRITISH SKY BROADCASTING GROUP PLC (“BSKYB”) TO THE OECD DISCUSSION DRAFT: TAX CHALLENGES OF THE DIGITAL ECONOMY

We are pleased to have the opportunity to comment upon the Discussion Draft published by the OECD on 24 March 2014 (referred to in this letter as “the Draft”).

1 Summary Comments

1. BSKyB supports the OECD’s initiative to combat BEPS;
2. We are of the view that it is a mistake to consider the digital economy as a separate phenomenon. There is no such thing as the digital economy per se. There are, simply, businesses - which employ digital technologies to a greater or lesser extent;
3. Subject to (2), we believe that the Ottawa principles of neutrality, efficiency, certainty, effectiveness and flexibility should be upheld in any anti-BEPS measures, together with an overriding principle that no new taxes should be introduced as part of efforts to tackle BEPs in this area;
4. BSKyB recommends that the most appropriate focus for reform to combat BEPS in this area may be for tax authorities to modernise their approach to applying the existing domestic and treaty rules as to whether a taxable presence or permanent
establishment exists, with particular regard to the interpretation of the existing exemptions;

5. On the other hand, we have concerns that several of the possible approaches set out in Section VII of the Draft do not comply with the core principles set out above;

6. We urge the Digital Economy Task Force to move as rapidly as possible to a distillation of its firm proposals, given the very short timeframe within which the final document must be prepared.

2 Background

BSkyB is the UK’s leading entertainment and communications provider, supplying TV, fixed line telephone and broadband to more than eleven million households. We are listed on the London Stock Exchange and we are a constituent of the FTSE-100 index.

BSkyB is also a major contributor to the UK economy through taxation: in the most recent survey carried out by PwC for the Hundred Group of leading UK businesses, BSkyB made the biggest UK tax contribution of any media company.

BSkyB’s business is predominantly carried out in the UK, but we also have a large customer base in the Republic of Ireland, and operations in a number of other jurisdictions. Wherever we operate, we pursue a policy of open and constructive engagement with the tax authorities, and seek to contribute constructively to the formulation of policy.

As such, we welcome the OECD’s initiative on BEPS, since we believe it presents an opportunity to achieve greater clarity and certainty in the rules of international taxation. In principle this should be good both for business and for tax administrations, and should help to achieve a better understanding of international taxation among opinion formers and the public.

3 Guiding Principles in formulating new proposals
With regard to Action 1 (Address the Tax Challenges of the Digital Economy), BSkyB believes that there are a small number of guiding principles which should inform the measures taken to combat BEPS.

Underlying our support for these principles is our belief that there is no such thing as the “digital economy” as a separate branch of the global economy. Instead, digital methods and technologies are merely tools which businesses use, to a varying extent, in pursuing their overall commercial objectives. It follows from this that there should not be a separate set of rules for the digital economy, but that instead, knowledge and understanding of these digital tools should inform the development of policy in other areas, for example the transfer pricing approach to intangibles and the definition of taxable presence.

Most of the core principles which we support are enshrined in the so-called “Ottawa Framework”, which was developed in the 1998 Ministerial Conference on Electronic Commerce, but are still highly relevant today:

- Neutrality
- Efficiency
- Certainty & Simplicity
- Effectiveness & Fairness
- Flexibility

We are pleased to note that the Draft endorses those principles, and that it states that they can help form the basis for evaluating the options for tax reform today.

We believe that one further principle should also apply. This is that there should be no new taxes as a result of the response to BEPS in the “digital economy”. We consider, instead, that the challenges presented by BEPS are best dealt with by updating and modifying existing principles and rules. Indeed this follows directly from the principle of neutrality: if this principle is to be upheld, any new taxes would need to apply to conventional business in the same way as digital businesses, and we do not believe that such sweeping change, affecting all types of business, is either necessary or desirable.
We are concerned that some of the potential options set out in Section VII of the Draft do not satisfy certain of these principles. We discuss these options below, by reference to the principles in question.

3(a) Neutrality

It is important that whatever steps are taken to address BEPS, or the danger of BEPS, they should not result in digital business being taxed more heavily than conventional business.

In this respect we agree with many of the observations in section 2.1.1 of the Draft. As stated there, most countries, in their domestic tax law, “require a degree of physical presence before business profits are subject to taxation”. That is certainly true in the strict sense of corporate income tax on profits. However, in certain cases there will nevertheless be an in-country tax burden on the foreign operator of a digital business, in the form of withholding tax on royalty flows. In this context, the withholding tax amounts to a form of proxy corporate income tax. Indeed, if there is not a suitable tax treaty between the home country of the operator and the country of consumption, such a withholding tax can form a significant net cost of doing business in the country in question.

These well-established concepts reflect two important policy principles that many industrialised countries have long subscribed to:

1. The distinction between doing business in a country and doing business with a country. In the former case, a permanent establishment (P.E.) will generally arise, because the foreign supplier has enough commercial substance locally to warrant the local tax authority having some taxing rights over profits generated there; while in the latter case, in the conventional analysis there is so little being done in-country that local taxation of the profits would be disproportionate.

2. The aim of achieving an equitable level of taxation in a situation when the supplier does not have a P.E. and where the income is generated, not by a real commercial business operation, but by a passive / portable asset such as a patent or a copyright. If this is the case, a withholding tax liability may arise in the country of consumption.
In our view, some of the examples of possible options for change set out in Section VII of the Draft violate the principle of neutrality.

The proposal at 3.4 for the creation of a new withholding tax on digital transactions falls into this category: a targeted special withholding tax that would apply to the supply of digital goods or services, but not to conventional supplies, would violate the principle of neutrality. As a consequence of this, it might have harmful economic effects, since it would act as a disincentive to the use or development of more efficient means of production and distribution, and would encourage suppliers to revert to more conventional, less efficient means.

For example, if the new withholding tax applies to a supply of software that is downloaded from a website, but not to an old-fashioned sale of a disk with the software stored on it, businesses will tend to post the disk to the customer. We do not think that tax policy should distort business behaviour to encourage less efficient practices in this way.

Similarly, the proposal at 3.3 to introduce the concept of a “virtual permanent establishment” which, by reference to at least the first two of the three stated scenarios, could only apply to a digital business (and never to a conventional business) also appears to be inconsistent with the principle of neutrality.

3(b) Efficiency

The proposals for modifying rules on consumption taxes have the advantage of not involving wholly new taxes, and as noted in the Draft, these developments have been anticipated to some extent within the EU.

However, as the Draft also rightly points out, it is critical that the tax authorities achieve a significant improvement in the registration and compliance requirements involved, failing which such changes are likely to lead to a quite disproportionate compliance burden. For smaller or more cost-sensitive vendors, this compliance cost could, on the margins, make it more cost-effective for them not to supply customers in particular countries – a highly undesirable outcome.
3(c) Certainty & Simplicity

The proposal for a new category of nexus based on significant digital presence is likely to add significant additional complexity and uncertainty for business. This would potentially apply in the case of enterprises which are engaged in certain “fully dematerialised digital activities” and which maintain a “significant digital presence” in the economy of another country.

The Draft sets out some potential elements of a test to determine whether a business has a “fully dematerialised digital activity”. The fact that eight of these elements are enumerated (with an indication that there could be others), and that some of them involve subjective judgments or are burdensome to prove, are evidence in themselves of a lack of certainty and simplicity (for example, a “considerable part” of the business must rely on digital goods or services; the “vast majority” of profits must be attributable to the provision of digital goods and services; and it must be demonstrated that customers are not influenced by the residence and location of the vendor).

Similarly, the “significant digital presence” test would include at least four elements, including deciding whether the number of remotely signed contracts is “significant” whether digital goods or services are “widely consumed” in the territory, and whether “substantial” payments are made by in-country clients. Even if an attempt were made to introduce thresholds to help define these otherwise subjective measures, these would be likely to have distortive effects for businesses at the margins of those thresholds, and possibly lead to competition between tax authorities to create more benign conditions than in other countries. We do not consider that this is likely to be regarded as a positive outcome by many OECD members.

4 Next Steps

We consider that the process of developing an effective response to the BEPS challenge in this area is best advanced by seeking to maintain the core principles described above.
As such, in our view the most appropriate way forward may be to seek to modernise the approach to applying and interpreting the application of existing rules governing taxable presence and permanent establishment. This may make it unnecessary to modify the exemptions themselves, as is briefly suggested at 3.1. This would notably have the merit of satisfying the principle of neutrality.

We would also caution against introducing too much subjective judgement into the analysis, for example by eliminating all of the subparagraphs (a) to (d) in para 4, Article 5 of the Model Treaty.

Changes in approach and interpretation should instead be targeted at the specific areas where difficulties have arisen in applying Article 5 in modern economic circumstances.

In our view these difficulties are largely to be found in relation to subparagraphs (a) and (b) (storage activities), whereas on the other hand we do not consider there is significant scope for BEPS abuse in an activity such as information gathering (subparagraph d) for example.

Finally, in the indirect tax field, we would commend the actions already taken within the EU to modernise the rules on Place of Supply from January 2015. This, together with the administrative support of concepts such as the Mini One Stop Shop, could be taken as a blueprint for developments outside the EU.

We would therefore encourage the Action Group to concentrate its efforts in these areas as it moves towards the formulation of its final proposals.

Yours faithfully
Jonathan Smith
Head of Direct Tax
British Sky Broadcasting Group plc

BUSINESSEUROPE represents through its members 20 million European small, medium and large companies. Active in European affairs since 1958, BUSINESSEUROPE’s members are 41 leading industrial and employers’ federations from 35 European countries, working together to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled “BEPS Action 1: Address the Tax Challenges of the Digital Economy, 24 March 2014 – 14 April 2014” (hereinafter referred to as the Draft).

General Comments

Before going into any specifics, BUSINESSEUROPE would like to emphasise the importance of distinguishing between income tax and consumption taxes (VAT, GST, etc.). In the OECD framework and as a global standard, income tax is based on residence and source. Consumption taxes on the other hand aim at taxing consumption. Levied on the supply of goods and services, VAT/GST are taxes that are self-declared and business serves to collect these taxes for the government. As clearly stated in the BEPS Action Plan, it is not the purpose of the BEPS project to change existing international standards on the allocation of taxing rights on cross-border income. Consequently, the place of consumption is not and should not be a factor when allocating income for income tax purposes. Instead, the place of consumption is relevant for consumption tax purposes such as VAT or GST.

The combination of origin based income tax and destination based consumption tax allows for a reasonable allocation of taxation rights between the country of origin and
the country of destination. This way, the income tax and the consumption taxes complement each other. This of course is not always the case since there are countries that do not have a consumption tax. That however is not an issue that requires action on a global level. Rather, this is a national issue to be solved in the countries in question.

That being said, BUSINESSEUROPE believes that the Ottawa taxation framework principles (neutrality, efficiency, certainty, simplicity, effectiveness, fairness and flexibility) constitute an appropriate framework when analysing the tax challenges. While it is clear that technology has rapidly evolved since 1998, the Ottawa taxation principles for electronic commerce outlined above, and developed under the leadership of the OECD CFA in 1998, remain relevant and valid.

We share the view presented in the Draft that it is not possible to ring-fence the digital economy. However, the Draft also tries to identify features that distinguish the digital economy. In our opinion, the features identified in the Draft are neither accurate nor limited to the digital economy. They may be relevant for some businesses in the digital economy, but they are not likely to be limited to the digital economy or to cover all aspects of the digitisation of the economy. Considering the complexity of this topic and the speed with which business models evolve, the features identified are likely to become obsolete in the near future. Consequently, we believe that the OECD should not develop any new guidelines, recommendations or amendments to the OECD Model Convention based on the Draft. Indirect tax issues referenced in the BEPS Draft are already being reviewed by the OECD through its existing WP 9 efforts related to B2C, and are also being discussed in OECD work on international VAT/GST guidelines. Business is fully engaged in that process.

In fact, it is our firm opinion that no specific rules are required for the digital economy as a “sector”. Considering that it is not possible to ring-fence the digital economy, we believe that it would be highly inappropriate to develop separate principles or rules for taxation of the digital economy from those applied to businesses engaged in the “conventional” economy.

Specific Comments

Nexus

The Draft points out that it is possible to be heavily involved in the economic life of another country without having a fixed place of business or dependent agent. In most cases, neither tax treaties (OECD Model Tax Convention Articles 5 and 7) nor domestic laws allow a country to tax income from a non-resident if there is not sufficient nexus. Sales to customers located in that jurisdiction would not constitute a sufficient nexus.
It is also stated in the Draft that the digital technology has had a significant impact on how activities are carried out, by enhancing the ability to carry out activities remotely, increasing the speed at which information can be processed, analysed and utilised, and, because distance forms less of a barrier to trade, expanding the number of potential customers that can be targeted and reached. According to the Draft, this increases the flexibility of businesses to choose where substantial business activities take place, or to move existing functions to a new location, even if those locations may be removed from both the ultimate market jurisdiction and from the jurisdictions in which other related business functions may take place.

In our opinion, this is true for all businesses and not only limited to the digital economy. Globalisation and the reduction of cross border obstacles allow businesses of all kinds to locate various functions in the most appropriate locations. Access to natural resources, cost of labour, capital costs, political stability, business climate, taxes etc. are all factors that are taken into account in such decisions. This is however not a matter of base erosion or profit shifting. This is sound business management aimed at enhancing economic efficiency and value. The only reason for countries to prevent this global aspect of modern business would be for protective reasons, which is contrary to the purpose of the OECD. Taxes must not be used to prevent trade and investment.

We do not consider the fact that a business can provide customers in a jurisdiction with goods and services, without a physical presence in that jurisdiction, to be an issue of great concern. Income taxes are not and should not be based on the location of customers. In our view this could potentially be an issue in a formulary apportionment situation but not as a BEPS concern. Given the fact that the Draft does not seem to clearly make this distinction, we would like to make some comments with respect to the fundamental income tax principles.

As previously stated, income tax is based on residence and source. Clearly, the traditional division of income based on factors such as functions of R&D, production and marketing is relevant also for the digital economy. Customers and markets are obviously necessary for any business, irrespective of whether a product is sold over the counter, by mail order through a catalogue or by digital means. A market is a condition of doing business but does not constitute functions, assets, risks or income by itself. Markets with many customers having disposable income may provide a business opportunity, but that is all it is: an opportunity. In order to turn those opportunities into income, companies must develop products that customers want to buy, find their customers, and deliver their products. Companies that cannot perform these functions will not earn income. The income that companies do earn is attributable to the performance of those functions, not the mere existence of the market. If the only thing that happens in the market jurisdiction is customer activity, it is difficult to see how, under traditional notions of income taxation, any income (as opposed to other bases of taxation) can be attributable to the market jurisdiction. This is true both for the digital economy and for the conventional economy.
Thus, the fact that a company provides goods or services to customers in a country does not by itself constitute a jurisdiction to levy income tax. If there is no need for a physical footprint, then the infrastructure of that country is not utilised and, consequently, that country should not have a jurisdiction to tax that income. The country where consumption takes place may, however, levy a consumption tax.

We understand that it is not the purpose of the BEPS project to alter fundamental principles of international taxation. Some of the options tabled in the Draft imply reallocation of income taxation to where the consumption occurs, even though there is no nexus. This would mean that the jurisdictions claiming the right to tax under current principles (based on function, assets and risks) will have to give up all or part of that right. These are most likely to be small economies with substantial exports and small markets of their own. Should those countries choose not to give up that right, double taxation would inevitably be the result. The negative revenue implications for a large number of countries could be substantial. In fact, many countries with small domestic markets could experience a considerable erosion of their national tax base as a consequence of actions taken by the largest economies represented in G20, taking actions in the name of the BEPS project.

Furthermore, we believe that the Draft contradicts other actions of the BEPS project. Several of the action points in the BEPS project require more substance in order to grant taxpayers the allocation of income to a jurisdiction or to grant treaty benefits. However, in the Draft the OECD seems to search for ways to allocate income to a jurisdiction where the taxpayers have no or very little substance (assets, function or employees). This is a contradiction in objectives that should be spelled out and explained. The risk of extra-territorial taxation should also be addressed and its consequences analysed. This has unfortunately not been done in the Draft.

We would furthermore like to make some specific comments with respect to the options in Chapter VII of the Draft related to nexus issues.

PE Exemptions in para. 4 of Article 5 of the OECD Model Convention

BUSINESSEUROPE strongly opposes any amendment of para 4 of Article 5 of the OECD Model Convention. Para 4 provides certainty with respect to the activities listed therein. Should the paragraph be amended or should the paragraph or parts of it be deleted, countries may consider all activities that currently fall under its scope as constituting a permanent establishment. The impact on conventional businesses would be severe. Businesses would have to re-evaluate all such activities and assess whether they would constitute a permanent establishment. This would result in either cost intensive restructuring or in a significant increase in the number of permanent establishments.

We strongly question whether such an extension of the permanent establishment concept would be feasible. If this would be the case, every enterprise would be
required to file a tax return in every country where that enterprise has sales. In practice, this would prove to be very difficult, if not impossible, especially for SMEs. We worry that further BEPS concerns would emerge as a result of the difficulties to attribute cost deductions, losses etc. to all the countries where an enterprise is considered to have a permanent establishment.

Furthermore, if this option was adopted, the increase in the number of permanent establishments would most likely require businesses to register for VAT purposes in every country where they would be deemed to have a permanent establishment. Tax administrations tend to require a VAT registration where a permanent establishment for income tax purposes exists, even though there is no link between the two. This would further add to the administrative burden for businesses.

**Significant Digital Presence Nexus**

We firmly oppose the option to establish an alternative nexus for businesses to address situations in which businesses are conducted wholly digitally. This is, in our opinion, contrary to the conclusion in the Draft that the digital economy cannot be ring-fenced and would create great uncertainty on practise. Furthermore, an action that would differentiate wholly digital activities from other activities would be contrary to the neutrality principle in the Ottawa Framework.

**Virtual PE**

As previously mentioned, there is in our opinion no jurisdiction for a country to tax income where there is no physical nexus in that country. A virtual permanent establishment concept is a matter of formulary apportionment or splitting the cake rather than a BEPS concern. It would be very difficult to find sound and acceptable rules for allocating profits to a virtual PE.

The concerns in relation to para 4 of Article 5 above are applicable to the virtual permanent establishment concept as well. A virtual permanent establishment would also lower the threshold significantly and, as a result, lead to a significant increase in the administrative burden for businesses and an increase in double taxation cases worldwide.

**VAT Collection**

CFA have requested WP9 to develop guidelines for applying the destination principle to cross-border supplies of services and intangibles to final consumers. BUSINESSEUROPE endorses the OECD’s work on VAT Guidelines, and would like to stress that this is the venue for further work on the topic at the global (OECD) level.
We would recommend that governments take a closer look at the international VAT/GST guidelines.

As previously stated, BUSINESSEUROPE believes that the appropriate means of taxing consumption is with consumption taxes rather than income taxes. VAT and other consumption taxes do not require allocation of revenue, costs, losses, etc. This difference from income tax makes consumption taxes more suitable in this respect.

The Draft identifies two main challenges with respect to VAT collection, namely the exemptions for import of low valued goods and the remote digital supplies to consumers.

With respect to the first mentioned challenge, we question whether this is an issue that warrants attention from the OECD. As stated in the Draft, a low value threshold exists because the administrative cost associated with collecting the VAT likely outweighs the potential VAT revenue. The risk of abuse should be taken into account by countries when calculating the appropriate threshold. If countries find such a threshold in their domestic VAT systems problematic, they are free to adjust or remove the threshold in question. It should also be mentioned that the need for a threshold is reduced with the reduction of the compliance and administrative costs of collecting the tax. This being the case, we believe that the best way forward here is for governments and the OECD to aim at reducing the compliance and administrative burden for businesses.

With respect to the challenge regarding remote digital supplies to consumers, we understand the concern expressed in the Draft. We believe that the appropriate means of addressing this issue is by enhanced administrative cooperation between tax administrations. Enhanced administrative cooperation would help the consumer countries tax administration to enforce and collect the VAT due. However, it should be noted that the framework with respect to distance selling requires a certain level of legal certainty and a feasible registration process. Whilst this may be the case for EU countries, the OECD should take into account that not all the OECD member countries have well developed VAT or similar systems. It is thus of utmost importance that the OECD keeps encouraging countries to simplify registration regimes and administrative and compliance burdens in general.

Finally, there is one very important point to highlight when it comes to supplier registration as a collection mechanism for VAT/GST purposes. As mentioned in the OECD VAT/GST guidelines, a registration for VAT purposes by itself does not constitute a permanent establishment. It is the experience of more and more businesses that, by acting as VAT/GST collectors for governments, foreign VAT registrations are misused by governments and are being re-qualified as permanent establishment for corporate tax purposes. This forces businesses to pay corporate tax in jurisdictions where, based on international direct tax principles, no corporate tax should be due. In the long term, and if this continues to happen on a larger scale, such developments could undermine the efficient collection of VAT/GST by dissuading businesses from registering for VAT/GST purposes.
Withholding taxes

Another option suggested in the Draft is to impose a withholding tax on certain payments made by residents of a country for digital goods or services provided by foreign e-commerce providers.

It is not further specified in the Draft how such a withholding tax would be designed other than that the financial institutions involved with those payments could be the ones to bear the compliance burden.

In theory, levying a withholding tax may sound appealing since it would not require net income filing and allocations of revenue and costs. However, this option is also in contradiction with the conclusion that the digital economy cannot be ring-fenced. In addition, it does not stand up to the Ottawa taxation framework conditions. Furthermore, we question whether it is appropriate for the OECD to suggest taxes that would be imposed on foreign providers and limited to the digital economy. The risk of extra-territorial taxation must be addressed and analysed.

The digital economy, or the digitisation of the global economy, continues to evolve. Generally, there is no special legislative regime preventing small enterprises with innovative ideas from emerging and becoming successful. In our view, these small and innovative enterprises are essential in the modern economy. This being the case, it is neither desirable, nor appropriate to increase the threshold for starting a digital business. A withholding tax on digital goods and services would discourage rather than promote cross border trade, investment and economic growth. A broad-based consumption tax, which does not make any difference between foreign and domestic providers and between digital goods and services and conventional goods and services, would in our opinion be preferable compared to a withholding tax.

Concluding remarks

Considering the complexity of this topic and the speed with which business models evolve today, a specific set of rules for the digital economy does not seem warranted or achievable. Taxes must not be used as barriers to trade and investment, to the detriment of the welfare of citizens. The digital economy is an area where a more in-depth policy debate on the merits of direct/indirect tax solutions is needed. It is also essential to analyse the risk of extra-territorial tax situations. Furthermore, making consumption the basis for income taxation would have significant revenue implications for a large number of countries, in particular for small countries with a limited domestic market.

The BEPS Action Plan states that actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income. However, several of the action points calls for greater reliance on where
economic activity takes place and in Action 1 the importance of actual sales for taxable profits is emphasised.

The argument that income can be taxed on the basis of the location of sales and irrespective of substance and presence of assets, functions and employees, is in sharp contrast to the BEPS approach, requiring and calling for more substance in order for companies to allocate income to low tax jurisdictions. Although markets are essential to businesses, they provide by themselves nothing more than a business opportunity to be explored. They do not constitute a basis for income taxation. However, sales and consumption are justifiably important sources of revenue for countries relying on consumption taxes like the VAT, GST or other consumption based taxes.

BUSINESSEUROPE is concerned that the nexus options in the Draft would lead to additional administrative and compliance burdens for businesses and substantially increase the risk of double taxation. To widen the scope of the permanent establishment concept would result in a completely new system for allocating international taxation rights across countries. It would also result in the reallocation of taxation rights between countries, which would diminish tax revenues for small open economies. It is essential that the larger economies in the G20 include small economies in Europe, Africa and elsewhere if a completely new framework for allocation of international taxation rights are to be developed.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

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April 12th, 2014

Tax Policies in P2P Digital Content Distribution

This comment touches upon a number of issues mentioned by the OECD in BEPS Action1, and specifically: the sharing economy and peer-to-peer technologies3; consumer-to-consumer models and peer-to-peer technologies4; barter transactions as a free supply5. It also deals with the impact of copyright law on tax law and specifically on VAT in the event of copyright infringement in connection with the distribution or re-distribution of digital content over non-proprietary platforms. A large quantity of the content available on the Internet, either for viewing or downloading, is protected by copyright6.

Peer-to-peer and content distribution

P2P networks7 are increasingly becoming an important medium for the exchange of digital information, in both legitimate and illegitimate scenarios. New business models are prefigured, pioneered, and fostered by early adopters and innovative companies, but the disruptive, personal, many-to-many model P2P enables has largely framed it also as a threat to the media and content industries as a whole. All digital or digitizable media products, software, films and music in particular, whose distribution models have been overlaid by the new, different and largely unorthodox technologically-driven social dynamics of large-scale sharing face an unprecedented challenge, an interesting opportunity, and the risk of legal double-standards.

In 2011, the OECD themselves highlighted how this broader world plays a crucial role in the world’s communication systems8. This awareness was already there even more before 2000, as doctrine stressed this multi-platform nature of the Internet while discussing the idea of “cyberspace”. P2P technologies are entirely different from the “traditional” model of business we are used to see on the Web based in client/server model. To explain where the differences lie and why this has vast

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1The author can be contacted at cristina.trenta@oru.se.
3OECD, Ibidem, para. 2.5 p. 17.
5OECD, Ibidem, para. 177, p. 56, and para.185, p.58.
7This paper has bee presented at the European University Institute Robert Schuman Centre for Advanced Studies, Conference in Florence, March 2014, Policy challenges in digital markets, Tax Policies and P2P Content Distribution, and it is based on Trenta, C., VAT in Peer-to-peer Content Distribution, Towards a Tax Proposal for Decentralized Networks, JIBS Dissertation Series No. 90, ISSN 1403-0470, 2013, and further investigates fiscal policies and the possible introduction of a new tax for social, and specifically P2P-based, content distribution.
repercussions on VAT and taxation in general I will briefly discuss the traditional way of downloading files (or accessing information) using the client / server model versus a P2P approach (Fig. 1 and 2), and for a traditional intranet for a company versus a P2P intranet (Fig. 3 and 4).

In these scenarios, all transactions are legitimate transactions, and Company A is pushing music towards users. It could of course be any kind of copyrighted, digitizable content, such as video, or text.

In Fig. 1, which deals with the traditional client / server model, Company A, a legitimate source offering their services to the public, acts as the source hub. As a result, Company A knows whom they finalize their transactions with and, among other things, can provide proper accounting. User1, user2, etc., all get their content from Company A.

Let’s see what happens when the same company engages in the same business using a P2P model (Fig. 2). It could very well be, because indeed that’s how the underlying P2P technology works, by distributing load, that only User1 accesses Company A, while most or all of the other users just access User1 or another user in the chain. In P2P networks, everyone who acquires by download (in P2P language, leeches) also provides by upload (in P2P language, seeds).

This has two immediate implications: Company A, the initial provider, might know nothing at all about all transactions past the initial one with User1; every single user is both acquiring the resource and giving it away at the same time.
Furthermore, P2P technology maximizes performance and minimizes loads by splitting up resources in individually-provided chunks, so that every user acquires and provides pieces of the content, never the whole. That means that resources User5 acquires may actually be provided for a 12% by User2, for a 35% by User3, and so on.

It is crucial to highlight that this is nothing like saying that User1 downloads a resource from Company A and then decides to distribute it: this is one single process, and it is the technology that the legitimate provider (Company A) has chosen to use to distribute its resources that allows and sustains this. P2P works by distributing bandwidth load for efficiency, so there is no current way Company A can prevent the fact that every user becomes a redistributor as soon as they have a piece of the resource. And when Company A is busy or overloaded, User<n> practically never gets to Company A.

As an interesting consequence, it seems that if we say that for example User3 in the chain is simply breaching Copyright law, we are de facto ruling out P2P as completely unlawful per se. It is not content, it is not a transaction, it is a whole technology which is rendered illegal on the spot.

In the second scenario, we illustrate how this is not just something that impacts the entertainment and media industry, but it is a disruptive model whenever applied and compared to current practices (Fig. 3 and 4). A medium-sized Company B has an intranet or WAN, a local network connecting independent offices, Site A and Site B.

![Figure 2](image)

Figure 2

resource from Company A and then decides to distribute it: this is one single process, and it is the technology that the legitimate provider (Company A) has chosen to use to distribute its resources that allows and sustains this. P2P works by distributing bandwidth load for efficiency, so there is no current way Company A can prevent the fact that every user becomes a redistributor as soon as they have a piece of the resource. And when Company A is busy or overloaded, User<n> practically never gets to Company A.
These could very well be offices in partner companies in different countries: in this example Site A is located in the EU and Site B is extra-EU. In Fig. 3 we see a simplified model of a traditional intranet. Site A hosts a file server where all users host work-related files. Since we are presuming complete legality, everything has a place, even territoriality, as the files are all hosted in Site A, in the EU, and all individual transactions can be traced.

In Fig. 4, a P2P model for the same intranet is outlined. Technically, nothing prevents that. Again, there is now no central repository and all users in the network are both suppliers and customers: they cannot be traced easily, and so cannot figures and general use.
Armed with the technical understanding of the way the technology works, and aware of the impact it might have in a business environment, we can now properly frame the issue.

**Nature of P2P transactions**

If we acknowledge that P2P is just and a completely different distribution model, we have questions to ask. Among them, how does VAT work? These users could easily be located in different parts of the world. And do they one by one configure an economic activity? What about consideration? The fact is, there is no current way for Company A, the legitimate source, to fulfill VAT and other legal requirements on behalf of all transactions.

Now, if these files are part of ongoing working relationships as they are in the scenario, they carry legitimate fiscal duties with them. But how can the place of supply and place of enjoyment, for example, be identified and defined? How can the number of transactions between Site A and Site B be counted for all involved duties?

The fact is that in figure 1 and 3 which represent the classic client / server model, there is no problem whatsoever in picturing these operations as liable for VAT purpose. It should be an issue if they are not.

While in Fig. 1 and 3 the provider and its servers may be considered as a permanent establishment according to the OECD Model Tax Convention or a fixed establishment according to the VAT Directive, the situation is much less clear in the scenarios depicted in Fig. 2 and 4, where the same file or files are still delivered by the company but by using P2P as its means of transportation. All users now actively distribute resources.

The parties will receive the same file, or the same content, unaware of any issue concerning taxation, and possibly free of VAT charge as of today, because of the lack of provision within the VAT Directive, and consequently in the national tax systems. The fact is that the same content is acquired in both Fig. 1 and 2, but VAT liability changes. It seems there is an urgent issue concerning in which ways it might be possible to tax these new operations (Fig. 2 and 4) for VAT purposes, whether they can be read as a services according to the VAT Directive.

**The role of taxation**

Taxation in this context is a particularly critical element, with vast repercussions on the development of a mature, profitable market. Taxes as a public revenue have to be related to demonstrations of the economic capacity of individuals as a parameter of contribution to public expenditure. The analysis carried out has positively identified expressions of economic capacity in BT P2P swarms. They can be

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9 OECD Model Tax Convention, Article 5.
10 Directive 2006/112/EC, Article 43 and 56.
11 Directive 2006/112/EC, Article 2 (1) (c).
configured “as a ‘third mode of production’ based on the cooperation of autonomous agents”

But do P2P transactions fall within the field of VAT? Should they? Will they in the foreseeable future? Do we need different or new taxation policies to address these new business models? What benefits businesses enterprises, the international community, the EU and national tax authorities might achieve by considering them fully integrated with the different taxation systems? What fiscal, and hence economic, consequences might result from classifying a file-sharing operation as liable for tax law for all players involved? Would this create a new market and foster economic growth?

BT P2P networks are characterized by several VAT-relevant traits: an economic connotation; a production chain, if different; a strong impact on competition in the internal market; and presence of consideration inside swarms in the form of digital barter. On the other hand, in its theoretical application to BT P2P networks, VAT shows both internal and external limiting factors, and fails prominently when dealing with the business models thriving in the digital market. Internally, we have the important issue of legal and illegal profiles. In cases dealing with digital copyright infringement, this alone can seriously compromise the possibility to consider a transaction in a P2P network as falling inside the VAT scope. According to the European VAT system, illegal transactions are considered as falling out of the scope of the VAT system if the goods that are provided are totally outside of commerce. It is immediately apparent that understanding the level of illegality for copyright infringement while using P2P technology is of the utmost importance for assessing the viability of P2P in both private and business scenarios.

From this perspective, copyright law is central to any discussion which deals with such a disruptive technology as P2P, introducing a fully different way to distribute digital content that does not rest well with the state of the law. This is also the reason why it is important to understand how copyright law connects to profiles in tax law. The attributed level of criminal liability of an activity because of copyright infringement is for example crucial in the whole conversation about P2P. The changes brought along first by Web 2.0 and then by the explosion of mobile access and social media have turned spectators into content creators and suppliers: videos on YouTube, reviews on Amazon, news on Digg. This is a radical change and this is a complicated change. On the other hand, private users and companies who already run P2P-based legitimate services, and there are some, also face potential legal risks just because of their adoption of P2P technology because of its perceived allure of unlawfulness. The Advocate General Poiares Maduro, in his Opinion in the Google France SARL and Google Inc. Case explains very well how technological

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16 Joined Cases C-236/08 to C-238/08, Opinion of Mr Advocate General Poiares Maduro, Google France SARL and Google Inc. v Louis Vuitton Malletier SA (C-236/08), Google France SARL v Viaticum SA and Luteviel SARL (C-237/08) and Google France SARL v Centre national de recherche en relations humaines (CNRRH) SARL and Others (C-238/08), [2010] ECR I-2417.
evolution and invention raise issues of IP infringement, but that is no rational reason to ban and stop development and progress.

Several reasons seem to suggest that BT P2P transactions are not liable to VAT in the event of criminal copyright infringement. After the Lisbon Treaty, infringing BT P2P operations are framed as a European crime, rendering such operations illegal in all Member states\(^1\). International conventions present a similar scenario\(^2\).

Furthermore, linking the supposed VAT liability of one operation to the examination of its degree of illegality in the light of VAT principles to understand if the operation is inside or outside VAT purposes does not seem the right way to go.

Externally, both the principles of tax territoriality and the regulations concerning the place of supply for VAT do not only present issues in connection with their adaptability, but could be said to be totally alien to the distributed logic that drives P2P. Secondly, it is difficult to calculate the taxable amount in P2P transactions. In swarms, consideration is present in the form of digital barter, but monetary equivalents are not simple translations. Case-by-case analysis would probably be the way to go, but given the large number of transactions happening at the micro-level this methodology does not seem to offer a feasible solution. This scenario led me to explore the possibility of tracing possible alternative solutions for taxing BT P2P transactions outside of the strict boundaries of VAT.

A necessary precondition of such an investigation is an understanding of the possible consequences of not taxing P2P transactions. It could be argued that introducing a new, separate tax could bring along disadvantages: fiscally speaking, a separate administration to manage the new obligations, for example. Future changes in VAT in the field would have to take into account this additional tax. Those changes would bring additional costs at the European as well as at the national level.

Consequences would be certainly even more complex if we consider not just tax design and tax bases, but the political and social point of view.

On the other hand, the lack of tax regulations in the field would leave P2P in the gray areas outside of any fiscal regulations, seriously hampering the business opportunities that might be exploited by entrepreneurial companies. Where there is uncertainty, even when it might seem to be favorable, so to speak, uncertainty, business plans are difficult to plan and execute. Opportunities for resource collection through taxes would not be taken as well, and legislators would proceed unhindered in the false belief that, as far as consumption taxation goes, regulating traditional electronic commerce inside the VAT Directive was everything the market needed, completely discarding how uneven the playfield actually is.

It could be argued that a new tax could introduce a distortive element in the economy of digital transactions, since taxpayers would choose transactions to avoid alternatively VAT or the other tax. This is a possibility, and something that would require study and careful planning. A simple suggestion could be that of linking the two taxes to mitigate the effects due to the introduction of the new one.

\(^1\)TFEU, Art. 83.
In 1998, the EU Commission, in their guidelines on electronic commerce and indirect taxation, prescribed that the existing VAT system had to be applied to electronic commerce, and no new taxes had to be introduced\(^9\). This document could not foresee nor regulate the dramatic changes that radical turns of the table such as distributed P2P allow to content distribution over the Internet. What was proper almost 15 years ago is not necessarily so now: regulatory tax frameworks need to change with the needs of the society they are an expression of.

Furthermore, in a more rigorous legal line of thought, BT P2P transactions do not identify as a traditional electronic commerce model, which share a common root in the existence of a provider and a consumer and configure static, point to multi-point services\(^{20}\).

As of today, P2P distribution lies outside of any taxation system, in a sort of “non-taxation zone” which prevents any successful business (and hence fiscal and social) exploitation of the technology. This ill compares to the scenarios illustrated by the OECD in that same 1998 in Ottawa\(^{21}\), where both double taxation and unintentional non-taxation in electronic transactions were pointed out as sub-optimal: unintentional non-taxation presupposes a tax system regulating a transaction, or better a transaction that escapes taxation while being part of the tax system. Unintentional non-taxation does not seem to refer at all to a total lack of any regulatory frameworks.

As the OECD outlined in that document, electronic commerce assumes different forms and “(t)axation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce”\(^{22}\).

Literature stressed this duality as well of that of “(d)oing business over the Internet or via the World Wide Web”\(^{23}\). Right now, this situation does not reflect in my opinion an equitable taxation, as per the OECD guidelines, between traditional e-commerce (taxed), and non-traditional (e-commerce) P2P transactions (non-taxed). As businesses move on the Internet and new approaches are tried out, legislation should start to regulate those forms of digital supplies which are not integrated in the current legal frameworks. Technological changes have an impact in the capability of states to collect taxes, and will probably affect the distribution of the tax burden\(^{24}\) in

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\(^{9}\)COM (1998) 374 final, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Electronic commerce and indirect taxation, para. V. “The first guideline has been formulated to reflect the basic concept that existing taxes should apply to electronic commerce: In the field of indirect taxation all efforts should to be concentrated on adapting existing taxes and more specifically VAT to the developments of e-commerce. no. new or additional taxes are therefore to be considered”.


the long run. Positive consequences for the collectivity and potentially large tax revenue sources in the future are being squandered.

The EU legal framework introduces the principle of technological neutrality, maintaining that there can be no difference in regulations based upon technological distinctions. According to this framework, regulators neither impose, nor discriminate in favor of any specific type of technology, except where necessary. This is explicitly stated by the Commission in their Net Neutrality Declaration. Similarly, the Communication on the open Internet and net neutrality in Europe maintains that:

(t)he essence of net neutrality and the issues underpinning the debate concern first and foremost how best to preserve the openness of this platform and to ensure that it can continue to provide high-quality services to all and to allow innovation to flourish, while contributing to enjoyment of and respect for fundamental rights, such as freedom of expression and freedom to conduct business.

There are two reasons why net neutrality is important. It eliminates the risk of future discrimination, and it facilitates fair competition ensuring the survival of the fittest model, rather than that of the one favored by network bias. Could we have network and fiscal neutrality with little or no regulation at all? Or with flawed regulations not calling for net neutrality? It seems difficult to maintain such a point of view. Nonetheless, such a question allows to illustrate an important consequence of an unbalanced market: the possible disadvantage would impact both traditional and new operators, depending on the sector being considered. In the case of telephony, for example, new non-traditional players have a clear competitive advantage service-wise, for example by leveraging audio / video calls or infrastructure-wise, as in the case of P2P-based architectures such as that of Skype.

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28 COM (2011) 222 final, Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions. The open internet and net neutrality in Europe.
29 COM (2011) 222 final, Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions. The open Internet and net neutrality in Europe, para. 2, p. 3.
This is indeed a challenge to present tax administrations, especially if we include the implications of intellectual property rights legislation\(^\text{33}\). On the other hand, it might lead to increases in tax revenue coming from innovative, unforeseen sources. The possibility to introduce a new tax was considered admissible and used to extract more revenue from taxpayers\(^\text{34}\). From a taxation perspective, a full understanding of the technological layer is a must if we want to regulate it. Unfortunately, the tax debate in the field is mostly inexistent.

From an economic perspective, the fact that P2P technology is vastly impacting the way of doing business is not for disputation, as the OECD had already mentioned in his work on Peer-to-Peer networks in OECD countries\(^\text{35}\). Its social and economic resonance is profound. If the first function of legal science is to write, and rewrite, uniform rules for society, those making economic activities possible in the first place are necessary, and those that allow carrying them out efficiently in a fair, leveled market are crucial\(^\text{36}\).

This might imply finding new ways. For example, taxation could be applied not to a taxable person as identified by the law, but to a more generically defined but still specific actor who plays a role on the economic scene\(^\text{37}\).

Currently, traditional consumption taxation systems ignore not only the real nature and fiscal implication of P2P networks, but P2P tout court. P2P is invisible. The solution is not to give up and declare an area franca, but to dig into the complexity of swarm transactions to understand how it works and provide solutions, if tentative. Such an analysis would also help foster an integral revision of the weak parts of the VAT system when it comes to distributed services.

The introduction of a new European tax would also acknowledge the economic impact of these new technologies, beyond any specific analysis of them either fulfilling or not fulfilling the rigid conditions of VAT, the existence of juridical relationships among the parties involved in a transaction, and the omnipresent territoriality rules, and would prevent the possible fragmentation of the internal market due to the introduction of different and diverse levies at the national level for private copies\(^\text{38}\). It would also steer the conversation towards effectively governing the phenomenon instead of trying to cure the symptoms without addressing the cause.

If tax burdens should not be seen as repressive and expropriative tools threatening one’s rights, but rather as equalizers turning abstract rights into concrete facts, domestic solutions are the wrong answer: this is a fiscal policy challenge the EU needs to adress as a whole.


\(^{35}\)OECD (2004), Peer-to-Peer Networks in OECD countries, Information Technology Outlook.


\(^{37}\)Schiavolin, R., Ibid., 2007, p. 16.

\(^{38}\)See for instance the German and Italian experience respectively: Ordentliche Bundesdelegiertenkonferenz, Dortmund, January 2009, Europawahlprogramm (vorläufig, Stand: 31.01.09) VIII. Kultur, Bildung und Forschung – Der GRÜNE Weg in die Wissenschaftsgesellschaft; Bill (Proposta di Legge), Camera dei Deputati no. 187; XVI Legislatura (Extended Collective Licensing), April 2008.
Draft diagram for a possible new form of EU taxation on the distribution of digital content

Countries who adhere to the International and European legal frameworks on copyright protection

Internet connection tax

Harmonized tax, with mechanisms to account for different rates

Business exploitation B2B, B2C

Private usage C2C

Redistribution to participating countries or other mechanism
CBI RESPONSE TO THE OECD DISCUSSION DRAFT ON BEPS ACTION 1: ADDRESS THE CHALLENGES OF THE DIGITAL ECONOMY

1. The CBI is pleased to comment on the OECD’s discussion draft on Action 1: Address the challenges of the digital economy (‘the discussion draft’) published on 24 March 2014.

2. As the UK’s leading business organisation, the CBI speaks for some 240,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

Our comments

3. The OECD has requested comments as to whether it is possible to ring-fence the digital economy from the rest of the economy and, if not, whether specific types of digital transactions could be identified and addressed through specific rules.

4. The CBI considers that it is not possible to ring-fence the digital economy. Every traditional business will be “digital” at least to some extent and every digital business will be “traditional” at least to some extent. It is not practical to identify a clear dividing line between digital and non-digital business activities. It is also impractical to identify specific types of digital transactions for the purpose of applying a special set of rules. Any such attempt is likely to result in uncertainty and difficulty at the boundary and give rise to complexity and compliance cost.

5. Furthermore, the discussion draft sometimes implies that businesses which are more digital in nature have greater opportunity for base erosion and profits shifting. We do not consider that this is necessarily the case and there may be merit in the final report on the digital economy in presenting digital businesses in a more neutral light.

6. The CBI believes that the challenges posed by the digital economy can best be met by the other actions of the BEPS project, particularly those relating to the definition of permanent establishments and those relating to transfer pricing. This is a much more appropriate approach than developing new options such as those outlined in Section VII 3 of the discussion draft (although we presume that option 3.1 will in any case be considered under Action 7 of the BEPS Action Plan).

7. We have not analysed those options in great detail in this comment letter but we consider that all of the other options present enormous practical difficulties and that they are very likely to result in double or multiple taxation when applied to the various business models of our members. The CBI therefore strongly urges that full consideration be given to the other BEPS actions first before re-assessment as to whether the new options should be considered.

8. We also note that the revision of the chapter of the OECD Guidelines on Intangibles may address some of the concerns and urge that this work be completed before the new options are taken further. The implications for the timetable of the BEPS programme should be fully considered and it may be that a
9. We agree that there is a significant role for VAT to play in addressing the challenges of the digital economy - although VAT cannot, by itself, address the concerns in their entirety or take the place of a properly imposed tax on profits. We agree that further work is required on many aspects of VAT as applied to the digital economy, not least of which is the difficulty of ensuring compliance. It is very important that this latter area is fully addressed as those businesses which are in compliance with their obligations will otherwise be placed at a competitive disadvantage with remote businesses which are not. We agree that VAT should be levied on a place of consumption basis, and at the rate applicable to that place. Finally, we note that there is a substantial body of experience in EU which might usefully be drawn upon here.

10. We note that although we do not see any of the options proposed under paragraphs 3.2 to 3.4 of the discussion draft as necessary or workable, however we believe that it is essential that, if the review suggested in paragraph 208 concludes that additional measures are needed, then that review should clearly set out:

   i. The nature and source of the concerns which remain;
   ii. Why those concerns are not capable of being addressed by the other BEPS Actions; and
   iii. What objectives those additional measures are designed to achieve.

   The above criteria will provide with clear metrics against which to consider the necessity and appropriateness of any additional measures proposed. In our view, it is particularly important to give clarity as to the reason for, and intended extent of, any re-allocation of taxing rights to customer jurisdictions —and to ensure that any measures have the effect of correcting misallocations rather than going beyond that and creating excessive allocations of taxing rights to customer jurisdictions.

11. Finally, once the OECD Digital Economy Task Force has completed its work and issued its report, we understand that it will be disbanded, at least in its current form. It would be advantageous if a mechanism could be found for monitoring the digital aspects of the work of the other groups so that digital economy aspects can be appropriately coordinated through to the conclusion of the BEPS project.
BEPS Action 1: Address the Tax Challenges of the Digital Economy
Response by the Chartered Institute of Taxation

1 Introduction

1.1 We refer to the public discussion document published by the OECD on 24 March 2014 regarding BEPS Action 1: Address the Tax Challenges of the Digital Economy.

1.2 We welcome the opportunity to comment on this work being done by the OECD and do not underestimate the challenges arising from the digitalisation of global markets. However, as we explain in more detail below, many of the challenges identified do not involve Base Erosion or Profit Shifting – they are consequences of advances in technology.

1.3 The document provides a good analysis of the growth of the digital economy, and illustrates that some of the specific BEPS concerns will be met by other work streams. In our view the challenges identified and discussed in Parts VI and VII of the document open up profound questions of how taxation should operate in a world of increasing digital commerce. We suggest these questions would best be discussed and debated outside the framework of the BEPS project. This is necessary to ensure sufficient time to consider difficult and complex decisions.

1.4 The BEPS project is very much focussed on direct taxation. We consider that indirect taxation has a contribution to make in enabling the territory of the customer to levy tax – albeit that it is collected from a digital supplier with a presence in a different country, and potentially borne by the consumer. An increased focus on indirect tax may assist to at least partially address the concerns that have been raised. However, it should be recognised that simply because a jurisdiction is entitled to levy VAT, does not mean that it is or should be entitled to a tax on business profits.
2 What is the digital economy?

2.1 Parts II and III of the Discussion Document provide good background information on the development and influence of information and communication technology, and how the ‘digital economy’ has become an increasingly large part of the whole economy. These parts, therefore, provide important context for the rest of the document.

2.2 In particular, it is our view that these parts of the Discussion Document deal comprehensively with the first three bullet points raised in paragraph 10 in Part I of the Discussion Document (the particular issues on which the OECD requests comment). They illustrate that it is not possible to ring-fence the digital economy from the rest of the economy and there would be substantial difficulties in creating special rules for digital business.

3 Are there any BEPS issues presented specifically by the digital economy?

3.1 Parts IV and V of the Discussion Document illustrate what, in our view, is an important point: BEPS is, largely, a feature or result of mismatches and missing elements in the international tax system. MNE’s that work in the most ‘digitised’ areas of the economy or use primarily digital methods to trade may be better placed to take advantage of such mismatches and missing elements; however, none of the BEPS issues are exclusive to such digital companies, and, in our view, there are no such ‘exclusive’ issues.

3.2 In relation to the fourth bullet point of paragraph 10, the other actions contemplated by the BEPS project will address BEPS for digital and non-digital companies alike.

3.3 In addition, the current work on VAT/GST (in Europe and the US) should also address BEPS issues. This is particularly so in relation to larger enterprises. In our view it will prove very difficult to eradicate a loss of VAT from smaller enterprises trading cross-border, as enforcing registration and collection may be impossible.

3.4 In relation to the fifth bullet point of paragraph 10, we do not see any value in other measures beyond those identified for direct taxation. In relation to indirect taxation, we would take the view that compliance would be encouraged if VAT/GST on digital transactions was set at lower levels.

4 The real challenges of the digital economy

4.1 We suggest that the broader challenges of the digital economy raised in Part VI of the Discussion Draft would exist even if the mismatches and missing elements of the current system were all eliminated. These challenges do not involve Base Erosion or Profit Shifting; rather they are a consequence of advances in technology.

4.2 We do not under-estimate these challenges, nor suggest they should not be debated. However, in our view, they open up profound questions of how taxation should operate in a world of increasing digital commerce. Thus, in relation to the sixth bullet point in paragraph 10, we suggest that these questions need to be discussed and debated outside the framework of the BEPS project. This is necessary to provide
time to investigate and consider difficult and complex decisions in this area.

4.3 What is not addressed in the Discussion Document is the extent to which tax challenges are perceived to be greater in countries that have been somewhat slower to adopt digital technologies, and thus may have a lower level of ‘digital exports’. The Discussion Document does not, in our view, sufficiently question whether the tax challenges of the digital economy could be more a matter of timing rather than permanent, and as digital exports become more evenly spread, the challenges recede.

4.4 If the challenges are a ‘timing issue’, any adaptations to the international tax system that entrench the current differences between economies are likely to lead to issues persisting rather than being solved.

4.5 Part VII of the document sets out potential options to address the tax challenges purportedly raised by the digital economy. We propose these should be debated separately from the BEPS action points. None of these recommendations should be introduced under the BEPS umbrella, as they are not addressing questions of Base Erosion or Profit Shifting.

5 Options to address the broader tax challenges and cost of compliance

5.1 As noted above, our view is that the issues discussed in Part VI of the Discussion Document should be addressed separately to the BEPS project. However, on the particular questions posed by bullet point seven (the options to address the broader tax challenges and eight (cost of compliance) we comment as follows.

5.2 A direct tax on profit attribution based on sales, which is what the ‘New Nexus based on Significant Digital Presence’ represents, goes against principles that value is created where a product is created not simply by a market for that product; it would be a fundamental - and in our view, inappropriate - shift in the international tax system. There appears to be some confusion with fragmentation issues in Paragraph 214, as these are mentioned in the fourth bullet point in that paragraph. These should be dealt with by other strands of the BEPS project.

5.3 A system based on a New Nexus based on Significant Digital Presence would also be very complex to administer and substantially increase compliance costs for business through increasing the number of returns required and the complexity of attributing profit to various jurisdictions.

5.4 The approach does also not fit well with a central concept of the BEPS project as a whole which is that value is created where significant people functions are located.

5.5 This is particularly relevant if a digital presence is considered to be created from collecting data – data collection itself, however massive, is generally useless. Although data is an important aspect of digital businesses, data itself has no intrinsic value. Value is created by properly analysing data, and knowing what data to throw away. This analysis will be done by people or, possibly, in part by people and in part by algorithms designed by people. The crucial question is thus where the significant people functions’ analysing the data or creating the analysis tools exist.

5.6 Turning to the three ‘virtual PE’ models – the first is rendered impossible by technologies that allow transactions to be made from multiple server locations; the second seems to be a restatement of the ‘New Nexus’ concept, and the third would
5.7 Applying a withholding tax to digital transactions raises similar concerns to the ‘New Nexus’ idea, in that it marks a shift in taxing where sales are made rather than where product is created. If the withholding tax is a substantial amount (certainly anything above 10% and probably anything above 5%) double taxation is highly likely to occur as the state where the product is created is unlikely to give full double tax relief on profits for the withholding on revenue to be fully compensated.

5.8 A withholding tax also transfers the burden of compliance/payment from producer to consumer, with the difficulties noted in the Discussion Document.

5.9 In our view, none of the options proposed address the question of increasing ‘digital exports’ in those countries currently lagging behind. Such an increase is likely to reduce international tensions over taxation of the digital economy.

6 Smaller enterprises

6.1 We suggest that specific consideration should be given to small and medium enterprises when considering any measures. There will always be a greater challenge of compliance for small and medium enterprises. The emergence of the web makes it much easier for quite small businesses to send goods or services internationally but compliance with some of the measures proposed would be challenging.

6.2 We suggest that there should be a sensible threshold for any compliance measures that are proposed.

7 VAT/GST

7.1 The Discussion Document raises a Consumption Tax Option. A ‘consumption tax’ (such as VAT) is best suited to the concerns about digital economy operators in market countries where they may have customers but no other presence. On the other hand, corporate profits based taxes, as origin based taxes, are less well suited because the tax is on the source of the profit rather than where the customer is based.

7.2 We would broadly agree that the principle effect of the Consumption Tax Option would be to require non-resident suppliers to register and account for VAT in states of consumption. Detailed consideration needs to be given to the compliance issues which would be much more significant for a global system than for the EU (where a single portal is being adopted).

7.3 As noted above, such a system would present a particular issue for small enterprises. It would be too much of an imposition to require them to register for VAT in another jurisdiction where they undertake a single transaction or very few transactions (digital or otherwise). Having a low threshold for registration would be a potential barrier to small businesses competing in a global market.

7.4 There are significant steps being taken in the EU in this respect. The EU has introduced changes to its place of supply rules that will affect businesses providing telecommunications, broadcasting or electronically supplied services within the EU.
This change comes into effect on 1 January 2015. The aim is to move revenue from the supply state to the consumer state and negate the incentive for suppliers to move operations to countries with low VAT rates. We do not yet know whether the change will lead to increases in consumer prices.

7.5 We suggest that the EU experience will be informative and will, in due course, inform the debate on what a combination of VAT and BEPS changes could mean.

7.6 We suggest that this analysis is done before layering on additional measures and compliance burdens beyond those already contemplated by BEPS.

8 The Chartered Institute of Taxation

8.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT’s work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members’ experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT’s comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT’s 17,000 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.

The Chartered Institute of Taxation
14 April 2014
Opinion Statement FC 7/2014 of the CFE
on the OECD Discussion Draft: Address the tax challenges of the
digital economy (BEPS Action 1)

Prepared by the CFE Fiscal Committee
Submitted to the OECD in April 2014
in April 2014
CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 32 professional organisations from 25 European countries (21 EU member states) with 180,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.

CFE is registered in the EU Transparency Register (no. 3543183647-05).

We will be pleased to answer any questions you may have concerning CFE’s comments outlined below. For further information, please contact Mr. Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Rudolf Reibel, Fiscal and Professional Affairs Officer of the CFE, at brusselsoffice@cfe-eutax.org.

Please note that due to the short deadline, the CFE comments hereunder are to be considered preliminary and thus may be subject to reconsideration. In this event, we shall inform the OECD of any changes.

Sincerely yours,

Confédération Fiscale Européenne

Ring-fencing the digital economy (para 10 of the Discussion Draft)

CFE strongly agrees with the statement in paragraph 59 of the Discussion Draft 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”.

We therefore doubt that solutions should be specifically designed for digital businesses. Instead, we believe that the relevant digital aspects should be addressed in the context of the work on other BEPS actions, e.g. a definition of “permanent establishment”.

We believe that any definition of the digital economy, parts of it like fully immaterialised services, could not keep pace with the rapid emergence of new business models and technology, so that frequent updates of any such definition would be required, all of which would have to go through the national legislative processes. This would significantly reduce the operability of such definition.

Ottawa framework

CFE strongly supports the key principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility, as expressed in the Ottawa framework. These shall be a guidance when designing tax solutions affecting the digital economy.

Exemptions from permanent establishment status (3.1)
Many businesses which use digital methods carry on their business in a great number of different countries without satisfying the traditional OECD definitions of a Permanent Establishment (PE) and so, under current rules, fail to create a taxable presence in the source country.

However, we do not believe that the solution to this problem should be a major reworking of the existing rules which could have as an end result that multinationals are deemed to have PEs in a very considerable number of countries and an obligation to make returns in those countries.

Although we recognize that finding a method by which non-resident MNEs may be liable to tax on a part of their profits by another State (such as the State wherein their customers/users are based) despite the lack of physical presence and/or the lack of activities therein which result in a PE under the current version of the OECD Model, the elimination of Article 5(4) all together, or the limitation of Article 5(4), may have far-reaching consequences which go beyond circumventing BEPS in the digital economy. One could consider limiting the Article 5(4)(a)-(d) exceptions to a PE to where the maintenance of a stock of goods, warehouse etc. is itself of a preparatory or auxiliary character, and not an integral feature of the business in question.

If there is to be a change of definition, we urge OECD to introduce a number of further examples in the Commentary so that it will be clearer as to what sort of activities will be considered to be of a preparatory or auxiliary character.

**Significant digital presence / virtual permanent establishments** (3.2 and 3.3)

None of the proposed definitions of a new nexus based on “significant digital presence” nor “virtual PE” appears convincing, as their application would lead to massive legal uncertainty.

The concept of “significant digital presence” creates a PE in a country for fully dematerialised digital activity if certain tests are satisfied including if there are a significant number of contracts signed remotely by the enterprise and a tax-resident consumer of that country or the customer, or substantial payments are made by the consumers resident in the country. Because of the wording “significant”, there have been suggestions to introduce thresholds. In our view, however, the concept of thresholds would not fit in a direct tax solution and would, by distinguishing between digital and non-digital services, not be in accordance with the Ottawa principles.

As we do not believe that there should be separate rules for the digital economy, we are not convinced that extending the definition of PE to “virtual” PEs will offer a workable solution. We are concerned that such concept would lead to the creation of a taxable presence for almost any activity.

**Transfer pricing aspects**

A substantial portion of the proposals brought forward are based on detailed transfer pricing reports and documentation being provided. Whilst being in agreement with transfer pricing and the arm’s length principle, a comment/concern is the extent to which transfer pricing documentation and reporting seems to be required under the current proposed discussion draft. Requiring “uniform transfer pricing” documentation which is further split into “country by country reporting” is very labour intensive and expensive.
Substantial focus is being given to "excessive" payments such as interest deductions and "excessive" royalty payments to low-taxed countries. The only way it seems that a business can prove that a payment is not excessive is through very detailed transfer pricing reports.

In particular our concern relates to how sustainable this is for small businesses who are genuinely trying to expand their business to another market. Having an abundance of documentation requirements might not allow that business to be commercially viable. One should be careful that the BEPS reports allow for realistic measures and do not fuel an over-kill in terms of documentation requirements.

Additionally, requiring transfer pricing reporting (only) when a cross-border situation arises (as domestic transactions do not impact BEPS) could create more burden to companies dealing in cross-border transactions compared those dealing solely in local digital transactions.

With regards to transfers of assets that seem difficult to evaluate, a "post-transfer profitability" is suggested to be taken into account. The uncertainty that this brings, unclarity in the length of time until when the profitability can be taken into account by a tax authority goes counter to the Ottawa principles and is in our view unacceptable.

The existing transfer pricing guidelines allow for a recharacterisation or for disregarding the taxpayer's transactional form in some exceptional circumstances. A clarification allowing taxpayers to better assess how and when transactions can be recharacterised would be welcome.

**Withholding Tax on Digital transactions (3.4)**

Although we can understand that the imposition of a withholding tax on the transaction may potentially solve the problem that in many cases the MNE would have no physical presence whatsoever in any other State since it is supplying e-products, this brings with it issues such as identification of the customer and State of residence for withholding tax purposes. Furthermore it is not clear who should withhold part of the payment: the customer, the provider of the payment service, or another party.

**Consumption Tax Options (3.5)**

The discussion draft identifies the opportunities presented by the digital economy to make significant sales, cross-border, without creating a taxable presence in the country of consumption.

In our view, indirect taxation seems better fit to provide specific solutions to address the challenges posed by the digitalisation of the economy. However, looking at the EU, it is clear that the current VAT system still faces operability concerns.

The EU is currently changing its place of supply rules in relation to telecommunications, broadcasting and electronically supplied services within the EU from 1 January 2015 so that from that date the place of supply will be the country of the consumer rather than the producer.

We suggest that the OECD awaits the entering into force of the new EU rules and closely monitors their practicability before deciding on an indirect tax approach to the digital economy.

**Impact on business, in particular SMEs**

As a general comment, we would like to stress that any solution reached should ensure certainty while not creating further double taxation. The desired tax compliance should be encouraged, without raising further complexity or distortions and excessive burden on businesses. In addition,
dispute resolution mechanisms should be fostered and mandatory arbitration should be implemented in order to effectively solve any dispute that may arise from the new framework.

The digitalisation of business has widened the trade horizons for SMEs and therefore, any proposed amendments need to take into consideration the substantial number of SMEs that operate in this way. Furthermore, any amendments should pay particular attention to increased tax compliance requirements in different States which would be a significant compliance requirement particularly for SMEs.
Action Item 1- Address the Tax Challenges of the Digital Economy

A REPRESENTATION

April 2014
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Action Item 1 - ‘Address the Tax Challenges of the Digital Economy’

Background

On March 24, 2014 the Organization for Economic Co-operation and Development (‘OECD’) issued a discussion draft report on Action Item 1 - ‘Address the Tax Challenges of the Digital Economy’ for public consultation. This is one of the 15 action plans recognized by OECD for addressing the issue of Base Erosion and Profit Shifting (‘BEPS’) practices adopted by Multinational Enterprises (‘MNEs’). The concern regarding BEPS was first highlighted by the G20 nations in 2011 and India being a part of the G20 supports the OECD work on BEPS.

The discussion draft suggests amendments to the OECD Model Treaty and the Commentary. The digital economy – through the power of information, communication and technology - has created new business models and advanced the ability to carry on business from various locations without physical presence. Growth of the digital economy and Information & Communication Technology (‘ICT’) services creates challenges for taxation as taxation rules of most countries as well as the Tax Treaties are framed to tax profits from traditional models. Thus, the first issue that needs to be addressed is whether the digital economy should be segmented from the rest of the Economy? The BEPS action plan concludes that segmenting the digital economy from the traditional economy is difficult and would require arbitrary lines to be drawn between what is digital and what is not. The discussion draft identifies various tax issues potentially raised by the digital economy and discusses possible actions to address them.

The options provided are primarily aimed at the prevention of the tax leakages in view of the growth of the digital economy and ICT services.

We recognize the efforts of G20 along with the OECD towards addressing the issues of tax challenges of the digital economy. However, in view of the existing Indian tax system and the legal and economic environment in India, we foresee certain practical challenges with regard to the digital transactions. Accordingly, we wish to bring to notice the following challenges and recommendations for your kind consideration.

1. As per section V of the discussion draft report, various Actions on BEPS are due to be rolled out by September 2015 such as Action 7 (Prevent the Artificial Avoidance of PE Status), Action 4 (Strengthen controlled foreign company rules), etc. These comprehensive tax measures would eventually take care of the menace of the taxation of the digital economy. This has been stated in para 208 of the section VII of the discussion draft report as under:

“In addition to the basic framework discussed above, it is expected that as described in section V, the development of the measures envisaged in the BEPS Action Plan will effectively address the BEPS concerns that arise in the digital economy, which may substantially impact the scope of the broader tax challenges raised by the digital economy. The results of the work on the BEPS Action Plan will
ultimately need to be taken into account when analysing the challenges raised by the digital economy described in section VI, and will inform decisions regarding the potential options to address them described in this section. In other words, if the BEPS issues outlined in section IV are fully addressed through the measures envisaged in the BEPS Action Plan, addressing the challenges described in section VI may become less pressing. On the other hand, if BEPS issues are not addressed fully in the context of the digital economy and extremely low effective tax rates continue to be norm, then addressing the broader tax challenges of the digital economy becomes a more pressing issue.”

Therefore, it is recommended that first the other Actions of the BEPS should be finalized and rolled out. Post finalization of the above policies, the tax policies in relation to the digital economy should be revisited in view the challenges still faced from the digital economy. The same may also be circulated again for comments.

2. India and China had expressed their opinion before the United Nations that the service PE clause in the treaty should be modified to the effect that a service PE could be triggered even where there is no presence in a contracting state of the personnel physically. Since this was rejected by the UN and does not feature as a draft action in the OECD we presume that India and China are no longer pursuing this line of reasoning.

3. Section VII of the discussion draft report has discussed various options to address the tax challenges of the digital economy. These options are discussed as under:

Modifying the rules of exemption from Permanent Establishment (PE)

Concerns

The discussion draft report proposes that the exemption contained in para 4 of Article 5 (exempting certain specific activities from creation of PE) should not be available. The discussion daft contemplates multiple variations which includes an altogether elimination of paragraph 4.

The prime concern around this proposal is the altogether elimination of para 4. The complete elimination will certainly have an impact on the business conducted through traditional models. The activities which were solely “preparatory” or “auxiliary” in nature would also come under the tax net. Further, there should be precise rules for distinction between core and non-core activities so as to avoid any hardship to the existing traditional business models as the intent of the BEPS strategy is to have rules for allocation of profits between different jurisdictions as the business conducted through digital economy spans across regions and each country thereby would seek to exercise right on taxation of profits based on sourcing principles.
Recommendations

a) There is a need to assess the impact of complete elimination of para 4 of Article 5 on the traditional business models which are in operation since long. A complete elimination may unsettle the settled positions since:

- under many tax treaties entered into by India, the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, is not considered to be a PE. Removing this would cause major hardships to the traditional inbound as well as outbound businesses and may affect the economy;
- genuine activities of a liaison office for collection of information or acting as communication channel may get hampered.

b) Modifying the rules of exemption from PE – if the exemption relating to preparatory and auxiliary services in the PE clause is removed to plug tax leakage on account of digital business taking shelter under this clause, it would have damaging impact on the traditional business.

c) The distinction between core and non-core activities seems appropriate under the circumstances and it is essential that precise rules should be framed for this purpose. This will avoid the ambiguity in interpreting whether an activity forms part of the core business or not.

d) Further it should be clarified that a core - non-core distinction is relevant only where a PE exist.

New Nexus based on Significant Digital Presence

Concerns

The discussion draft report proposes that an enterprise engaged in certain “fully dematerialized digital activities” would have a PE if it maintained a “significant digital presence” in the economy of another country. Thus, this part of the discussion draft report deals with a situation in which businesses are conducted wholly digitally.

The major concern here is that the present rules on PE are primarily in relation to creation of a PE through physical presence and not due to digital presence. For an enterprise engaged in a fully dematerialised business, a significant digital presence could be deemed to exist in a country when, for example:

- Significant number of contracts for the provision of fully dematerialized goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes;
- Digital goods or services of the enterprises are widely used or consumed in the country;
- Substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise’s core business; or
- An existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise.

This would require fundamental drastic changes in existing rules of PE under Article 5 and also calls for changes in rules relating to Attribution of Profits under Article 7. Also, taxing of digitally sold goods due to above stated factors is discriminatory especially where in similar circumstance, physical goods are not taxed. Such broad factors/interpretation may also create PE of the MNEs in every country on account of significant advertisers and end-user presence.

Recommendations

a) The value attributable from digital economy business should be on the basis of functions, assets & risks and not on the basis of users for taxing digital transactions and when no such FAR exist in India then it should not be taxed in India.

b) Making separate rules for digital economy would unsettle the settled principles. Even today the source state cannot tax such payments. In traditional businesses where title in goods is transferred outside India, the same is not taxable. The provision of existence of a PE based on Significant Digital Presence on the basis that goods are widely used in the country, substantial payments are made from clients in the country to the enterprise, etc. would unsettle the settled.

c) Rules to tax the profits arising from digital economy should not change, extend or dilute the rules relating to traditional business. Hence, instead of changing the existing rules, new Article relating to PE and Attribution of Profits for the tax challenges arising due to digital economy can be considered.

Virtual PE

Concerns

The discussion draft report prescribes that a virtual fixed place of business PE would be created when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website.
The prime concern here is that whether a mere hosting of a website on the server outside India would create a PE of the foreign enterprise in that state where server is located. It may lead to creation of multiple PEs across the globe.

The discussion draft report also provides that a “virtual agency PE” would cover circumstances in which contracts are habitually concluded on behalf of an enterprise with persons located in the jurisdiction through technological means, rather than through a person.

In case of digital downloads wherein the customer has to accept the standard user license and no modifications are generally permitted, in those situations, the contracts concluded through digital means should not pose an agency PE risk.

**Recommendations**

(a) A “virtual fixed place of business PE” should not exist merely because website is hosted in a server located in a country as the business of the website can be carried out across the globe.

(b) A “virtual agency PE” wherein contracts are habitually concluded on behalf of an enterprise with persons located in the jurisdiction through technological means, rather than through a person. In digital downloads, the customer has to accept the standard user license and no modifications are generally permitted, thus, there should not be an agency PE as contracts are concluded through digital means.

(c) The methodology of creation of PE and consequent attribution of profits should be more objective providing clear guidance.

(d) Rules relating to creation of Virtual PE should have exemptions which provides for the situations/scenarios under which digital transactions/business is not taxable. Exemptions similar to para 4 of Article 5 should be provided.

**Withholding of tax on Digital Transactions**

**Concerns**

The discussion draft report recommends imposing a final withholding tax on certain payments made by residents of a country for digital goods/services provided by a foreign e-commerce provider. This type of proposal is intended to address the concern of the non-taxability of e-commerce services under current PE rules despite of substantial economic activity due to lack of physical presence in the market.
The concern in collecting the taxes through withholding is practically challenging. In most of the e-commerce transactions, the payments are done through credit card or online credit. The buyers, in most of the cases are the individuals. The report suggests that the financial institutions involved with those payments would be required to comply with withholding taxes. Keeping a track of these multiple transactions and to determine their taxability for the purpose of withholding would be extremely challenging.

Recommendations

(a) Though this option may eliminate the subjective test on PE and consequent subjective test on attribution of profits, this option should be used only as a means of collection of tax in cases where a primary liability to tax exists on the foreign e-commerce provider.

(b) Rules relating to Foreign Tax Credit under the treaty and under domestic tax law should be modified to give effect to WHT on digital transaction.

(c) Alternatively, taxes may be in the form of an indirect levy (i.e. a transaction tax) as opposed to a withholding tax. This should not be difficult to implement and monitor.

General comments

(a) No new rules required to tap digital economy as Controlled Foreign Corporation rules and anti-avoidance rules are likely to take care of most of the existing concerns.

(b) Presumptive taxation regime may be imposed on the foreign companies undertaking e-business in India. This will simplify the determination of the income chargeable to tax since determination of income and expenses for arriving at profits chargeable to tax on a net basis could be a difficult exercise.

(c) All business have gone digital in some way or the other. Even the brick & mortar businesses are digital. The traditional businesses also have significant IPRs structured in low/no tax jurisdictions in the same way as the digital economy. Any artificial demarcation for digital economy would affect the existing traditional businesses as well.

(d) The Indian domestic law needs significant modification as taxation of digital economy is dependent on characterization of income, for example, whether income earned with respect to the use or sale of software is royalty or business income or capital gains, whether data warehousing could be characterized as royalty, fee for technical service or business income, etc.
(e) India treats software sale as royalty and levies withholding tax which is objected by many countries such as USA. Where other countries levy tax on Indian software businesses under the digital economy rules it will have to be assessed if India would provide the tax credit for the payment of such taxes abroad. Also, since many software businesses are under tax holiday regime, they would not be able to avail the tax credit which may lead to double taxation of the income.
The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government, and civil society, through advisory and consultative processes.

CII is a non-government, not-for-profit, industry led and industry managed organization, playing a proactive role in India's development process. Founded over 118 years ago, India's premier business association has over 7100 member organizations, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 90,000 companies from around 257 national and regional sectoral associations.

CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialised services and global linkages. It also provides a platform for consensus-building and networking on diverse issues.

Extending its agenda beyond business, CII assists industry to identify and execute corporate citizenship programmes. Partnerships with over 120 NGOs across the country carry forward our initiatives for integrated and inclusive development, in affirmative action, healthcare, education, livelihood, diversity management, skill development, empowerment of women, and water, to name a few.

The CII Theme for 2013-14 is Accelerating Economic Growth through Innovation, Transformation, Inclusion and Governance. Towards this, CII advocacy will accord top priority to stepping up the growth trajectory of the nation, while retaining a strong focus on accountability, transparency and measurement in both the corporate and social eco-system, building a knowledge economy, and broad-basing development to help deliver the fruits of progress to many.

With 63 offices including 10 Centres of Excellence in India, and 7 overseas offices in Australia, China, France, Singapore, South Africa, UK, and USA, as well as institutional partnerships with 224 counterpart organizations in 90 countries, CII serves as a reference point for Indian industry and the international business community.
The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled “BEPS Action 1: Address the Tax Challenges of the Digital Economy” 24 March 2014 – 14 April 2014 (hereinafter referred to as the Draft).

General Comments

ACTION 1 – Address the Tax Challenges of the Digital Economy

"Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector."

Issues to be examined include, but are not limited to
a) the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules

b) the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services

c) the characterisation of income derived from new business models

d) the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services

Before going into any specifics, the Confederation of Swedish Enterprise would like to emphasise the importance of distinguishing between income tax and consumption taxes (VAT, GST, etc.). In the OECD framework and as a global standard, income tax is based on residence and source. Consumption taxes on the other hand aim at taxing consumption. Levied on the supply of goods and services, VAT/GST are taxes that are self-declared and business serves to collect these taxes for the government. As clearly stated in the BEPS Action Plan, it is not the purpose of the BEPS project to change existing international standards on the allocation of taxing rights on cross-border income. Consequently, the place of consumption is not and should not be a factor when allocating income for income tax purposes. Instead, the place of consumption is relevant for consumption tax purposes such as VAT/GST.

The combination of origin based income tax and destination based consumption tax allows for a reasonable allocation of taxation rights between the country of origin and the country of destination. This way, the income tax and the consumption taxes complement each other. This of course is not always the case since there are countries that do not have a consumption tax. That however is not an issue that requires action on a global level. Rather, this is a national issue to be solved in the countries in question.

That being said, The Confederation of Swedish Enterprise believes that the Ottawa taxation framework principles (neutrality, efficiency, certainty, simplicity, effectiveness, fairness and flexibility) constitute an appropriate framework when analysing the tax challenges. While it is clear that technology has rapidly evolved since 1998, the Ottawa taxation principles for electronic commerce outlined above, and developed under the leadership of the OECD CFA in 1998, remain relevant and valid.

We share the view presented in the Draft that it is not possible to ring-fence the digital economy. However, the Draft also tries to identify features that distinguish the digital economy. In our opinion, the features identified in the Draft are neither accurate nor limited to the digital economy. They may be relevant for some businesses in the digital economy, but they are not likely to be limited to the digital economy or to cover all aspects of the digitisation of the economy. Considering the complexity of this topic and the speed with which business models evolve, the features identified are likely to become obsolete in the near future. Consequently, we believe that the OECD should not develop any new guidelines, recommendations or amendments to the OECD Model Convention based on the Draft. Indirect tax issues referenced in the BEPS Draft are already being reviewed by the OECD through its existing WP9 efforts related to B2C, and are also being discussed in OECD work on international VAT/GST guidelines. Business is fully engaged in that process.
In fact, it is our firm opinion that no specific rules are required for the digital economy as a “sector”. Considering that it is not possible to ring-fence the digital economy, we believe that it would be highly inappropriate to develop separate principles or rules for taxation of the digital economy from those applied to businesses engaged in the “conventional” economy.

**Specific Comments**

**Nexus**

The Draft points out that it is possible to be heavily involved in the economic life of another country without having a fixed place of business or dependent agent. In most cases, neither tax treaties (OECD Model Tax Convention Articles 5 and 7) nor domestic laws allow a country to tax income from a non-resident if there is not sufficient nexus. Sales to customers located in that jurisdiction would not constitute a sufficient nexus.

It is also stated in the Draft that the digital technology has had a significant impact on how activities are carried out, by enhancing the ability to carry out activities remotely, increasing the speed at which information can be processed, analysed and utilised, and, because distance forms less of a barrier to trade, expanding the number of potential customers that can be targeted and reached. According to the Draft, this increases the flexibility of businesses to choose where substantial business activities take place, or to move existing functions to a new location, even if those locations may be removed from both the ultimate market jurisdiction and from the jurisdictions in which other related business functions may take place.

In our opinion this is true for all businesses and not only limited to the digital economy. Globalisation and the reduction of cross border obstacles allow businesses of all kinds to locate various functions in the most appropriate locations. Access to natural resources, cost of labour, capital costs, political stability, business climate, taxes etc. are all factors that are taken into account in such decisions. This is however not a matter of base erosion or profit shifting. This is sound business management aimed at enhancing economic efficiency and value. The only reason for countries to prevent this global aspect of modern business would be for protective reasons, which is contrary to the purpose of the OECD. Taxes must not be used to prevent trade and investments.

We do not consider the fact that a business can provide customers in a jurisdiction with goods and services, without a physical presence in that jurisdiction, to be an issue of great concern. Income taxes are not and should not be based on the location of customers. In our view this could potentially be an issue in a formulary apportionment situation but not as a BEPS concern. Given the fact that the Draft does not seem to clearly make this distinction, we would like to make some comments with respect to the fundamental income tax principles.

As previously stated, income tax is based on residence and source. Clearly, the traditional division of income based on factors such as functions of R&D, production and marketing is relevant also for the digital economy. Customers and markets are obviously necessary for any business, irrespective of whether a product is sold over the counter, by mail order through a catalogue or by digital means. A market is a condition of doing business but does not constitute functions, assets, risks or
income by itself. Markets with many customers having disposable incomes may provide a business opportunity, but that is all it is: an opportunity. In order to turn those opportunities into income companies must develop products that customers want to buy, find their customers, and deliver their products. Companies that cannot perform these functions will not earn income. The income that companies do earn is attributable to the performance of those functions, not the mere existence of the market. If the only thing that happens in the market jurisdiction is customer activity, it is difficult to see how, under traditional notions of income taxation, any income (as opposed to other bases of taxation) can be attributable to the market jurisdiction. This is true both for the digital economy and for the conventional economy.

Thus, the fact that a company provides goods or services to customers in a country does not by itself constitute a jurisdiction to levy income tax. If there is no need for a physical footprint, then the infrastructure of that country is not utilised and, consequently, that country should not have a jurisdiction to tax that income. The country where consumption takes place may, however, levy a consumption tax.

We understand that it is not the purpose of the BEPS project to alter fundamental principles of international taxation. Some of the options tabled in the Draft imply reallocation of income taxation to where the consumption occurs, even though there is no nexus. This would mean that the jurisdictions claiming the right to tax under current principles (based on function, assets and risks) will have to give up all or part of that right. These are most likely to be small economies with substantial exports and small markets of their own. Should those countries choose not to give up that right, double taxation would inevitably be the result. The negative revenue implications for a large number of countries could be substantial. In fact, many countries with small domestic markets could experience a considerable erosion of their national tax base as a consequence of actions taken by the largest economies represented in G20, taking actions in the name of the BEPS project.

Furthermore, we believe that The Draft contradicts other actions of the BEPS project. Several of the action points in the BEPS project require more substance in order to grant taxpayers the allocation of income to a jurisdiction or to grant treaty benefits. However, in the Draft the OECD seems to search for ways to allocate income to a jurisdiction where the taxpayers have no or very little substance (assets, function or employees). This is a contradiction in objectives that should be spelled out and explained. The risk of extra-territorial taxation should also be addressed and its consequences analysed. This has unfortunately not been done in the Draft.

We would furthermore like to make some specific comments with respect to the options in Chapter VII of the Draft related to nexus issues.

- **PE Exemptions in para 4 of Article 5 of the OECD Model Convention**

  The Confederation of Swedish Enterprise strongly opposes any amendment of para 4 of Article 5 of the OECD Model Convention. Para 4 provides certainty with respect to the activities listed therein. Should the paragraph be amended or should the paragraph or parts of it be deleted, countries may consider all activities that currently fall under its scope as constituting a permanent establishment. The impact on conventional businesses would be severe. Businesses would have to re-evaluate all such activities and assess whether they would constitute a permanent establishment. This would result in either cost intensive restructuring or in a significant increase in the number of permanent establishments.
We strongly question whether such an extension of the permanent establishment concept would be feasible. If this would be the case, every enterprise would be required to file a tax return in every country where that enterprise has sales. In practice, this would prove to be very difficult, if not impossible, especially for SMEs. We worry that further BEPS concerns would emerge as a result of the difficulties to attribute cost deductions, losses etc. to all the countries where an enterprise is considered to have an permanent establishment.

Furthermore, if this option was adopted, the increase in the number of permanent establishments would most likely require businesses to register for VAT purposes in every country where they would be deemed to have a permanent establishment. Tax administrations tend to require a VAT registration where a permanent establishment for income tax purposes exists, even though there is no link between the two. This would further add to the administrative burden for businesses.

- **Significant Digital Presence Nexus**

  The Confederation of Swedish Enterprise strongly opposes the option to establish an alternative nexus for businesses to address situations in which businesses are conducted wholly digitally. This is, in our opinion, contrary to the conclusion in the Draft that the digital economy cannot be ring-fenced and would create great uncertainty in practise. Furthermore, an action that would differentiate wholly digital activities from other activities would be contrary to the neutrality principle in the Ottawa Framework.

- **Virtual PE**

  As previously mentioned, there is in our opinion no jurisdiction for a country to tax income where there is no physical nexus to that country. Consequently, The Confederation of Swedish Enterprise does not believe that there is justification for and strongly contest a virtual permanent establishment concept. This is a matter of formulary apportionment or splitting the cake rather than a BEPS concern. Furthermore, it would be very difficult to find sound and acceptable rules for allocating profits to a virtual PE.

  The concerns in relation to para 4 of Article 5 above are applicable to the virtual permanent establishment concept as well. A virtual permanent establishment would also lower the threshold significantly and, as a result, lead to in a significant increase in the administrative burden for businesses and an increase in double taxation cases worldwide.

**VAT Collection**

CFA have requested WP9 to develop guidelines for applying the destination principle to cross-border supplies of services and intangibles to final consumers. The Confederation of Swedish Enterprise endorses the OECD’s work on VAT Guidelines, and would like to stress that this is the venue for further work on the topic at the global (OECD) level. We would recommend that governments take a closer look at the international VAT/GST guidelines.
As previously stated, The Confederation of Swedish Enterprise believes that the appropriate means of taxing consumption is with consumption taxes rather than income taxes. VAT and other consumption taxes do not require allocation of revenue, costs, losses, etc. This difference from income tax makes consumption taxes more suitable in this respect.

The Draft identifies two main challenges with respect to VAT collection, namely the exemptions for import of low valued goods and the remote digital supplies to consumers.

With respect to the first mentioned challenge, we question whether this is an issue that warrants attention from the OECD. As stated in the Draft, a low value threshold exists because the administrative cost associated with collecting the VAT likely outweighs the potential VAT revenue. The risk of abuse should be taken into account by countries when calculating the appropriate threshold. If countries find such a threshold in their domestic VAT systems problematic, they are free to adjust or remove the threshold in question. It should also be mentioned that the need for a threshold is reduced with the reduction of the compliance and administrative costs of collecting the tax. This being the case, we believe that the best way forward here is for governments and the OECD to aim at reducing the compliance and administrative burden for businesses.

With respect to the challenge regarding remote digital supplies to consumers, we understand the concern expressed in the Draft. We believe that the appropriate means of addressing this issue is by enhanced administrative cooperation between tax administrations. Enhanced administrative cooperation would help the consumer countries tax administration to enforce and collect the VAT due. However, it should be noted that the framework with respect to distance selling requires a certain level of legal certainty and a feasible registration process. Whilst this may be the case for EU countries, the OECD should take into account that not all the OECD member countries have well developed VAT or similar systems. It is thus of utmost importance that the OECD keeps encouraging countries to simplify registration regimes and administrative and compliance burdens in general.

Finally, there is one very important point to highlight when it comes to supplier registration as a collection mechanism for VAT/GST purposes. As mentioned in the International VAT/GST guidelines, a registration for VAT purposes by itself does not constitute a permanent establishment. It is the experience of more and more businesses that, by acting as VAT/GST collectors for governments, foreign VAT registrations are misused by governments and are being re-qualified as permanent establishment for corporate tax purposes. This forces businesses to pay corporate tax in jurisdictions where, based on international direct tax principles, no corporate tax should be due. In the long term, and if this continues to happen on a larger scale, such developments could undermine the efficient collection of VAT/GST by dissuading businesses from registering for VAT/GST purposes.

**Withholding taxes**

Another option suggested in the Draft is to impose a withholding tax on certain payments made by residents of a country for digital goods or services provided by foreign e-commerce providers.
It is not further specified in the Draft how such a withholding tax would be designed other than that the financial institutions involved with those payments could be the ones to bear the compliance burden.

In theory, levying a withholding tax may sound appealing since it would not require net income filing and allocations of revenue and costs. However, this option is also in contradiction with the conclusion that the digital economy cannot be ring-fenced. In addition, a withholding tax does not stand up to the Ottawa taxation framework conditions. Furthermore, we question whether it is appropriate for the OECD to suggest taxes that would be imposed on foreign providers and limited to the digital economy. The risk of extra-territorial taxation must be addressed and analysed.

The digital economy, or the digitisation of the global economy, continues to evolve. Generally, there is no special legislative regime preventing small enterprises with innovative ideas from emerging and becoming successful. In our view, these small and innovative enterprises are essential in the modern economy. This being the case, it is neither desirable, nor appropriate to increase the threshold for starting a digital business. A withholding tax on digital goods and services would discourage rather than promote cross border trade, investments and economic growth. A broad-based consumption tax, which does not make any difference between foreign and domestic providers and between digital goods and services and conventional goods and services, would in our opinion be preferable compared to a withholding tax.

Concluding remarks

To widen the scope of the PE concept would result in a completely new system for allocating international taxation rights across countries. Considering the complexity of this topic and the speed with which business models evolve today, a specific set of rules for the digital economy does not seem warranted or achievable. Taxes must not be used as barriers to trade and investment to the detriment of the welfare of citizens. The digital economy is an area where a more in-depth policy debate on the merits of direct/indirect tax solutions is needed. It is also essential to analyse the risk of extra-territorial tax situations. Furthermore, making consumption the basis for income taxation would have significant revenue implications for a large number of countries, in particular for small countries with a limited domestic market.

The BEPS Action Plan states that actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income. However, several of the action points calls for greater reliance on where economic activity takes place and in Action 1 the importance of actual sales for taxable profits is emphasised.

Market jurisdictions argument for sales seems to be that the value attributable to a digital transaction is based solely on a large market, i.e. a large number of consumers. Consequently, the income should be considered as derived from that market jurisdiction and taxed therein. The argument that income can be taxed on the bases of the location of sales and irrespective of any substance (presence of assets, functions and employees) is in sharp contrast to the BEPS approach, requiring and calling for more substance in order for companies to allocate income to low tax jurisdictions. Although markets are essential to businesses, they provide by themselves nothing more than a business opportunity to be explored. They do not constitute a basis for income taxation. However, sales and consumption are
justifiably important sources of revenue for countries relying on consumption taxes like the VAT, GST or other consumption based taxes.

For smaller open economies like Sweden, attributing sales an increased importance when assessing where profits should be taxed, would result in substantial revenue losses from the corporate income tax. It would deprive governments in such jurisdictions with tools, within the framework of the corporate tax system, to keep parent companies and central functions within the country. In the long run it could result in the reallocation of production and activity which would further diminish tax revenues for small open economies. This is simply not acceptable, in particular since smaller countries are not members of the G20 and therefore have little or no influence on new rules but would encounter the largest tax revenue losses.

On behalf of the Confederation of Swedish Enterprise

April 11, 2014

Krister Andersson
Head of the Tax Policy Department
Dear Sirs

COMMENTS ON DISCUSSION DRAFT ON ACTION 1 (THE TAX CHALLENGES OF THE DIGITAL ECONOMY) OF THE BEPS ACTION PLAN

We refer to the above titled document.

We note the request for comments on page 7 of the Discussion Draft. In the time available, it is not possible to address all of the issues identified in the request for comments, nor indeed to comment in adequate detail on all the points raised. It is highly unsatisfactory that such a short timeframe be allowed for analysis and comment on a document of this complexity with such potentially far-reaching consequences. We are therefore limiting our comments on this occasion to certain key observations.
General Observations

1. It might have been expected that the proposals would seek to address the more controversial types of tax planning noted in the public domain by some multi-nationals. However it seems to us that the proposals go much further. If followed through they could result in a fundamental change to the business model for many companies, major multinationals and smaller indigenous exporters of digital products and services alike.

2. The most challenging proposals are those which involve a redefinition of the current Permanent Establishment concept, for example the introduction of a “virtual” permanent establishment. The consequences would be that for income tax purposes, the recognition of company profits would move away from where value is actually created to the locations where products are sold or consumed. This is a fundamental revision which seems at odds with the objectives of other Plan Actions which seek to align the location of profits with value creating activities. For reasons which are explored further below, we consider that the better approach for businesses which have no physical presence in the consumer market would be to retain income tax source taxation with destination based VAT/consumption taxes. This would seem to us to pose least risk of developing proposals which cause double taxation and of creating a barrier to flows of international trade.

3. There are echoes of the thinking described at Point 2. above behind concepts in the OECD discussion draft pursuant to Action 6 (Prevent Treaty Abuse). Such proposals, when viewed alongside proposals for Limitation of Benefits tests which focus on local ownership would severely prejudice international trade. Companies operating in economies with large volumes of international trade go beyond their geographical bounds to source both markets and capital. The ownership restriction as described in the Action 6 discussion draft is only workable with considerable derogations and exclusions so as not to be detrimental to international trade. Similarly, in the case of the digital economy proposals, care must be taken that any measure does not create a barrier to international trade. This is especially the case for the digital economy which offers such exciting opportunities for growth in international trade.

4. We are not convinced that digital economy companies should be taxed differently, and we see this as a departure from the Ottawa principles. Based on the findings presented in the draft in the report, it seems to us that most businesses are now digital economy companies at least to some extent, as they advertise and take orders online etc. It can be anticipated from the trends described in the draft report that the extent of permeation of the digital economy throughout all business sectors will only grow.

5. Many Irish accountants are concerned with commercial issues on an all island of Ireland basis, dealing with both the Irish and UK tax jurisdictions. Both Ireland and the UK are major exporters of information and communication technologies. From the figures published in your discussion draft, the exports by these two countries in the sector constitute almost 20% of the world market. The proposals in your discussion draft are therefore of considerable concern to us. In our view, they would of themselves distort and potentially erode the existing tax base of both countries. The proposals would
similarly prejudice other countries with similar sectoral profiles – a significant export presence and a relatively small domestic market.

Specific Comments
The discussion draft invited comments on a number of particular issues which it had addressed.

*Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules;*

taken with

*Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.*

The discussion draft reflects the emphasis placed by the Task Force on the conclusions of the 1998 Ottawa conference:

> The Task Force considers that these principles are still relevant today and, supplemented as necessary, can constitute the basis to evaluate options to address the tax challenges of the digital economy.

(at paragraph 7 page 6)

However, there may be an important omission from these principles as quoted in the discussion draft. The full text of the taxation principles as agreed as Ottawa reads as follows:

> The same principles that governments apply to taxation of conventional commerce should equally apply to e-commerce, namely: [Neutrality, Efficiency etc as recited at Box 1]¹

The Ottawa Ministerial Conference in 1998 therefore seems to have dismissed the drawing of any distinctions between conventional commerce and e-commerce. As the ministers put it –

> Government intervention, when required, should be proportionate, transparent, consistent and predictable, as well as technologically neutral²

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²At page 5 of Ottawa conference conclusions – SG/EC(98)14/FINAL
Of course time has elapsed since then. For all the forward thinking evidenced in 1998 by the Ottawa participants, it is unlikely that they foresaw the extent to which e-commerce would develop in the following 15 years. We consider that the draft report, having taken as its starting point the Ottawa principles, should equally reflect the key agreement that there be no distinction between conventional commerce and e-commerce. We do not think that the findings set out in the report present a convincing case for drawing a distinction between those businesses that are heavily reliant on the digital economy and other business sectors.

This viewpoint was also expressed by us in our contribution to this process by letter of 19 December 2013. One important facet of the work being undertaken should be to define more clearly the industries and entities involved when considering digital economy issues. It is apparent that there has been a coherent attempt in the discussion draft to better analyse digital economy issues, which we acknowledge. However, we also pointed out the importance of the first principles of taxation. It seems that this concern was an important outcome of the Ottawa conference and should be re-emphasised in the final version of the report.

As identified in the discussion draft, there are many ways in which businesses can engage in e-commerce activities. In practice, it is by now unlikely that a sensible distinction can be drawn between digital economy business and what the Ottawa Conference termed conventional commerce. If this distinction is pursued, the inevitable outcome is that many businesses will suffer a compliance burden under two separate tax regimes – one applicable to their digital economy activities, and another to everything else. This would surely be inefficient for businesses and Revenue Authorities alike and must serve to damage international trade.

The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy;

The BEPS Action Plan mandated work “to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services.”

VAT and GST are taxes on consumption. For EU VAT purposes, taxes are levied in the country as specified by the EU VAT directive depending on the nature of the supply, and the nature of the supplier and the receiver (B2B, B2C etc). Short of relocating its consumers or changing the nature of its goods and services, it is impossible for a business to erode the VAT base. Often neither such actions are practical. We note in particular the recent EU initiatives in connection with the Mini One Stop Shop (MOSS) which we are confident should serve to eliminate one of the last remaining barriers in establishing an efficient mechanism for the collection of VAT at the point of consumption.
It is important to recognise the distinction between ineffective consumption tax legislation, and ineffective consumption tax collection mechanisms. There can be a risk that overly onerous direct and indirect tax measures will simply mask, or attempt to make redress for, deficiencies in collection mechanisms at the point of sale to the consumer.

The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft;

We have considered options advanced at Paragraphs 211, 212 and 217

Paragraph 211

The revision to the exclusions in the definition of permanent establishment would mean that having a storage facility for stock, or a purchasing division, or an advertising and research department in a country would make the company liable for tax in that country.

Paragraph 212

A “dematerialised digital activity” where digital services are provided, contracts are concluded on-line, payments are made electronically and the customer is indifferent to the location of the supplier could be deemed taxable in the location of the customer. This is a proposal for little other than a consumption tax framed as a direct tax. It poses a real risk of double taxation.

Paragraph 217

A “virtual permanent establishment” – where services are provided and contracts concluded remotely could be deemed taxable in the location of the customer.

All of these proposals are unacceptable as they represent a fundamental change to taxation of the profits of companies by aligning the taxation of company profits away from where value is created to locations where products are sold. We consider that the best model to promote and support international trade remains a combination of income source taxation with destination based sales and consumption taxes. This appears to present the least risk of double taxation and of adding more complexity and uncertainty that could hinder business taking advantage of the opportunities for growth which are afforded by developments in the digital economy.

Closing Comments

You may wish to note that this response is from a representative body. The Consultative Committee of Accountancy Bodies – Ireland is the representative committee for the main accountancy bodies in Ireland. It comprises Chartered Accountants Ireland, the Association of Chartered Certified Accountants, the Institute of Certified Public Accountants in Ireland, and the
Chartered Institute of Management Accountants, which represent a combined membership of some 40,000 accountants. Brian Keegan, Director of Taxation at Chartered Accountants Ireland (brian.keegan@charteredaccountants.ie, +353 1 6377 347) may be contacted if any further details in relation to this letter are required.

We have already offered observations, as noted earlier, in our letter of 19 December 2013, and in our letter to your colleagues of 9 April 2014 in the context of BEPS Action 6.

Yours faithfully

Paul Dillon, Chairman, CCAB-I Tax Committee
Comments on the BEPS Action 1 Draft of 24 March 2014 (digital economy)

By Gaetano Pizzitola, Crowe Horwath Italy - Partner in charge of Cross-Border Tax Services

Dear Sirs,

We are pleased for the opportunity to submit our comments on the subject matter (the “Draft”).

The Draft contains a thorough analysis of empirical evidence on the digital life every human being is increasingly living within, whether in cosmopolitan cities or in the smallest underground village of the outback. It is not only the economy yet the entire daily life that is more and more digitally virtualised.

As a result, it is welcome paragraph 59 of the Draft whereby it acknowledges that

As digital technology is adopted across the economy, segmenting the digital economy is increasingly difficult. In other words, because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy. Attempting 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.

The Tax Force has identified three major options to address the tax treatment of digital businesses and transactions:

• The permanent establishment approach (“PE”) with its variations including restrictions to the PE exemption rules, a new concept of digital PE or a similar virtual PE under the traditional framework of the fixed place and the agency PE concepts or the otherwise labelled on-site PE;

1 Comments are sent as partner in charge of Cross-border Tax Services of SASPI - Studio Associato Servizi Professionali Integrati, Italian member firm of Crowe Horwath International providing tax and legal services in Italy, and on behalf of the latter Italian firm.
- A withholding tax approach imposing a final withholding tax on cross-border digital transactions, and/or
- The consumption tax approach.

The first two income tax approaches may overlap with the third one, which indeed has perhaps been the main source of concern by leading to inequality and unfair competition in the local market, especially in the European Union. It is only from 2015 that one of the main cause of EU tax shopping unbalance between member States will be addressed with the introduction of new measures ensuring that consumption taxes such as VAT will result in taxation in the jurisdiction where consumption takes place.

Consumption Tax

Consumption tax is probably the most urgent area of attention as cross-border B2C transactions, particularly if characterising as supply of services, may distort competition in the local markets if no effective mechanisms ensuring tax charge in the market of consumption is provided for.

Simplified registration regimes and thresholds as outlined under paragraph 3.5 of the Draft will have to balance the need of ensuring equal treatment of local and foreign suppliers from a consumption tax standpoint and the minimization of compliance burden on businesses.

As payments of remote digital supplies to consumers ordinarily take place through credit cards or online payment mechanisms, wonder whether withholding VAT mechanisms may be provided for. As online resellers do trade products and services through authorised paying agents, the latter may act as withholding agents for the payment of any VAT or any further consumption tax embedded in the sale price to consumer.

Use of foreign bank accounts to somehow disguise the place of consumption may be counteracted through various forms of blocks if the place of delivery does not match with the place of credit card issuer and/or red flags embedded mandatorily in the software tools authorized for use by online resellers.

The current level of sophistication and enhancement in the payment systems will guarantee an effective application of withholding mechanisms to ensure collection of consumption taxes on sales to end consumers.

If consumption tax enforcement is a critical area for protecting local businesses from unfair competition through the use of offshore trading, we are sceptical, by contrast, on any attempt to introduce specific measures in the area of income taxation, particularly both with respect to the notion of permanent establishment and income withholding taxes.

Income Withholding Tax on Digital Transactions

Paragraph 218 of the Draft mentions that the introduction of a final withholding tax on payments of digital goods and services to foreign suppliers has been suggested. Such an income withholding tax
approach has apparently been perceived by someone as a potential solution addressing BEPS concerns that

it may be possible to maintain substantial economic activity in a market without being taxable in that market under current permanent establishment rule due to lack of physical presence in that market.

The above statement echoes the eternal struggle between source Country vs residence Country for the taxation of business income and, indeed, it is the underlying BEPS concern, which is clearly targeting no tax or low tax jurisdictions interposed by multinationals between their headquarters or main business locations and their market of sales.

Withholding taxes had historically been found as a simple mechanism for capital import Countries, broadly, to collect a fair share of revenues from foreign companies investing their capital assets into the local market by extracting cash through forms of passive income such as dividends, interest and royalties and, in certain jurisdictions, on lease of movable assets and/or technical service fees.

OECD Countries have opposed so far any withholding tax at source on any form of active income. Indeed, the OECD has gradually reduced the scope of withholding taxes on passive income and the latest OECD Model Treaty, indeed, provides for withholding tax only on dividends, strictly speaking, although many Countries still apply the older versions of the OECD Model in their tax policy and treaty negotiations, whether or not consistently with the current development of their local economy as a capital import or capital export Country.

The introduction of a withholding tax on digital transactions would somehow invert the trend by extending the scope of withholding taxes to transactions deriving from active business, eg, e-commerce of goods or services such as software licenses, cloud computing, etc.

BEPS pursuit is a symptom not only of concerns but also of uncertainty about international tax policies. New phenomena such as the digital economy raise concerns as it is typical of any new phenomenon previously unknown to a community. Concerns increase uncertainty about any new phenomenon.

Withholding taxes at source are tax tools for capital import Countries. As stated, they have historically been applied on passive income sources such as dividends, interest and royalties. They were developed at times where States had full sovereignty on their tax policies and local legislation also provided for stringent exchange control mechanisms. Capital export Countries have progressively removed withholding taxes from their treaty policy by maintaining those mechanisms in their domestic legislation. The USA have been one of the best examples for consistent policy-driven application of such a two-layer policy: withholding tax in the domestic legislation vs treaty exemption.

Countries of the EU have by contrast accepted the elimination of withholding taxes and other taxation at source on the same sources of income such as dividends, royalties and interest within multinationals.
The introduction of a **withholding tax on digital transactions** may address concerns of the source Country on the one hand, but it **raises a number of key questions** such as:

- **What level of substantial economic activity** in the market does trigger the withholding tax liability;
- **How to apply it within the EU and/or other free movement zones**;
- **The impact of any foreign withholding tax incurred** by domestic company doing business abroad, ie, the reciprocity principle.

The first question raises what really would be the substantial activity locally that should trigger the withholding tax liability to the foreign supplier. Such a withholding tax approach looks like an easy fix to raise revenues. However, what **substantive rationale** would allow justifying the withholding tax levy from a jurisdiction to tax standpoint? If the rationale would be that the foreign business would benefit from substantial sales in the domestic market, we wonder whether it would de facto make an **income tax a consumption tax**. Discussions about digital economy have somehow been influenced by the political actions against Amazon, Facebook, Google, etc. They are digital giants nowadays but they are amongst the pioneers of the digital economy, which has benefited largely consumers all over the world. Would they have been able to grow up to their current level if they had to suffer withholding taxes on their sales cross-border?

Withholding taxes generally are not creditable when companies are in a loss position, which is typically the case of any start-up. Applying withholding taxes on digital transactions would hamper the market development with obstacles and barrier entry to newcomers. Paradoxically, the introduction of a **withholding tax nowadays would favour giants such as the usual suspects for BEPS guillotine by imposing cash flow disadvantages to new players**. Rather than favouring local competition the withholding tax would unfairly restrict market competition and affect consumers paying higher prices.

Paragraph 119 of Draft states that

> corporations operating only in domestic markets or refraining from BEPS activities may face a competitive disadvantage relative to MNEs that are able to avoid or reduce tax by shifting their profits across border.

The above statement is a pillar of the BEPS project as a whole and can be found in several prior BEPS documents. **Withholding taxes** cannot be seen as an instrument for levelling the playing field. By contrast, they **are discriminatory in nature and the ECJ has ruled several times that they infringe the fundamental freedoms** if they are not equally levied to domestic taxpayers. By applying on gross income while domestic business taxpayers qualify for net income basis approach, withholding taxes disadvantage foreign direct investments.

Equal treatment and fair competition cannot be looked at only focusing narrowly on a specific feature of the tax system. **Each Country has other mechanisms to favour local businesses.** Italy, for example, has introduced incentives for high-tech start-up businesses and historically subsidises industrial and commercial activities with tax credits, grants, etc.
Introducing withholding taxes will not realize any equal treatment of local vs foreign competitors as they are in a different position and the former may benefit from incentives that the latter do not qualify for without a local footprint.

Furthermore, as any cross-border tax measure, withholding taxes cannot be looked at only through the opera glass of a capital import Country. Most of the OECD member Countries are indeed capital exporters. Each OECD Country should look at withholding taxes from both perspectives as a capital import and capital export Country. Imagine any local business doing e-commerce with foreign customers being subject to withholding taxes in all other OECD Countries. Local withholding taxes may be overwhelmed by non-creditable foreign withholding taxes. Both businesses and the local Exchequer will lose. Managing withholding taxes in such a framework will become almost impossible.

In conclusion, withholding taxes on digital transactions may seem an easy fix to perceived abuses by multinationals. However, each Country has its own policy instruments to favour local businesses. Rather than introducing withholding taxes that would have a short-focused viewpoint by looking at taxes only from the perspective of a capital import Country, OECD member Countries and external partners should also consider that each Country is or will also be a capital export one.

There may be some Countries more advanced than others in the digital economy at this stage. However, recent history shows that capital import Countries, eg, the BRICS, are more and more becoming capital export ones. Although they have become big market forces nowadays, the above may be true for each country, regardless of its size and power in an open digital economy.

Digital economy may dramatically turn capital import Countries into capital export ones quickly if governments are able to introduce incentives to attract local and foreign investors to develop digital products and services while the business community invests capital in the field.

As stated earlier, it is the entire life and the entire world being digitalized nowadays and not specific businesses, as can be inferred from paragraph 59 of the Draft.

For all the above, we hope that any attempt to justify the introduction of withholding taxes on digital transactions will be abandoned.

**Permanent Establishment**

The expansion of the scope of the PE concept has also been suggested as an alternative to manage the challenges raised by the digital economy. Three main variations have been identified under paragraph 218 of the Draft:

- Restrictions to the PE exception under paragraph 4 of Article 5 of the OECD Model Convention, which may take different variations as outlined under paragraph 211 of the Draft;
- A new nexus based on significant digital presence, ranging from the basic nature of the business if digital web sites as the exclusive means to conclude contracts or residence of the vendor if immaterial for the purchaser, and so forth; and/or
A third definition of PE, which would add the new concept of Virtual-PE to the ones of Material-PE (par. 1-4 Art. 5) and of Agency-PE (par. 5-6, Art. 5); the concept of Virtual-PE has been submitted either as a variation of the latter two traditional concepts depending on whether the PE will have basis on servers or contracts execution, or as a novel one based on the supply of on-site services or other business interface at the customer’s location.

Clearly, the expansion of the concept of PE ties with the BEPS pursuit under Action 7 targeting prevention of any alleged artificial avoidance of PE status. Paragraphs 151-152 identify two potential cases that are often perceived as abusive conduct of business:

- Online seller of tangible goods or online provider of advertising services through the sales force of a local subsidiary negotiating and executing sales with prospective clients (par. 151);
- Online seller of tangible goods maintaining a local warehouse if proximity to customers and the need for quick delivery to clients are key components of the business model (par. 152).

Action 7 also targets alleged mismatch between economic activities and contractual allocation of risks, the commissionaire contract being deemed as an abusive scheme with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country (BEPS Action Plan, Action 6, page 19).

There is already quite an overwhelming (and, in our view, unnecessary) debate on the old concepts of PE that one wonders what the benefits of a third species of PE would be. More broadly, we wonder if an expansion of the scope of PE to arrangements such as commissionaires or to traditional exceptions such as the ones under paragraph 4 of Article 5 is strictly necessary to achieve a fair allocation of taxable income (and losses) amongst all Countries, including the home Country, the market or source Country as well as any other low-tax jurisdiction that may be interposed as the odd man out. Reference to commissionaire and Action 7 is made herein as we believe that the underlying issues are essentially the same even with respect to digital economy. We had already commented on the current debate about expansion on the definition of PE with our letter of February 9, 2012 on the first OECD PE Draft of October 11, 2011 and remain of the same opinion today.

We believe that most of the PE cases can be handled with transfer pricing approaches. If a multinational is implementing a commissionaire contract and a tax inspector believes that the profits taxed locally is not enough to compensate the efforts made by the local subsidiary, wonder what benefit any PE claim may have for the local tax authorities from a revenues collection standpoint.

There is a foreign multinational selling goods to a local subsidiary acting as commissionaire, which is a contract well defined in most jurisdictions from a legal and tax standpoint, especially VAT, at least within the EU, which treats commissionaire agreements as buy-sell arrangements from a VAT standpoint.

Whether the transaction between the foreign group supplier and the local commissionaire is treated as a buy-sell or service arrangement from an accounting standpoint (in the practice both approaches are followed) and/or from an income tax standpoint, in all circumstances the value attributable to the products transferred infragroup or the services made by the local subsidiary to its foreign sister company will be subject to transfer pricing test by being an intragroup transaction by nature.
If that is the case, we wonder what level of taxable income may a commissionaire arrangement subtract to the market Country if not the one, if any, that should not be subject to tax because FRAs (functions, assets and risks) are not connected with the local market.

The commissionaire example equally applies to the new ways of doing business under digital economy models. **A fair allocation of taxing rights may be achieved even if a multinational is organised through one or more local subsidiaries doing business as service providers rather than as buy-sell distributors.**

Experience shows that, **at least in the Italian practice, service business models by multinationals are re-characterized as deemed-PE under the Agency-PE doctrine** whereby the local subsidiary acts really as an agent or as a commissionaire by merely managing sales promotion and clients’ purchase orders with customer care teams.

If the same balance of tax rights may be achieved under the transfer pricing principles, **PEs are often an irrelevant excess of accounting and tax compliance burden** because no additional value can be attributed to a local branch if the actual management of functions and risks locally is limited to specific functions such as sales promotion and customer care. In most scenarios, a PE claim or a defensive PE tax filing in advance would not add much value to the split of taxing rights between the market Country and the foreign one. From that standpoint, **PE claims have the same nature of the excess compliance required for foreign suppliers to register for VAT purposes**, which paragraph 3.5 of the Draft identifies as one of the main drawbacks for consumption tax purposes.

If a local subsidiary carries those functions under a service business model, as a commissionaire or as buy-sell distributor, **profits allocation should not change materially** under a proper application of the transfer pricing principles, which indeed merely apply economic practice between independent parties to intragroup transactions. It is widely spread the use of independent distributors that do not bear inventory or credit risk in the market. Commissionaire and similar low-risk arrangements are neither unique of multinationals nor of BEPS unfair practices.

We believe that in all circumstances whereby an MNE is doing business in a foreign market through local subsidiaries acting as group service providers, tax authorities should refrain from applying PE claims under the **Agency-PE clause**. Indeed, we wonder whether such a concept, which is the cause of widespread debate and huge uncertainty, should rather be **abolished** in the current digital economy whereby the value attributable to services and all intangibles may have a wider impact on the overall profit allocation within a group; or, **at least, limited to circumstances whereby a foreign group is trading product and services by escaping source taxation altogether** by exploiting the auxiliary exemption clause under paragraph 4 of Article 5 without any proper remuneration of the local functions.

Based on the above, as far as digital economy is concerned, we doubt that a third species of PE, the virtual one under any shape, is strictly necessary to allow the market country to achieve a fair allocation of income taxes.
We hope that the Action 6 project will clearly identify and distinguish three main scenarios:

- Foreign groups doing digital economy activity in any market Country through one or more subsidiary or branch acting as service providers for the benefit of their foreign company, whether or not invoicing the local customers directly, which should not be subject to PE claims by being subject to transfer pricing scrutiny;
- Foreign groups doing digital economy activity in any market Country by managing directly warehouses or other local functions through their own facilities, which would fall under any of the PEs under paragraphs 1 and 2 of Article 5;
- Foreign groups doing digital economy activity in any market Country without any local service presence or any facility that may give rise to a material-PE.

The first two scenarios may lead to a fair allocation of income taxes to the market Country either under the transfer pricing principles or under the material-PE clause, the latter regardless of the introduction of any new Virtual-PE concept.

The third scenario should not give rise to local income taxation because no function, asset, risk whatsoever is managed locally by the foreign company, which only has customers therein. From that standpoint, there is no difference between old and new economy, traditional and digital one. In all cases, value creation is not in the local market whereby it is only the customer base that will prefer the foreign supplier for its reputation, quality of services, etc., which were developed elsewhere.

Claiming a Virtual-PE under any shape in the latter scenario would somehow distort income tax concepts to apply income taxes merely because customers purchase online, which would de facto confuses income taxes with consumption tax. Income tax rights should be allocated to the Country where value is developed and functions managed rather than where customers buy, which is the rationale of consumption tax.

In reality, anyhow, most if not all digital economy players will need a local presence in the market Country as service providers facilitating business.

Traditionally, cost-plus has been the basic transfer pricing method to test services arm’s length. There is an increasingly shift towards profit split or other value creation formulas to test the value of services. Based on such developments in the transfer pricing sector, we wonder whether a concept of Virtual-PE may indeed further protect the tax base of market Countries significantly more than any transfer pricing approach.

Again, as per the withholding tax approach, each jurisdiction should look at PE claims from a two-fold perspective. Not only with the eyes of the market Country but also with the reciprocal ones of the home Country. There is no segregation between home and source Countries within two blocks. In the current open economy, each Country has a dual role, however different could be to date the level of development of the digital economy in the local market.

Looking at digital economy only from the market Country standpoint may sooner or later have a boomerang effect for any Country with business competing abroad as it is the case of almost if not all OECD Countries and main partners.
BEPS concerns seem to overstate the market Country loss of revenues by claiming the need, if any, for a Virtual-PE.

Based on the above, we believe that the two examples under paragraphs 151 and 152 of the Draft may be managed accordingly from a transfer pricing standpoint as follows:

- The sale of tangible goods and of advertising services by online foreign suppliers acting through the sales force of a local subsidiary negotiating and executing sales with prospective clients (par. 151) may be managed by attributing to the local sales force a level of profits and revenues commensurate to their contribution to the value chain;
- Similarly, warehousing services and logistics ones may be allocated similar level of profits based on the enhancement they provide for to the market potential of the foreign online seller (par. 152).

In cases other than the above ones, the market Country should better refrain from claiming any taxing rights as there is no value creation generated locally by the foreign supplier.

The competitive disadvantage that any local online trader may have compared to any foreign one should better be managed with public expenditure rather than tax collection. From the development of a strong digital economy and related infrastructures will depend most of the future of any country competing in a global open economy.

From that standpoint, the Action 1 Draft has a flavour of tax protectionism by seemingly looking back to the old days when each Country had its own barriers to foreign investors such as custom duties, exchange controls, regulatory restrictions, etc., which we are and will not be nostalgic about. Not sure if really the old days where the fairest way of promoting business cross-border and enhancement of business developments or, rather, the result of fiscal protectionism favouring local businesses that would struggle in the current open economy.

Transfer pricing approach as market Country and effective CFC rules as home Country should allow any OECD member and peers to maintain a balanced approach by addressing simultaneously any concern that the G20 and any tax administration may have about BEPS in the digital economy era in most if not all circumstances with no tax or low tax jurisdiction in between being able to take most of the pie.

Thank you for the opportunity with our initial contribution on this very controversial topic. The Draft contains a wide range of concepts and thoughts that will deserve the utmost consideration by dealing with new fields and tentative actions that will have to balance multiple and sometimes conflicting general purposes.

SASPI – Studio Associato Servizi Professionali Integrati
Italian member firm of Crowe Horwath International
Tax and Legal Services

Gaetano Pizzitola
Partner in charge of Cross-Border Tax Services
Dear Sirs

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

Thank you for the opportunity to comment on the non-consensus Discussion Draft – ‘Address the Tax Challenges of the Digital Economy’ released on 24 March 2014 (the ‘Discussion Draft’).

Digital businesses and models continue to evolve with advances in technology. It is essential that there is flexibility in taxation (and regulatory) models to accommodate new developments, which bring benefits through boosting global economic growth. As the Discussion Draft acknowledges, all digital services include a significant human component. We support the focus on examining whether changes to areas such as the transfer pricing of intangibles and changes to the definition of permanent establishments can reduce the potential for BEPS.

However, as the Draft notes, some forms of digital business allow remote sales and delivery of digital services without a presence in the market country. This is likely to present difficulties in determining the attribution of profit to permanent establishments or the approach to profit splits for digital transactions on a basis that is consistent with the existing rules. We think it would be helpful for the OECD to set up a Working Group to continue investigating the broader taxation issues specifically attributable to the digital market, outside the scope of the BEPS project.

Withholding taxes and other revenue-level taxes are unlikely to offer a practical approach. For some businesses they will be too high relative to overall margins, and for others may be too low to provide consistent taxation with other, non-digital, businesses. There is also a risk that high levels of withholding taxes discourage investment, and become an inhibitor to economic growth. Digital businesses encompass a wide range of businesses, including many start-ups and small businesses as well as a small number of very large businesses; any new approach to taxation will need to cater for all.

The European Union will change its rules in 2015 covering ‘place of supply’ for certain digital and telecoms services. The change will yield VAT for EU Member States where the consumer is based, instead of in the country where the service provider is based. However, this approach brings significant compliance challenges, even for 28 countries. Additionally, it will increase irrecoverable VAT borne by
some sectors, as well as public services of health and education. The change also highlights the different VAT treatment of physical product and digital product – which is unhelpful. All these practical difficulties will need to be addressed by the OECD if this type of system is to be workable as a more global approach.

We welcome the reference to the Ottawa principles for designing international rules in relation to digital transactions, and agree that this is a helpful and sensible approach to consideration of the difficult issues posed by new technologies allowing for remote activity.

Responses to specific questions asked in the Discussion Draft are in the attached appendix.

If you wish to discuss any of the points raised in this letter, please do not hesitate to contact either me (bdodwell@deloitte.co.uk), or Alison Lobb (alobb@deloitte.co.uk).

Yours faithfully

W J I Dodwell
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Appendix 1 – Responses to questions raised in the Discussion Draft

Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules

- Due to the nature of the digital economy, including the rapid pace of change of technology and the effect these changes have on a wide variety of international businesses in different sectors in different ways, we do not think it is possible to ring-fence the digital economy. There is not a clearly defined and separate digital economy; instead, there is integration of digital models into traditional businesses. There is also the evolution of new, digital delivery business models which, whilst anchored in human inputs familiar in the traditional world, operates in a different fashion. The taxation issues are broader than those arising from base erosion or profit shifting and warrant a longer study outside the scope of the BEPS project.

- As noted in the Discussion Draft in paragraph 120, BEPS concerns in relation to digital businesses are similar to the nature of strategies used to achieve BEPS in more traditional businesses.

- There are many variations of business model and approach, and it is hard to make general statements or comments on how businesses operate within the digital economy. As with traditional business, there are also many factors influencing how these businesses choose to structure their operations, such as access to markets, access to skills and resources, infrastructure, regulation, legal protection, business and tax environment, political stability etc.

- As with traditional business models, it is important to recognise the effect larger international organisations can have on smaller enterprises including start-ups and developing businesses. These impacts may be both positive and negative. For example, positive impacts may include support through providing a web platform, facilities or shared services.

- It may be possible to introduce more specific rules when addressing the other areas of the BEPS Action Plan that reflect the nature of some types of digital transactions; but there is a need for consistency with the levels of taxation imposed on traditional businesses.

The ability of the measures developed in the course of the BEPS project and the current work on VAT/GST to address BEPS concerns in the digital economy

- Many BEPS concerns apply equally to digital and traditional businesses and we anticipate that the development of the other Actions in the BEPS Action Plan will go a considerable way to addressing the BEPS concerns that arise in relation to the digital economy.

- However, some of the key issues identified arise from an international tax system that does not always reflect modern business models and technologies.

- The Discussion Draft highlights some areas within the digital economy that may need to be addressed as part of the BEPS Action Plan. The key areas are Action 7, which will consider the definition of permanent establishments for the digital economy and Action 8-10, relating to transfer pricing and value creation.
• For these, it is relevant for the appropriate Working Parties and the Digital Task Force to consider the functions that may be carried out in each jurisdiction alongside the value of those functions. There are qualities of some forms of digital business that allow remote sales and delivery of digital products without people or a presence in the market country, and this may necessitate a change of approach. It would be entirely inappropriate for a system of taxation to be based on where the customer is located, which does not adequately remunerate the country in which people are undertaking activities, including services and/or the creation or maintenance of intangible assets. Multinationals will have intangibles, people and/or infrastructure in different countries for many reasons, including at the request of key personnel, access to financing and investors and for more technological reasons, such as servers being located near customers.

• The ongoing work on International VAT/GST Guidelines (‘the Guidelines’) is looking to set international standards for VAT/GST. We welcome this work and agree that consistent international rules are needed.

• A proper and consistent implementation of the agreed business-to-business ‘place of supply’ Guidelines would reduce the current distortions. However, this is not the only VAT/GST issue. Consideration needs to be given to potential differences between the VAT/GST treatment of traditional goods and their digital equivalents. For example, within the EU physical books are subject to VAT at low, or zero rates. The digital equivalent – eBooks – is taxed at standard rates (although this is the subject of litigation before the European Court of Justice). Consideration also needs to be given to the inability of businesses in some sectors and some public services to recover input VAT.

**Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones**

• The key issue in relation to digital business is the effective modernisation of the rules that allocate taxing rights between countries. Other aspects of the BEPS Action Plan that are concerned with providing recommendations for domestic anti-avoidance rules or treaty solutions to counter abuse are equally relevant to traditional and digital businesses.

**The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation**

• We agree with the broader tax challenges identified by the Task Force. We also agree that the fundamental nature of core business activities has not changed, for example, in relation to advertising and customer support, but that digital technology has had a significant impact on how these activities are carried out by some businesses. It is important not to overstate the issue of nexus, although it is currently possible to generate a large quantity of sales without a taxable presence.

• The key VAT/GST challenges raised by the digital economy are noted above. Some of these challenges will be addressed in the ongoing work on the business to consumer VAT/GST Guidelines. We think the other issues also need to be addressed.
The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft

- Withholding tax on digital transactions would be a very blunt tool to address the broader tax challenges raised by the digital economy, and it is difficult to see this being implemented in a consistent and equitable way. Gross level taxation (as opposed to the net profit level) is problematic in terms of setting an appropriate rate given significant differences in profit levels across the spectrum of digital businesses. In particular, withholding taxes can be a barrier to international expansion and to investment into new markets (especially, but not solely, by small and medium sized enterprises). There are further significant practical considerations in terms of how this could be applied to consumer sales.

- To the extent that there are any changes to the permanent establishment definition and any new nexus based on some criteria for ‘significant digital presence’, there should be a clear de minimis threshold in each country below which no permanent establishment would be created. Without such a minimum threshold, a business model may create a scenario where, under the proposed options, there are numerous very small permanent establishments across multiple countries. This will create a significant compliance burden for taxpayers and tax administrations - and will be costly relative to the tax raised in local countries. In addition, as identified in the Discussion Draft administrative challenges, it may not be straightforward to identify if a business has a significant digital presence in a country or where its customers are located.

- Any changes to the international model in relation to permanent establishment will need to be capable of being put into practice on a principled and consistent basis, including in relation to valuation, to avoid lengthy and complex disputes between governments. In particular, mechanisms involving consumer data are impossible to measure and value in a meaningful way and are thus currently impracticable.

The VAT/GST Guidelines, once finalised, will deal with remote digital supplies. In relation to the options suggested to address concerns on the import of low value goods, minimising the administrative costs of compliance is an important priority.

- The Discussion Draft highlights the direct and indirect tax challenges and options for addressing these on a separate basis (except a brief mention in paragraph 210). The report should include clear guidelines on the differences and interaction between direct and indirect tax measures. For example, a review of the definition of a permanent establishment for direct tax purposes could have significant indirect tax consequences regarding the application of place of supply rules and new VAT registration obligations which might be incorrectly considered as creating a direct tax permanent establishment.

The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives

- Any changes will incur administration and compliance costs for businesses, and also perhaps systems changes, and we would recommend a lead-time is built in for businesses to adapt.

- The level of potential administrative cost of compliance is the key concern of businesses regarding any options considered for addressing the VAT/GST collection challenges within the digital economy. It is essential for the recommendations by the Task Force to emphasise that any
new registration or declaration obligations for non-established businesses need to be implemented in the least burdensome way (e.g. applying thresholds, enabling electronic registrations and declarations and optional use of third party intermediaries, setting reasonable proxies for identification of customer location). If not, it may result in widespread non-compliance or businesses withdrawing from national markets due to unreasonable compliance costs.

**Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented**

- We agree the Ottawa taxation framework principles identified are an appropriate framework for analysing options. As mentioned, in a fast-paced, changing environment, it is imperative that a sensible framework is used to address new business models when they arise and to give some level of consistency between traditional and digital businesses for investors.

- It is important that all countries involved agree to the proposed framework. This may establish consistency and provide businesses with a reasonable level of certainty on an international level.

- The VAT/GST Guidelines will be based on the Ottawa taxation framework principles. These principles are relevant and provide a reasonable basis for international VAT/GST standards.
April 13, 2014

Submitted by E-Mail: CTP.BEPS@oecd.org

Mr. Jesse Eggert
Senior Advisor, BEPS Project
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development

Re: Comments on the Public Discussion Draft on BEPS Action 1: Address the Tax Challenges of the Digital Economy

Dear Mr. Eggert:

On March 24, 2014, the Task Force on the Digital Economy (the “Task Force”) released a Public Discussion Draft on BEPS Action 1: Address the Tax Challenges of the Digital Economy (the “Discussion Draft”). We are writing to provide the comments of the Digital Economy Group (the “DEG”), an informal coalition of leading U.S. and non-U.S. software, information / content, social networking, and e-commerce companies that provide goods or services through digital and nondigital means.

I. Executive Summary

The DEG commends the Task Force for preparing a draft report that is both thorough and thoughtful. The Discussion Draft follows the best OECD traditions of being factually based and analytically oriented while remaining alert to administrative challenges. The DEG also commends the Task Force for seeking input from business on the factual elements of the Discussion Draft, the potential options to address the broader tax challenges raised by the digital economy (the “Options”), and the framework for analyzing the Options. We applaud the decision to release the Discussion Draft even though it does not represent a consensus view of the Task Force, as that allows informed public comment at a very appropriate point in the deliberative process.

The DEG agrees with the Task Force that:

- ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible.
- the principles established by the 1998 Ottawa Ministerial Conference on Electronic Commerce (the “Ottawa framework principles”) and applied consistently by the OECD since then constitute the proper framework for evaluating any tax proposals that affect the digital economy.
- any assessment of the need for additional special rules to address the tax challenges of the digital economy should follow completion of the work on
Actions 2 - 15 of the BEPS Action Plan because these Actions are expected to address BEPS issues generally, including the phenomenon of stateless income, in ways which will significantly affect digital economy enterprises.

With respect to the Options:

- The DEG believes that the consumption tax Option relating to digital supplies to consumers is the Option which most appropriately addresses the tax challenges of the digital economy, as it can be seen to level the playing field between resident and nonresident suppliers of digital goods and services.
- This Option is more consistent with the Ottawa framework principles than any of the other Options and is the only Option that proposes a tax which is properly imposed by reference to the location of consumption.
- As this Option imposes an extraterritorial obligation, further work would be required to achieve reasonable compliance mechanisms to balance the administrative burden with the amount of tax collected.
- None of the Options, however, is better suited to deal with opportunities for BEPS in the digital economy than the proposals to be developed under Actions 2 - 15.
- Those Options which depart from the fundamental principle of direct tax nexus based on the actual business substance of personnel and assets in the taxing state or which specifically target digital / internet companies are inconsistent with the Ottawa framework principles.
- Those Options which define a set of transactions by reference to on-line activity are in essence proposing a separate tax regime for the digital economy, despite the Discussion Draft conclusion that ring-fencing the digital economy is not feasible.
- Further policy discussion of the Options should take into account the increasing global reciprocal trade in the digital economy, as many digital economy enterprises are emerging outside the United States.

II. Information and Communication Technology and Its Impact on the Economy

The DEG commends the Task Force for producing a detailed analysis that shows how Information and Communication Technology (“ICT”) is shaping the modern economy.

III. The Digital Economy, Its Key Features and the Emergence of New Business Models

The DEG strongly agrees with the Task Force that, “because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy.”1 The DEG also considers it

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1 See Discussion Draft ¶ 59.
“difficult, if not impossible, to ring-fence” “pure play” digital / internet companies\(^2\) from other companies because the internet of things, virtual currencies, and 3D printing all blur the line between digital / internet service providers and providers of manufacturing, design, development, and financial services.\(^3\)

A. Refining the Understanding of the Digital Economy

As noted above, the DEG commends the Task Force for producing a thorough description of the evolution of ICT, and of the digital economy, its key features, and the emergence of new business models in Chapters II and III of the Discussion Draft. In some particulars, however, the Discussion Draft’s generalizations about all enterprises operating in the digital economy paints with a very broad brush. Those broad descriptions perhaps have been inspired by press reports of successful start-ups, but may not be an accurate generalization when applied to mature businesses. We offer below a few observations which might be considered in revising Chapters II and III.

1. Observations on Statements in Chapters II and III

The Discussion Draft notes that the “digital economy has given rise to a number of new business models.”\(^4\) The DEG agrees that some of the business models of digital / internet companies are new but notes that most of the business models which are commonly described as part of the “digital economy” are traditional business activities that are enhanced through the use of ICT. For example, online payment, media, auction, and logistics solutions have offline analogues in the form of money transfer services, publishing and broadcasting, auction services, and logistics services.

The Discussion Draft acknowledges that many digital economy business models “have parallels in traditional business” but considers these business models to be “new” on the theory that “modern advances in ICT have made it possible to conduct many types of business at substantially greater scale and over longer distances than was previously possible.”\(^5\) The progressive improvement of manufacturing and distribution capabilities of enterprises is responsible for much of the efficiency gains in the global economy for many years. Outsourced manufacturing to low-cost environments, other communication and transportation revolutions in areas other than digital communications, the ability to access human capital across borders, and other similar developments have all revolutionized commerce by giving enterprises the ability to produce, deliver, and support their goods and services to customers in remote markets at lower cost. These

\(^2\) “Pure play” digital / internet companies use the internet as their principal method to deliver goods and services, including communicating with users and suppliers through hosted web pages.

\(^3\) See Discussion Draft ¶¶ 30 - 34, 38 (describing the internet of things, virtual currencies, and 3D printing as part of the emerging and potential future developments in the digital economy).

\(^4\) See Discussion Draft ¶ 60.

\(^5\) See Discussion Draft ¶ 60.
efficiency gains are not unique to the digital economy, and many enterprises not considered part of the “digital economy” achieve these gains through ICT investments.

2. Enterprises Normally Cannot Scale Without Substance

It is a common misperception that digital economy enterprises as a general matter are able to operate with significantly fewer personnel than other enterprises. For most digital / internet companies, the ability to scale is not attributable to an ability to “carry on economic activity with minimal need for personnel to be present,” although there are certainly some digital / internet companies, principally some in their start-up phase, for which this statement is true. Most digital / internet companies maintain significant personnel in their development, marketing, logistics, customer support, IT, and other functions, which are essential to the companies’ financial and operational success, and thus have large numbers of employees who are generally resident in the various jurisdictions in which they live and work.

In a similar vein, the DEG respectfully questions whether Figure 8, which appears below paragraph 98 of the Discussion Draft and shows the “[a]verage revenue per employee of [the] top 250 ICT Firms,” provides an accurate depiction of the profitability of employees of the majority of digital / internet companies. First, many digital / internet companies are low-margin companies, which have high revenues but low profits. Without the names of the “top 250 ICT Firms,” it is impossible to determine whether the digital / internet companies with high revenues per employee also have high profits per employee. Second, a fair assessment of the relative profitability per employee of digital / internet companies requires comparative information about enterprises in high-margin industries that are absent from Figure 8, such as financial services enterprises.

3. Operating Costs Arise in Areas Outside Supply Chains

The Discussion Draft also suggests that, as a rule, digital / internet companies enjoy lower operating costs as a percentage of revenue compared to other enterprises because “B2C e-commerce can in many cases dramatically shorten supply chains by eliminating the need for many of the wholesalers, distributors, retailers, and other intermediaries that were traditionally used in businesses involving tangible goods.” Apart from the costs of physical stores, e-retailers of tangible goods generally bear the same supply chain costs as traditional enterprises dealing in tangible goods. Moreover, although some digital / internet companies may enjoy lower operating costs in some functional areas than their non-digital counterparts, developing, hosting, and operating the technologies that characterize many digital / internet companies give rise to costs in those functional areas that more traditional enterprises may not bear. For example, many digital / internet companies bear significant costs associated with product development, marketing, and

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6 See Discussion Draft ¶ 98.
7 See Discussion Draft ¶ 64.
customer support because high-technology product cycles are rapid, the life of technology is very short, and high-technology / data-intensive businesses have specific legal compliance costs. Moreover, many digital / internet companies incur significant start-up losses, which are funded through risk capital provided either by the companies’ founders or equity investors. As a result, some digital / internet companies become profitable only after a long period of time.

4. Mobility Concerns Are Overstated

In addition, the DEG respectfully suggests that the Discussion Draft’s concerns with respect to the mobility of users, functions, and intangibles are overstated. Users are not inherently mobile because users generally live and work in a single location, from which they purchase goods and services and access applications.

The Discussion Draft suggests that digital enterprises have an exceptional ability to locate business functions in advantageous locations. It is certainly true that many enterprises of all sorts have sought to create operational efficiencies by centralizing many business functions. This point therefore does not distinguish digital economy enterprises from others. In any event, enterprises are able to centralize functions only in those locations where appropriate personnel can be found, at which point the functions and the personnel who perform them normally remain in a single, central location. Finally, the fact that income is allocated to jurisdictions where personnel in fact are located is not a BEPS issue, as the BEPS Action Plan addresses only artificial base erosion.

The most significant concern, undoubtedly, is over the mobility of intangible assets. Multinational enterprises inevitably engage in intercompany transactions with respect to many of their assets, including intangible ones. The transfer of intangible property between affiliated enterprises, however, requires compensation under the arm’s length principle, just as does the transfer of tangible assets. The transfer of an intangible asset thus comes with a cost equal to the cost of transferring any other appreciated asset. Therefore, any issues arising from the fact that intangible assets can be transferred within multinational groups should be addressed by Actions 8 - 10.

5. Value in Data Lies in the Enterprise’s Analytical Tools

The Discussion Draft suggests that “[i]t is common in the digital economy for businesses to collect data about their customers, suppliers, and operations.” All enterprises, including digital / internet companies, use data in their businesses to tailor offerings to customers, improve supply chain efficiency, and assess the success of their operations. These practices are not new, although the volume of data is greater, and more sophisticated tools are available today for aggregating and analyzing data. For decades, enterprises that engage in customer-facing activities have used focus groups, surveys,
contests, and other, similar data collection methods to better tailor their offerings to consumers. Likewise, advertisers have used data on television viewing practices to better target their advertisements to the proper audience.

6. Volatility Is a Common Feature of the Digital Economy

The DEG agrees with the Task Force that volatility is a key feature of the digital economy since “in short periods of time, [digital / internet] companies that appeared to control a substantial part of the market have found themselves rapidly losing market share to challengers that built their businesses on more powerful technology, a more attractive value proposal, or a more sustainable business model.” Accordingly, the DEG respectfully disagrees with the Discussion Draft’s suggestion that digital markets more commonly “end[] up being dominated by a few major players” than is the case in any other industry sector. Few digital / internet companies enjoy a large share of the global market undisturbed for long periods of time, as the Discussion Draft acknowledges. Volatility is thus a far more common feature of digital / internet companies, since more than 90 percent of digital / internet start-ups ultimately fail, and even the most successful digital / internet companies can be unseated by new rivals in a single product cycle.

IV. Identifying Opportunities for BEPS in the Digital Economy

Chapter IV of the Discussion Draft correctly identifies facts that may result in the minimization of direct tax in a market jurisdiction. Some of these facts relate to tax planning practices that are common among enterprises across business sectors, such as minimizing functions, assets, and risks located in a jurisdiction to minimize taxable income arising in that jurisdiction. In itself, such actions do not raise BEPS concerns to the extent that income is allocated to those jurisdictions where such functions are, in fact, located. Other facts relate to structures which rely on the normal operation of the current rules, which apply to all enterprises, including digital / internet companies, such as treaty exemptions from or reductions in withholding tax and CFC rules.

Once the Discussion Draft has noted how these rules apply in practice, the groundwork has been set for a principled policy discussion of whether these existing rules remain

10 See Discussion Draft ¶ 118.
11 See Discussion Draft ¶ 117.
13 One clear example of this statement is the rapid switch by business users from BlackBerry devices to iPhones.
14 See Discussion Draft ¶ 125.
15 See Discussion Draft ¶ 129.
16 See Discussion Draft ¶¶ 134 - 135.
appropriate today. We respectfully express disappointment that instead of setting the parameters for the policy discussion, Chapter IV contains many disparaging assertions of noncompliance by, or aggressive direct tax positions of, digital / internet companies. This perhaps is an encouragement for increased enforcement efforts, but it is not an appropriate foundation on which to make policy choices. Accordingly, the DEG respectfully recommends that the Task Force reorient Chapter IV towards a policy discussion of whether the provisions of existing law which have been identified as giving rise to BEPS warrant change on the merits, and remove generalized statements about the compliance of digital economy enterprises.

We set forth below examples of pejorative statements in Chapter IV. As expressed in the Discussion Draft, the Task Force suggests that digital / internet companies as a group:

- “artificially fragment their operations among multiple group entities” to qualify for the exceptions to permanent establishment (“PE”) status under Article 5(4).17
- engage in the practice of “allocat[ing] . . . functions for tax purposes in ways that may not correspond to actual business functions performed.”18
- achieve BEPS by “undervalu[ing] intangibles” that are transferred to affiliates in low-tax jurisdictions and by “allegedly stripp[ing] of risk” operations of affiliates in high-tax jurisdictions.19
- avoid a PE in a jurisdiction by using in-country personnel with the “effective authority” to conclude contracts on behalf of a nonresident enterprise.20
- avoid withholding tax through “treaty shopping by interposing shell companies located in countries with favourable treaty networks.”21
- reduce tax “by generating excessive deductible payments,” such as royalties, to entities located in low- or no-tax jurisdictions.22
- minimize tax by “undercompensat[ing]” functions in HQ jurisdictions.23

The direct tax section of Chapter IV thus stands in contrast to the VAT section of this Chapter, which properly identifies a statutory gap in the current indirect tax rules that may lead to an unintended result as a matter of policy.

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17 See Discussion Draft ¶ 124. Unless otherwise specified, references to “Article” or “Art.” are to Articles of the 2010 version of the OECD Model Tax Convention.
18 See Discussion Draft ¶ 125.
19 See Discussion Draft ¶ 126; see also Discussion Draft ¶ 132 (noting that intangibles are “sometimes” transferred for a “less-than-arm’s length price”).
20 See Discussion Draft ¶ 127.
21 See Discussion Draft ¶ 129.
22 See Discussion Draft ¶ 133.
23 See Discussion Draft ¶ 134.
We note that many of the assertions in the list above relate to transfer pricing matters. In that regard, the DEG supports the OECD’s efforts to prevent the separation of income from the activities that generate the income. The current work on Chapter VI of the Transfer Pricing Guidelines plus Actions 8 - 10 provide the appropriate platform for addressing transfer pricing practices. We also note, however, that allocating income to a jurisdiction other than a market jurisdiction should not be regarded as a BEPS concern if significant people functions, assets, and risks are absent from the market jurisdiction and present in other jurisdictions. This result is not the reflection of policy choices, like CFC or PE rules or withholding tax exemptions, because the arm’s length principle simply allocates less income to those locations in which fewer functions, assets, and risks of an enterprise are present.

V. Tackling BEPS in the Digital Economy

The DEG appreciates that much of the concern regarding the tax challenges of the digital economy arises from the phenomenon of stateless income. This phenomenon, of course, is not unique to the digital economy. Stateless income arises through the interaction of domestic tax rules and tax treaties as applied to many enterprises in many industries. Other BEPS issues identified in the Action Plan also are not unique to the digital economy.

The DEG agrees with the Task Force that Actions 2 - 15 of the BEPS Action Plan will address BEPS issues in all sectors, including the digital economy. A recent report from HM Treasury and HM Revenue & Customs, entitled, “Tackling Aggressive Tax Planning in the Global Economy: UK Priorities for the G20 - OECD Project for Countering Base Erosion and Profit Shifting” (the “UK Report”), reaches the same conclusion.24

For that reason, it is prudent that the mandate of the Task Force is only to produce Options for further consideration in due course. The future work to assess these Options should be undertaken only after the implementation of the other BEPS Actions has been completed.25 Thus, for example, any further consideration of the Discussion Draft’s Options on direct tax nexus should be undertaken only after the work on Action 7 is complete.

24 See UK Report ¶ 2.6 (acknowledging that many BEPS challenges that appear in the digital economy “can be addressed through work that is already within the scope of the BEPS Project” - e.g., work on Actions that specifically address PE and transfer pricing issues).

25 The UK Report suggests supplementary rules for the digital economy only “if progress on updating the existing international tax framework fails to materialise.” See UK Report ¶ 2.8.
The DEG agrees with the Task Force that “the development of the measures envisioned in the BEPS Action Plan,” including work on the following Actions, “will effectively address the BEPS concerns that arise in the digital economy”: 26

- Action 2 will prevent digital / internet companies from using hybrid instruments to obtain deductions without corresponding income inclusions.
- Action 3 will prevent digital / internet companies from sheltering income from intangible assets from tax through the use of no-taxed or low-taxed passive CFCs.27
- Actions 4 and 9 will limit the ability of digital / internet companies to reduce taxable income through the use of certain deductible payments.
- Action 5 will prevent digital / internet companies from enjoying the benefits of preferential regimes without engaging in substantial business activities.28
- Action 6 will prevent digital / internet companies from using treaties to achieve double non-taxation.
- Action 7 will prevent digital / internet companies from avoiding PEs by fragmenting activities to take advantage of Article 5(4), treating core activities as excepted activities under Article 5(4),29 or disregarding contract-concluding activities of local salespeople.
- Actions 8 - 10 will ensure that digital / internet companies align intangible-related returns with the creation of value, make arm’s length intangible-related payments, and value intangibles appropriately.

VI. Broader Tax Challenges Raised by the Digital Economy

The DEG agrees with the Task Force that the principal policy considerations associated with the taxation of the digital economy relate to questions of direct tax nexus, the characterization of payments, and indirect tax collection obligations. As discussed

26 See Discussion Draft ¶ 208.

27 See UK Report ¶ 3.4 (noting that the UK CFC rules “do not tax businesses on profits arising from genuine activity outside the UK”). The DEG nevertheless respectfully suggests that there is no good policy foundation for any CFC rule that is specific to the digital economy, such as a rule that targets “income from the remote sale of digital goods and services,” since such a rule is divorced from any further requirement relating to how such income is generated. See Discussion Draft ¶ 169. For example, such a rule could not be justified on the same basis applicable to the inclusion of passive income in a CFC regime, as income as described above arises from active business activities.

28 See UK Report ¶ 3.24 (encouraging the development of a “better understanding of what constitutes substance . . . so as to effectively address those instances where preferential regimes do present an opportunity to shift profits”).

29 The DEG nevertheless does not consider the maintenance of a local warehouse to constitute a “core activity” of an on-line seller of physical products because the core activity of an on-line seller is selling goods and providing services to customers. See Discussion Draft ¶ 152. In addition, the DEG notes that the maintenance of local warehouses for logistical advantages is not unique to digital / internet companies because logistics and proximity to customers are crucial across many industries, from computer hardware to consumer goods.
further below, the DEG respectfully submits that data does not fall into the same category as direct tax nexus, characterization, and indirect tax collection obligations because possession and use of data do not properly represent a policy consideration associated with the determination of when or how a defined category of income should be taxed.

The DEG further agrees with the Task Force that “spill-over effects from economic activity spurred by the digital economy, both in terms of overall economic growth and tax revenues, may have an offsetting effect to the tax revenue loss” that is perceived to flow from the application of the current tax rules to transactions of digital / internet companies with consumers in market jurisdictions. The reference to “spill-over effects” echoes the DEG’s submission in its response to the OECD’s Request for Input Regarding Work on Tax Challenges of the Digital Economy of the beneficial “multiplier effect” that digital / internet companies have on the local service sectors of the economies in which they are based and on the economies of the jurisdictions of their consumers and suppliers. Similar benefits will arise in many economies in the future as digital enterprises continue to emerge in greater numbers outside the United States.

A. Nexus

The Discussion Draft suggests that the digital economy presents a challenge for nexus rules that are based on the concept of physical presence because pre-digital enterprises maintained “high-value” in-country operations, “such as procurement, inventory management, local marketing, branding, and other activities that earned a local return subject to tax in the market country.” The Discussion Draft also notes that ICT permits digital / internet companies “to choose where substantial business activities take place, or to move existing functions to a new location” even if such locations are remote from one or more market jurisdictions. The Discussion Draft thus questions whether the “current rules are fit for purpose in the digital economy” where “it is possible to generate a large quantity of sales without a taxable presence.”

In essence, the Discussion Draft raises the issue of whether nexus rules should be changed so that direct tax is imposed solely by reference to the fact that purchasers exist in a market jurisdiction. It is clear that such a nexus rule would be a radical departure

30 See Discussion Draft ¶ 173 n.18.
31 See DEG, Response to Request for Input Regarding Work on Tax Challenges of the Digital Economy at 8, 10 (Dec. 23, 2013); see also Enrico Moretti & Per Thulin, Local Multipliers and Human Capital in the United States and Sweden, 22 INDUSTRIAL AND CORPORATE CHANGE 339 (2013); Enrico Moretti, Local Multipliers, 100 AMERICAN ECONOMIC REVIEW: PAPERS & PROCEEDINGS 373 (May 2010).
33 See Discussion Draft ¶ 175.
34 See Discussion Draft ¶ 179.
35 See Discussion Draft ¶ 180.
from the current international tax system. In raising this possibility as an Option for further discussion under Action 1, the Discussion Draft implicitly raises the separate questions of whether such a rule is appropriate under international tax norms at all, and second, if it is, whether it should be applied separately to the digital economy or equally to all enterprises.

On the question of whether such a nexus rule could be supported in principle, we note that the Discussion Draft does not endeavor to articulate policy reasons why direct tax nexus should be imposed solely by reference to consumer location. The policy justification for allocating income only to the jurisdictions where the enterprise actually conducts its activities is fully consistent with the BEPS project principle that tax bases should not be artificially shifted. As noted above, these Options may be further considered after the implementation of the rest of the BEPS Action Plan. At that time the policy framework will need to be more completely elaborated on the question of whether the right to impose direct tax should be reallocated to recognize nexus based solely on access to a market.

On the subsidiary question of whether such a rule, even if justified as a policy matter, should be applied separately to digital economy enterprises, we respectfully submit that there is no justification for a separate and unique application of such a rule to a single set of business enterprises. This is particularly true if the basis for the separate application is an assumption that digital economy enterprises are able to produce their goods and services without significant human and other inputs located outside the market jurisdiction. As discussed above, digital economy enterprises produce their goods and services through personnel and other inputs in the same way as other enterprises. All such activities take place somewhere, even if that location is not a market jurisdiction. We believe that the jurisdiction in which such activities take place has the right to impose direct tax on income attributable to those activities, regardless of whether the enterprise operates in the digital economy or not.

The Discussion Draft further acknowledges that the domestic laws of many jurisdictions are consistent with the principle that income follows activities that generate the income. To achieve direct taxation based on access to a market, countries would first be required to change their domestic laws to impose direct tax nexus on this basis. Treaty law changes would follow thereafter. A wholesale transition to a new nexus regime would thus be a two-step process that would require global consensus.

### B. Data

The Discussion Draft identifies the collection, storage, and use of data as a feature of the digital economy. The DEG emphasizes that all enterprises, including digital / internet companies, use, and have long used, data to enhance their product and service offerings. Examples of such enterprises include grocery stores that print coupons based on customers’ purchasing behavior and financial institutions that offer services based on
customers’ financial profiles. Any taxation option based on data collection would need to take into account these similar business models.

The DEG further emphasizes that the acquisition of data alone does not create value for such enterprises. Rather, value creation lies in the development and use of new and sophisticated tools to structure and analyze this data. The development and use of these tools may or may not take place in one or more of the jurisdictions from which the data originates.

The DEG considers data to be one input into the process of value creation, in the nature of a commodity. Thus, the fact that an enterprise may be able to deploy “massive computing power and broadband connection” has no bearing on the value of data itself and instead relates to the process of creating value through the process of structuring and analyzing data.36 The Discussion Draft acknowledges this point by observing that “it may be challenging . . . to assign an objective value to the raw data itself.”37 The DEG strongly agrees with the Discussion Draft’s observation and reiterates its belief that the relative value of raw data is minimal as compared to the value of aggregated and analyzed data.

The DEG also agrees with the Task Force that it is “challeng[ing]” to characterize transactions in which users receive free products and services in exchange for providing data.38 If such transactions are properly characterized as barter transactions, users recognize income in connection with these transactions and are subject to direct tax on this income. Users currently do not consider the receipt of free products and services in exchange for data to be a taxable transaction and would undoubtedly be opposed to any change in treatment that limits, or imposes a tax cost on, their access to such free products and services.

C. Characterization

The Discussion Draft notes that questions may arise concerning the appropriate characterization of some products and services provided through digital technology. In particular, the Discussion Draft refers to the absence of guidance regarding cloud computing transactions.

The DEG agrees that the OECD could provide some useful clarification in this area. On this point, the guidance of the Technical Advisory Group on Treaty Characterisation of Electronic Commerce Payments (the “Treaty Characterisation TAG”) remains relevant to the characterization of income streams from the activities of digital / internet companies. In a 2001 report (the “Treaty Characterisation TAG Report”), the Treaty Characterisation

36 See Discussion Draft ¶ 176.
37 See Discussion Draft ¶ 184.
38 See Discussion Draft ¶ 185.
TAG discussed approaches to characterizing common e-commerce transactions, several of which fall within the scope of “cloud computing” transactions. The Treaty Characterisation TAG determined that section 7701(e) of the U.S. Internal Revenue Code, which provides factors to distinguish lease contracts from services contracts, was useful for this purpose. The Treaty Characterisation TAG then applied the section 7701(e) factors to payments for application and data warehousing services and concluded that such payments should be characterized as services income, not rental income.

The Treaty Characterisation TAG reached this conclusion in part because providers of application and data warehousing services normally own the equipment through which they provide services, provide services to many customers using this equipment, and do not allow service recipients to obtain exclusive possession of or control over the equipment. In addition, recipients of application services access software concurrently with other customers and may not have possession or control over the software. The Treaty Characterisation TAG’s characterization of payments for application and data warehousing services as services income is consistent with the OECD’s characterization of payments in transponder leasing arrangements as business profits rather than equipment royalty income on the grounds that such arrangements provide access to transmission capacity as opposed to physical possession of a transponder.

Accordingly, the DEG respectfully recommends that the Task Force endorse the prior extensive and thorough work by the Treaty Characterisation TAG and the OECD in characterizing payments, including in cloud computing transactions, for purposes of any further consideration of Options regarding creating a withholding tax on digital transactions.

D. VAT

The Discussion Draft identifies two scenarios in which a nonresident supplier may be able to supply goods and services to a consumer without VAT, in contrast to a local supplier of the same goods or services. While the two examples given are not specific to digital economy transactions, we understand the concern expressed by many commentators that the current VAT rules do not create a level playing field, including in the provision of digital goods and services. While sound policy arguments certainly exist

39 See Treaty Characterisation TAG Report ¶ 28 (2001). The section 7701(e) factors are: “whether or not . . . (A) the service recipient is in physical possession of the property; (B) the service recipient controls the property; (C) the service recipient has a significant economic or possessory interest in the property; (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract; (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient; and (F) the total contract price does not substantially exceed the rental value of the property for the contract period.”


41 See OECD Model Tax Convention, Commentary, Art. 12 ¶ 9.1.

42 See Discussion Draft ¶¶ 136-142.
to support the position that a jurisdiction should not impose a tax collection obligation on an enterprise over which it has no direct legal jurisdiction, we appreciate that the uneven playing field phenomenon can exist in the absence of reciprocal trade with jurisdictions which also do not impose an extraterritorial indirect tax collection obligation.

As a policy matter, the DEG believes that an indirect tax is the proper tax to be levied by reference solely to the place of consumption. Accordingly, the DEG views the extraterritorial obligation to register for, charge, collect, and remit indirect tax on B2C transactions as the Option which is most responsive to the policy challenge of digital economy enterprises being able to engage in remote selling into a jurisdiction.

VII. Potential Options to Address the Broader Tax Challenges Raised by the Digital Economy

The DEG welcomes the opportunity to comment on the Options and respectfully asks the Task Force to continue to seek input from stakeholders on the Options through the remainder of the BEPS project. The DEG strongly agrees with the Task Force that the Ottawa framework principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility provide the appropriate framework for evaluating the Options. The Ottawa framework principles are inherently compelling. For example, governments should not fashion tax rules that favor one form of economic activity over another (the “neutrality” principle) and should tailor reasonable tax laws to ensure that taxes are collectible in light of limited enforcement resources (the “effectiveness” principle).

The OECD has consistently applied the Ottawa framework principles in evaluating proposals for taxing digital / internet companies, including in the 2004 report of the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits (the “Business Profits TAG”). In addition, the Ottawa framework principles have found wide acceptance outside of the OECD. In a 2001 report, the G7 Finance Ministers welcomed the progress of the OECD with respect to the taxation of e-commerce and urged the OECD to continue to work towards implementing the Ottawa framework principles in this regard. Likewise, in 2001, the Indian High Powered Committee on Electronic Commerce and Taxation issued a report that endorsed the Ottawa framework principles as guidelines for developing tax policy in the arena of e-

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commerce. The Ottawa framework principles are not the exclusive factors to consider when evaluating the Options. Policymakers should also consider whether an Option reflects a fundamental shift in tax policy that must first be the subject of a broad and open debate. One example of a fundamental shift is where an Option abandons the established principle that direct tax is imposed only where income is created, for the principle that merely trading with a jurisdiction constitutes a basis for being subject to direct tax. Another example is the elimination of Article 5(4), which represents more than 50 years of international consensus that certain activities contribute to the productivity of an enterprise but are sufficiently remote from the actual realization of profit so as not to justify a PE. Similarly, policymakers should consider whether any Option could be characterized as a special rule for the digital economy and should reject any sector-specific rule that singles out and discriminates against a form of business activity.

The following sections of this comment letter assess the “pros and cons” of the Options and then analyze the Options using the Ottawa framework principles.

45 High Powered Committee on Electronic Commerce and Taxation, Report, Ch. 2, pp. 55 - 56 (2001).
### A. Modifications to the Exemptions from Permanent Establishment Status

1. **Eliminate Article 5(4)**

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Achieves clarity because all business activities that a nonresident enterprise conducts through a fixed place at its disposal or a dependent agent with authority to conclude contracts give rise to a PE.</td>
<td>Departs from more than 50 years of international consensus that certain activities do not justify PE status.</td>
</tr>
<tr>
<td>Affects all enterprises, not only digital / internet companies.</td>
<td>Large majority of additional tax revenue will be collected from enterprises other than digital economy enterprises.</td>
</tr>
<tr>
<td>Results in some modest additional direct tax for market jurisdictions from all enterprises, not only digital / internet companies, that conduct Article 5(4) activities in those jurisdictions.</td>
<td>Deters enterprises from performing supportive functions in market jurisdictions, thereby imposing a financial impediment to international trade.</td>
</tr>
<tr>
<td></td>
<td>Increased administrative and compliance costs arising from local tax return obligation for low-value activities, including disputes over profit attribution.</td>
</tr>
<tr>
<td></td>
<td>Additional tax revenue likely to be small as Article 5(4) activities in fact normally are low value-add activities, and many groups choose to structure such activities in separately taxable entities in any event.</td>
</tr>
</tbody>
</table>

This Option satisfies:

- the *neutrality* principle because it applies to all enterprises.
- the *certainty and simplicity* principle because all business activities that a nonresident enterprise conducts through a fixed place at its disposal or a dependent agent with contract-concluding authority give rise to a PE.

This Option does not satisfy:

- the *efficiency* principle because it will increase compliance and administrative costs significantly, including the need to determine profit attribution for a large number of low-value activities, without an equivalent direct tax benefit.
- the *effectiveness and fairness* principle because it will impose significant compliance and administrative burdens on nonresident enterprises with minimal activities in a jurisdiction.
- the *flexibility* principle because it represents an overbroad response to the narrow concern that Article 5(4)(a)-(d) activities of a few nonresident enterprises are not preparatory or auxiliary for those enterprises.
A. Modifications to the Exemptions from Permanent Establishment Status

2. Eliminate Article 5(4)(a)-(d) / Require Article 5(4)(a)-(d) to be Preparatory or Auxiliary

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affects all enterprises, not only digital / internet companies.</td>
<td>Departs from clear international consensus that the activities in Article 5(4)(a)-(d) are by definition preparatory or auxiliary.</td>
</tr>
<tr>
<td>Results in some modest additional direct tax for market jurisdictions from all enterprises, not only digital / internet companies, that conduct Article 5(4) activities in those jurisdictions.</td>
<td>Additional disputes as to whether typically low-value activities are preparatory or auxiliary activities for a particular enterprise.</td>
</tr>
<tr>
<td></td>
<td>Existing Article 5 Commentary already includes anti-fragmentation rule.</td>
</tr>
<tr>
<td></td>
<td>Deters enterprises from performing supportive functions in market jurisdictions, thereby imposing a financial impediment to international trade.</td>
</tr>
<tr>
<td></td>
<td>Increased administrative and compliance costs arising from local tax return obligation for low-value activities, including profit attribution issues for typically modest activities.</td>
</tr>
</tbody>
</table>

This Option satisfies:

- the **neutrality** principle because it applies to all enterprises.
- the **flexibility** principle because it allows treaty partners to determine whether activities are preparatory or auxiliary on a case by case basis as business models evolve in tandem with technology.

This Option does not satisfy:

- the **efficiency** principle because it will increase compliance and administrative costs significantly without an equivalent direct tax benefit.
- the **certainty and simplicity** principle because it will require taxpayers and tax authorities to make a subjective determination on a case by case basis whether activities are preparatory or auxiliary.
- the **effectiveness and fairness** principle because it will give rise to disputes over whether activities are preparatory or auxiliary.
## B. A New Nexus Based on Significant Digital Presence

<table>
<thead>
<tr>
<th><strong>Pros</strong></th>
<th><strong>Cons</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Yields additional direct tax for market jurisdictions by creating a PE for certain nonresident digital / internet companies with no functions, assets, or risks in a jurisdiction.</td>
<td>Applies only to a subset of digital / internet companies, effectively creating a special rule for the digital economy.</td>
</tr>
<tr>
<td>Responds to public pressure regarding perceived base erosion by digital / internet companies.</td>
<td>Directly conflicts with Discussion Draft conclusion that it is not possible to separately define the digital economy.</td>
</tr>
<tr>
<td></td>
<td>A radical departure from the fundamental principle that a nonresident enterprise must be physically present in a jurisdiction to be subject to direct tax in the jurisdiction.</td>
</tr>
<tr>
<td></td>
<td>No or minimal profit could be attributable to a PE under this Option:</td>
</tr>
<tr>
<td></td>
<td>- No profit attributable under the current rules because no people functions, assets, or risks are present in the relevant jurisdiction.</td>
</tr>
<tr>
<td></td>
<td>- No profit attributable under rules that may emerge under the OECD’s work on Chapter VI of the Transfer Pricing Guidelines because attributing profit to a PE under this Option is inconsistent with that work.</td>
</tr>
<tr>
<td></td>
<td>Proposed description of targeted enterprises as having no physical elements in the value chain other than websites and servers is an unrealistic description of any active business.</td>
</tr>
<tr>
<td></td>
<td>Definition includes many subjective standards that are likely to give rise to disputes between taxpayers and tax authorities.</td>
</tr>
<tr>
<td></td>
<td>Extraterritorial tax liability results in significant administrative, compliance, and dispute resolution costs.</td>
</tr>
<tr>
<td></td>
<td>Significant impediment to international trade in digital goods and services.</td>
</tr>
</tbody>
</table>

This Option does not satisfy:

- the **neutrality** principle because it targets only “pure play” digital / internet companies.
- the **efficiency** principle because it will result in significant administrative and compliance costs while yielding at best a modest direct tax benefit.
- the **certainty and simplicity** principle because it is uncertain how to attribute profits to a location from which people functions, assets, and risks are absent.
• the *effectiveness and fairness* principle because it imposes tax in locations where value is not created and changes settled law for a single sector of the economy in response to concerns about remote sales.

• the *flexibility* principle because it focuses on factors intended to define a certain set of “pure play” digital / internet company characteristics that may quickly become ineffective or obsolete.
### C. Virtual Permanent Establishment

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yields modest additional direct tax for market jurisdictions by creating taxable nexus for nonresident enterprises with no functions, assets, or risks in a jurisdiction.</td>
<td>Applies only to a subset of companies, although not limited to digital / internet companies, by virtue of very broad scope of website hosting and on-line contracting rules.</td>
</tr>
<tr>
<td>Responds to public pressure regarding perceived base erosion by digital / internet companies.</td>
<td>Conflicts with Discussion Draft conclusion that it is not possible to separately define the digital economy, although the criteria selected cover large scope of business activity.</td>
</tr>
<tr>
<td>All the virtual PE alternatives - the “virtual fixed place of business PE” in particular - impose direct tax on a much wider swath of enterprises than “pure play” digital / internet companies.</td>
<td>A radical departure from the fundamental principle that a nonresident enterprise must be physically present in a jurisdiction to be subject to direct tax.</td>
</tr>
</tbody>
</table>

- “Virtual fixed place of business PE” applies to any enterprise that uses a local web hosting provider, including unrelated providers.
- “Virtual agency PE” applies to any enterprise that conducts internet sales, thus creating a very wide scope of application.
- “On-site business presence PE” apparently is redundant to prior OECD work on the “services PE” alternative now expressed in the Article 5 Commentary.
- “Virtual fixed place of business PE” rule would eliminate any local independent web hosting industry, if using a web hosting provider results in a PE.

No or minimal profit could be attributable to a PE under this Option:
- No profit attributable under the current rules because no people functions, assets, or risks are present in the relevant jurisdiction.
- No profit attributable under rules that may emerge under the OECD’s work on Chapter VI of the Transfer Pricing Guidelines because attributing profit to a PE under this Option is inconsistent with that work.

Results in significant administrative, compliance, and dispute resolution costs, which will be particularly burdensome to emerging enterprises.

Significant impediment to international trade in digital goods and services.
This Option does not satisfy:

- the *neutrality* principle because the virtual PE alternatives are intended to result in different tax outcomes for e-commerce and conventional forms of commerce.
- the *efficiency* principle because PEs in all customer jurisdictions will result in significant compliance and administrative costs for taxpayers and tax authorities which outweigh the amount of tax to be collected.
- the *certainty and simplicity* principle because the amount of profit attributable to, and thus the amount of direct tax on, a virtual PE is uncertain.
- the *effectiveness and fairness* principle because the amount of any profit attributable to a virtual PE will likely be modest but will still be subject to disputes, and thus outweighed by the significant administrative and compliance costs of this PE, and because a “virtual fixed place of business PE” essentially imposes a tariff on any enterprise that uses a local web hosting provider.
- the *flexibility* principle because it generally applies by reference to technological features of ICT that enterprises employ in current commercial practice and thus runs the risk of becoming ineffective or obsolete.
## D. Creation of a Withholding Tax on Digital Transactions

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allows market jurisdictions to impose substantial direct tax on nonresident e-commerce providers.</td>
<td>Specifically targets certain digital / internet companies, thereby creating a special rule for the digital economy.</td>
</tr>
<tr>
<td>Responds to public pressure regarding perceived base erosion by digital / internet companies.</td>
<td>Conflicts with Discussion Draft conclusion that it is not possible to separately define the digital economy.</td>
</tr>
</tbody>
</table>

- Deviates from settled conclusions regarding the characterization of e-commerce payments as business profits not subject to withholding tax.\(^{48}\)
- Definition of targeted digital goods and services likely to create significant disputes over characterization of transactions if not based on principles developed in prior OECD work.
- Withholding tax is a poor proxy for a tax on net income because gross revenues do not account for allocable deductions.
- Places low-margin digital / internet companies at a competitive disadvantage vis-à-vis their high-margin counterparts.
- Increases the risk of double taxation due to characterization disputes and inability to claim full foreign tax credits in residence states for gross-based taxes.
- Will need to consider in light of EU fundamental freedom principles if intent is to discriminate against nonresident suppliers.\(^{49}\)
- Will need to consider compatibility with World Trade Organization rules if intention is to discriminate against imports.\(^{50}\)
- Deters e-commerce companies from providing goods and services to consumers in jurisdictions that implement this Option.

This Option satisfies:

- the *efficiency* principle because corporate payors subject to local audit will act as tax collectors.
- the *certainty and simplicity* principle in part because a withholding tax eliminates uncertainty associated with a tax on the net income of a PE, if the categories of income subject to tax are clear.

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\(^{49}\) See UK Report ¶ 1.20.

\(^{50}\) See UK Report ¶ 1.25.
This Option does not satisfy:

- the *neutrality* principle because it specifically targets e-commerce enterprises.
- the *certainty and simplicity* principle in part if the definition of categories of income subject to tax is subjective and amenable to dispute.
- the *effectiveness and fairness* principle because a withholding tax is an imperfect proxy for an income tax, which is imposed on net income, not gross income; gives rise to a risk of double taxation; discriminates against low-margin taxpayers; and presents significant implementation challenges in B2C transactions as no obvious withholding agent exists.
- the *flexibility* principle because it represents a draconian solution in response to perceived base erosion in some cases.
E. Consumption Tax Option

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Levels the playing field between resident and nonresident suppliers.</td>
<td>Reduction of low value goods limit creates additional compliance costs for transactions by definition not producing significant VAT.</td>
</tr>
<tr>
<td>As a policy matter is the appropriate tax to impose by reference to the location of consumption and a consumer base.</td>
<td>Significant administrative burden required to register and report, potentially in many jurisdictions in which enterprise conducts no business activities.</td>
</tr>
<tr>
<td>Responds to public pressure regarding perceived base erosion by digital / internet companies.</td>
<td>Mechanisms to identify user location may be imprecise, creating need for reasonable approach to demonstrating location.</td>
</tr>
<tr>
<td>Does not change the balance between source and residence taxation.</td>
<td>Extraterritorial compliance obligations generally not favored in international law.</td>
</tr>
<tr>
<td>Low-value good exception amendments apply to all supplies of goods, regardless of the medium of supply.</td>
<td>Practical limits on ability of smaller enterprises to comply with complex registration and reporting requirements for digital supplies.</td>
</tr>
<tr>
<td>Compliance challenges of extraterritorial obligation imposed on nonresident digital service suppliers have been addressed in EU.</td>
<td></td>
</tr>
</tbody>
</table>

This Option satisfies:

- the *certainty and simplicity* principle in part because imposing tax at the location of consumption allows suppliers and consumers to anticipate the tax consequences of transactions.
- the *effectiveness and fairness* principle in part because a consumption tax falls at the time of and in the location of all consumption and does not have a distortive effect on commerce.
- the *flexibility* principle because a tax that applies purely by reference to consumption focuses solely on whether a consumer acquires a good or a service and is thus best positioned to adapt to technological and commercial developments with respect to the medium of supply.

This Option does not satisfy:

- the *neutrality* principle because it applies only to digital supplies by nonresident enterprises.
- the *certainty and simplicity* principle in part because any extraterritorial tax regime will necessarily entail some noncompliance.
- the *effectiveness and fairness* principle in part because it allows jurisdictions to impose extraterritorial tax obligations on enterprises that may conduct no business activities in the jurisdictions.
- the *efficiency* principle because the administrative burden for many suppliers will be disproportionate to the amount of tax collected.
F. Summary

The DEG believes that of the several Options, the consumption tax Option applying to remote digital supplies to consumers is the most appropriate Option as a matter of tax policy. It addresses directly the challenges of the digital economy, as it can be seen as leveling the playing field between resident and nonresident suppliers.

The DEG nevertheless notes that extraterritorial compliance obligations are rarely imposed, for policy, equity, and administrative reasons. The proposed consumption tax Option will present compliance and administrative challenges for both tax authorities and nonresident suppliers. The DEG also notes, however, that an extraterritorial consumption tax solution is gaining some acceptance outside the EU, as developments in South Africa show.

The DEG believes that the Consumption Tax Technical Advisory Group and Working Party No. 9 on Consumption Taxes are the appropriate bodies to engage in the further work necessary to resolve compliance and administrative challenges. To allay concerns about compliance and administrative burdens, the DEG respectfully recommends that this Option be revised to include the following components: (i) online registration for nonresident enterprises in both the consumer jurisdiction’s native language and English; (ii) reasonable registration thresholds; (iii) online filing in the consumer jurisdiction; (iv) reasonable methods to prove customer location and other relevant attributes necessary to determine the applicable tax; and (v) reasonable means of collecting and remitting the applicable tax. A global equivalent of the EU’s Mini One-Stop Shop may also facilitate consumption tax registration.
Yours sincerely,

Gary D. Sprague

Mary C. Bennett

Ethan S. Kroll
Introduction

It is no secret for the Tax community that several principles used for a long time in taxation are now obsolete. For example, Internet rendered the physical nexus of a Permanent Establishment, (PE), obsolete. When a customer can buy online a product or a service everywhere in the world, server location as a PE does not really give a fair picture where the company is conducting its business. It is simply everywhere where there is a customer and we need to rethink the idea where a company is doing business.

Corporate groups, although spread around the world through subsidiaries, are acting like one single enterprise, either because that is cost effective to maximize profit or to reduce the overall Tax burden, which it a legitimate purpose from a business point of view. The problem has to be within Tax rules as they stand now.

In this globalisation, corporations were way ahead of tax authorities to optimize their risk management at all levels. So, Governments are losing billions of Taxes, through Aggressive Tax Planning, Transfer Pricing and all kind of schemes facilitated by the differences in Tax rules between countries, incentives from Tax havens and bank secrets. In different forums like the OCDE and the G20, governments are suddenly aware of the urgent need to quarantine Tax havens, put the pressure to get rid of bank secrets, promote the exchange of information between Tax authorities and to rethink major principles and rules of Taxation to seek some harmonization for fairness between the parties.

This is a humble contribution to the collective effort.

Basic rules

Permanent Establishment, (PE)

There is a wide understanding that the PE notion is no longer a physical nexus for a fix place of business and the need to have the same definition for E-Commerce and for the traditional business. So, what is manifestation of doing business in general for both? We suggest that is buying and selling goods or services. Therefore, a customer is the base for having a business through the internet or elsewhere. Businesses earn income only when they sale their products or services. It seems then that the location of the customer is the common thread to lean on
and we can free ourselves from the fix place of business, mind and management or the server location to focus on the customer’s location.

We just linked sales tax to income tax. As there is already a big effort to secure sales tax because of the sizable Cash Flow involved, we think that there is a good opportunity to parallel the income tax and save resources.

Registration

This is the punch line where we have a technical challenge that needs world conventions and collaboration to function: let’s imagine that a business registration everywhere in the world requires an online unique number, initiated by a local authority and that only differentiated by country and of possible subdivisions for federations. This means, that for doing business in any country after its own jurisdiction, a company will produce that same number for validation by other authorities where it seeks doing business.

Of course local authorities may think of a threshold for smaller businesses of a single working person for example. The General public is largely aware of the issue of tax evasion or avoidance and its impact on the erosion of public services. It is willing to do its part to support public authorities by systematically say asking for a bill of sale. Public campaigns is always an option to stimulate good citizenship.

Even some small businesses with local scope, like restaurant or a pub’s cahier can very well be hooked to the internet.

Billing sales online will take into account the customer location (final shipping destination) for sale’s tax to be paid by the customer and an income tax instalment through a percentage of the bill before sale tax will to be paid by the company. The purpose here is to secure an income tax amount, as close as possible to actual, from every single sale that will be adjusted later upon regular Tax filing. Past filings may be used to determine a rate for these installments. All selling entities, regardless of their legal status: company, partnership, trust or other are subject to the same rule when a sale is done. The adjustment will take into account the legal status, if and when warranted, of the entity on filing.

A local authority still has the same possibility as before to promote job creation or support a weak sector through tax incentives that will be considered also when filing.

This kind of registration should be secured by the authorities who should retain a direct and, of course, confidential access to make sure that the billing does not shift a company income tax to customers, but customers pay only sales tax and company pays its own instalment on the income tax.
The company has the regular fiduciary duty to collect and remit those taxes to every jurisdiction in which it is doing business.

Needless to say that local authority should intervene to prevent a company from doing business without a valid registration and/or giving online access to its sales.

**Tax Filing**

**Financial Statements**

Here, there is an obvious and natural trend to refer to International GAAPs for standard and easy comparison. There is no real need for more explanations.

**Consolidation**

As we know corporate groups, guided by optimization and through subsidiaries in different locations aim to locate income in low tax jurisdictions and expenses in high tax ones, regardless of where business is actually done or where value is created. This is making it difficult for local tax authorities to see the global and real picture to correct it when it is abusive. So, for Tax purpose we suggest that the norm for filing would be a full consolidation of a group with additional information for business done country-by-country: Gross sales, Sales Tax, income Tax......whatever needed information. The share of income that will not qualify under GAAP for consolidation, like from a non-controlling interest in a partnership, will be added to the consolidated income of a group where an entity of the group has that interest.

That **Audited** Financial Statements and country-by-country information has be the same for all and produced to every concerned jurisdiction.

The overall result for tax purpose, is that all inter group exchanges are eliminated and we need not to worry about the arm length principle (that attempts to avoid Income shift through transfer pricing), economic substance or beneficial ownership.

Taxable income may vary from one jurisdiction to another according to rate of inclusion for taxability of different items, tax credits and other local incentives, but every jurisdiction has a full and global picture of the group and adjusts its income Tax according to international agreements and local needs to introduce fair and acceptable incentives.

A jurisdiction will tax its fraction of the overall income at its own rate and after its own incentives.

The only deductible cost within a group will be from transactions with third parties that meet necessarily the economic substance, and reasonable provisions under GAAP, like amortization,
and reserves that are monitored by specific and generally accepted rules and validated by independent professionals.

No more Daylight loan’s pretext to generate artificial interest expense in one jurisdiction to the detriment of another.

**Special Industries**

Customer location may be not fit for special industries, like ships, trains, air planes, where the company is earning its income through a distance and the customer is paying to reach or have goods reach a final destination.

But what Taxes do recover for a jurisdiction? Is it a fraction of the cost of infrastructure and public facilities for use and a permission to pass through? We suggest that a simple answer is probably close to those lines.

From the customer point of view the payment is made to reach the final destination, but each crossed jurisdiction has a legitimate claim to tax a fraction of the income generated in its territory as its infrastructure is solicited and needs to provide for its maintenance.

So, we think that when these special industries are filing their Tax returns, the distance criteria are more suitable to consider.

**Conclusion**

We hope this approach, where the main lines were presented very briefly, has some merit to retain attention for further possible development.

In the other hand, in a just and a fair world, the active help of developed countries to developing ones to hook them to such a worldwide network will assist them build their own Tax administrations and collect their right share of taxes. This will improve developing countries infrastructure and supplying needed public services to their communities with less assistance from developed countries.

This will have also the merit to close uncontrolled holes in the system that will ultimately promote avoidance in those jurisdictions.

Thank you for your time and attention

Djelloul Omari
ETNO-GSMA Tax Policy Committee Response to the OECD’s Discussion Draft on the Tax Challenges of the Digital Economy

The ETNO-GSMA Tax Policy Committee (The Committee) appreciates the opportunity to provide its input at this stage of the process and provides the following comments.

The Committee welcomes and supports the purpose of the Task Force and is willing and available to provide its contribution in this or future phase of this complex work.

The Committee strongly supports the principle that the possibly complex tax challenges that are posed by an evolving economic environment should be addressed in a comprehensive way at OECD level. The Committee anyhow acknowledges that some European Union countries have tried to unilaterally deal with the problem: this is not the way. The lack of coordination could be very harmful: double taxation (or even double deduction) situations might arise.

Businesses operating in the field of digital economy are aware of the urgency to find a solution to the BEPS issue. In this perspective, it seems appropriate to establish a set of common rules; such rules should be:

- Compliant with EU fundamental principles, Directives and Regulations
- Capable to ensure a fair level of taxation, in accordance with some agreed drivers and guidelines referring to some key questions (e.g., the appropriate place of taxation both for direct and indirect taxes; the appropriate compensation in case of intergroup transactions);
- Capable to ensure a level playing field (as far as taxation is concerned) in the competitive scenario
- Workable from a business point of view (even in a cross-border scenario, which is often the rule for the digital economy transactions) and easily auditable from the tax administrations’ point of view
• According to this set of rules, there should be no room for any case of double taxation (nor for any case of zero/close to nil taxation as a result of wholly artificial arrangements or unintended consequences of legislative mismatches), since such cases could be very harmful for the definition of a fair competition environment, and a co-operative relationship with the tax authorities.

• A last, but not least, fundamental principle of the digital economy (future) taxation guidelines, should be the neutrality in the tax treatment of operations and supplies, in comparison with the corresponding physical products; lack in neutrality might result in a lowering of digital economy huge potential.

• The same neutrality should be applied to the telecommunications services and the various business arising from the digital economy; it’s clear that the relationship between them is significant, and shall become even more. Taxation principles have surely to consider this perspective, in order to avoid discriminations and lack of workability.

• Currently clear distortion exists between services being offered by nationally regulated telecoms operators and trans-national Internet service providers which offer services across borders which can offer clear advantages in terms of industry specific taxes or even corporate income taxes.

• Specifically the negative impact of mobile-specific taxes on consumers, the operators and the country economic development should be considered and assessed carefully in order to try and avoid as far as possible the introduction of distortive measures which heavily affect the creation of even playing field.

A. General comments on the Discussion Draft.

1. The Committee fully endorses the Task Force’s view that the "Ottawa Taxation Framework Conditions", i.e. Neutrality, Efficiency, Certainty, Simplicity, Effectiveness, Fairness, Flexibility are still relevant today. The Committee considers that the above principles should be the basis to evaluate any options to address the tax challenges of the digital economy.
2. The Committee fully supports the Task Force’s decision that ring-fencing the Digital Economy as a separate sector and applying ad hoc tax rules is neither appropriate nor feasible. The Committee is of the opinion that the Digital Economy is not characterized by the presence of new business models, instead ‘digital’ is really just a means of delivery and any concerns should be addressed by the appropriate application of transfer pricing rules, tax treaties and challenges to artificial arrangements. If BEPS Action Points 6-10 are appropriately addressed then there should be little need to focus on special measures for digital goods and services, data analytics, IP, and other intangibles.

3. The Committee does not share the Task Force’s statements in some paragraph of the Discussion Paper (e.g. 126, 127, 128, 129) where it is somehow envisaged that multinational systematically misrepresent to tax authorities the actual functions, assets and risks located in a jurisdiction. Reference to words like "alleged", "purported" etc. does not help in creating a cooperative environment to find an effective solution to the BEPS issue. The Committee thinks that current rules do already exist in most jurisdictions to effectively target these alleged behaviors which are not typical anyhow of the Digital Economy. The Committee considers that there is no need to introduce new rules, options, taxing models to this purpose.

4. The Committee considers that ways to improve the current dispute resolution mechanism are a necessary part of the BEPS initiative in the Digital Economy (actually not just in the Digital Economy). The Committee has noted that no reference to this very critical issue exists in the Discussion Paper and would very much welcome its inclusion.

5. The Committee is particularly concerned that formulary approaches are considered in different parts of the Discussion Draft where the Task Force deals with interest deductions (Para 157) or business risks (para 163) or base eroding payments (Para 165). The Committee considers this potentially disruptive as it could erode the Arm’s Length Principle.
6. The Discussion Draft deals with the topic of Cloud Computing Taxation (para 187 and 188): this is a highly complex topic which requires careful consideration of the consequences of any possible option. The Committee is of the opinion that any attempt to qualify the relevant payments requires an in-depth analysis of the very complex technical implication of Cloud Computing and is available to support in this field, if required.

B. Potential Options to address the broader tax challenges raised by the digital economy.

7. Modification to the exemptions from PE status: the Task Force is considering several variation, included the elimination of the paragraph 4 of article 5 of the OECD Model Tax Convention. This needs to be carefully managed and its consequences assessed in order to avoid to trigger undue taxation in jurisdiction where mere preparatory and auxiliary activities are carried out.

8. The Committee noted that the Discussion Draft defines a "fully dematerialized digital activity" by means of a list of qualifying elements (para 213). Starting from that, the Discussion Draft tries to identify a “significant digital presence” in a jurisdiction by considering a number of features. The Committee considers that this is exactly the way of ring-fencing the digital economy which the Task Force itself has stated to be neither appropriate nor feasible.

9. The whole concept of "Virtual PE" is also seen as potentially creating some real challenges to operators merely wanting to transact across borders.
10. Creating a WHT on digital transactions: in general terms, revenue is a poor proxy for net income and in any case, the principle of introducing a WHT on digital transactions stems, once again, from the ring-fencing of the digital economy.

11. The Committee acknowledges that the Discussion Draft deals with the potential challenges of collection of VAT in the Digital Economy. The Committee appreciates that remote digital supplies to consumers are currently being dealt with by WP9 through the OECD VAT/GST TAG process (to which The Committee contributes). The Committee is of the opinion that the TAG process is the most effective and appropriate considering the highly technical subject. The Committee here wants anyhow to highlight two comments:

- The Committee welcomes the Task Force’s statement at paragraph 223 that registration thresholds should be used to alleviate burdens on business and to make VAT systems workable in practice. This is important to ensure that businesses are not forced to register for VAT and to deal with all the complexities of a different VAT system in relation to a small number of supplies. The use of thresholds is therefore important in order to ensure that the cost of compliance is proportionate for business. In this respect, it is important to note that simplified registration procedures is only part of the answer to alleviating the burden of business of having to register for VAT remotely – it must be coupled with registration thresholds in order to ensure that businesses are only required to register for VAT where there is a sufficient level of supplies in order to make this worthwhile for both the business and the tax authority.

- The Committee considers that it is extremely important that the VAT place of taxation/registration rules remain separate and distinct from the rules which apply to the determination of a PE in a corporate tax context.
We look forward to continued dialogue on this important topic.

Best regards.

Brussels, 14th April 2014

Daniel Pataki, Director, ETNO

Martin Whitehead, Director, GSMA Europe
European Business Initiative on Taxation (EBIT)

Comments on the OECD's Discussion Draft on BEPS ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY
Dear Pascal,

EBIT welcomes this opportunity to provide comments to the OECD on the Discussion Draft on BEPS ACTION 1: Address the Tax Challenges of the Digital Economy (hereinafter: “Discussion Draft”).

General Comments

EBIT agrees with the OECD in its Discussion Draft that “ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible” and that it will therefore be important for business that the neutrality principle is satisfied for any of the OECD’s proposed potential solutions.

V. TACKLING BEPS IN THE DIGITAL ECONOMY

2. Restoring Taxation on Stateless Income

We note that the Discussion Draft in relation to direct tax is focused heavily on restoring taxation on “stateless income” and that this is expected to be delivered by various measures including on treaty abuse, hybrids, PEs, CFC rules etc. Indeed, EBIT believes that the answers to the difficulties with BEPS in relation to the digital economy lie in addressing the other action items rather than special measures for the digital economy.

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

3. Options Proposed to the Task Force

3.1. Modifications to the Exemptions from Permanent Establishment Status

EBIT believes that it may be reasonable to revisit the borderline between what is to count as crossing the PE threshold rule and what is treated as not creating tax nexus for the purposes of the rule given the potential to operate in the market of another state without or with hardly any physical presence. However, EBIT considers that the variations of the proposed changes by the OECD to the exemptions of PE status for various items of a preparatory or auxiliary nature (Article 5, paragraph 4 of the Model Convention) suggested, are relevant to some (but probably a limited number of) digital businesses, but may potentially have a more significant impact on wider businesses, which does not seem an even-handed approach to the issue.
3.2. A New Nexus based on Significant Digital Presence

EBIT notes that the OECD is effectively presenting a new nexus band / PE threshold concept but leaves open the difficult related and contentious questions pertaining to how to attribute profits to a PE and value to data.

EBIT is of the opinion that these proposals are not helpful and should be rejected on the grounds that they are not practical. It will be extremely difficult to measure the tax base and extremely difficult to appropriately allocate either revenues or costs. There is a high risk of multiple double taxation as countries will not agree on the allocations.

3.4. Creation of a Withholding Tax on Digital Transactions

This option moves away from the trend in previous years in international taxation which was based on an international consensus to minimise or eliminate withholding taxes because taxes imposed on gross income do not take into account profitability and making cross-border expansion unprofitable. Imposing a new withholding tax could also mean that many non-digital or conventional businesses would become subject to withholding tax on digital products designed for a specifically targeted industry. EBIT would like to know which payments would become subject to tax and which rates would apply, and whether these decisions would be taken at local or international level?

EBIT is also concerned about the collection and enforcement issues for tax authorities related to the possible introduction of a myriad of domestic withholding taxes.

3.5. Consumption Tax Options

EBIT believes that consumption taxes will not provide a solution to the problem posed by BEPS. This is because the subject of consumption taxes is consumption whereas the issue with BEPS is the erosion or shifting of the tax base applicable to the business activities which generate the profits.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this area. We are happy to discuss with and remain committed to a constructive dialogue with the OECD.

Yours sincerely,

The European Business Initiative on Taxation – April 2014

For further information on EBIT, please contact its Secretariat via Bob van der Made, Tel: +31 6 130 96 296; Email: bob.van.der.made@nl.pwc.com.

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Dear Madame/Sir:

We are herewith forwarding our comments on the Discussion Draft regarding Beps Action One in the attachment.

We remain at your disposal for any clarification.

Sincerely yours,

The Members of the European Tax Circle

* Ashurst, London; Blumers & Partner, Stuttgart; Cuatrecasas, Gonçalves Pereira Barcelona; Macchi di Cellere Gangemi, Rome; Homburger AG, Zürich; van Doorne, Amsterdam; WolfTheiss, Vienna
EUROPEAN TAX CIRCLE

Comments on Discussion Draft regarding Beps Action One:

Address the Tax Challenges of the Digital Economy, March 24, 2014

(The "Document")

We wish to thank the OECD for the opportunity to comment on an issue of crucial importance.

1) As a general comment, we do not think it appropriate to ring-fence the digital economy from the physical economy. Having two sets of corporation tax rules and nexuses would lead to unintended arbitrage opportunities. Addressing some of the key issues that apply to the physical economy (such as the determination of a permanent establishment where there is no human presence and the determination of value attributable to intangibles) which form part of other working parties should result in fairer taxation of the digital economy. We agree with the approach set out in Part V of the document.

2) The Digital Economy represents a terrific driver for the entire world economy (see point 53 of the Document). The media campaigns putting the blame on the industry forget to mention that any enterprise is legitimately entitled to exploit the tax advantages made available in certain jurisdictions.

The cancellation of preferential tax treatment for certain income arising from the exploitation of IP (see point 158 of the Document) and the strengthening of the CFC rules would reduce the "incentive to shift profits from a source country into a third low tax jurisdiction" (see point 167 of the Document).

The doubt arises as to whether the emphasis should be on the Harmful Tax Practices

3) We consider it advisable to deal separately with the different business models adopted by the industry as the digital economy encompasses a variety of transaction models some of which have neither a physical nor a human presence in a source state but where revenues are generated in significant amounts.

a) In many cases the digital business is associated with the physical presence of the enterprise in the country of consumption.
A typical case is a company delivering goods or services in a third country where associated entities (subs or branches) promote the penetration of the market, rendering consultancy/marketing/customer support services.

The problem of taxing the value of such services is not new: it appears that an efficient, widespread recourse to APA and having regard to the arm's length principle of transfer pricing may represent the most appropriate (and less contentious) method of tackling the problem.

Recent experiences in various countries seem to support this conclusion.

The “modernization” of the concept of PE (see point 152 of the Document) or the improvement/amendment of transfer pricing techniques (see point 160, et seq of the Document) may also contribute to solve the problem: however, the risk exists of “polluting” long standing and well “oiled” mechanism and concepts contaminating industries that do not form part of nor rely on the digital economy.

b) In many other instances however, e.g. the supply of remotely delivered services, the industry requires less (or none) physical presence in the consumption market. In such cases, the experience of the EU in the VAT taxation of e-commerce may offer interesting possibilities.

EU Directives 2002/38 and 2006/112 provide that a non EU supplier, before entering into e-commerce transactions with EU resident customers, shall register in any of the EU member states collecting from the customers both the selling price and the VAT at the rate applicable in the country of consumption. Periodically the VAT so collected shall be remitted to the Fisc of the consumption country. Based on available information, it does not seem that such system represents a major burden for e-commerce companies. The same VAT collection mechanism shall be soon (2015) extended also to e-commerce transactions carried out by EU resident e-commerce enterprises.

Given that most payments for digital goods and services are through electronic means (debit and credit cards), consideration should be given to the providers of such payment mechanisms acting as collecting agents in source countries.

A multinational instrument (or the bilateral treaties) may provide that enterprises engaging in the digital economy should be required to register in the consumption market collecting from the customers an amount corresponding to a percentage of the selling price which would be then remitted to the Fisc of the consumption country. The percentage may be calculated based on ad hoc parameters to be agreed upon, preferably, at international level. Failure to register may trigger a withholding tax based on the selling price to be levied, collected and remitted to the Fisc by the Financial Institution involved in the digital transaction (see point 210 of the Document).
La Fédération Française des Télécoms (FFTélécoms) approuve la décision du groupe de travail « économie numérique » du plan d’actions BEPS de l’OCDE de ne pas isoler le secteur de l’économie numérique des autres secteurs économiques et de ne pas lui appliquer par conséquent une fiscalité spécifique.

En effet la Fédération considère que l’isolement de l’économie numérique n’est pas envisageable aujourd’hui et encore moins demain, tant le numérique est en train de diffuser dans tous les secteurs économiques, et alors qu’en matière de fiscalité, les acteurs économiques ont besoin de stabilité, de prévisibilité et de non-singularité d’un pays à un autre pour éviter les optimisations.

Elle considère par conséquent, comme le groupe de travail de l’OCDE, que les principes de cadrage dégagés lors de la conférence ministérielle d’Ottawa de 1998 sur le commerce électronique doivent être conservés :
- la fiscalité s’appliquant aux échanges de biens et services numériques doit être neutre et équitable par rapport au commerce conventionnel - pour ne pas créer de déséquilibre profitable à un mode d’activité plutôt qu’un autre - et aussi entre les entreprises du numérique ;
- elle doit être claire et simple, efficace et juste, flexible et dynamique tels que ces termes sont définis pages 63 et 64 de la consultation de l’OCDE. Compte tenu de la volatilité des activités numériques et de leur évolution extraordinairement rapide, la FFTélécoms est en effet favorable à la définition d’un corpus de règles « intangibles », mais de critères d’application structurellement adaptables au fil du temps pour tenir compte, régulièrement, de la déformation des échanges économiques sous l’impulsion des évolutions technologiques et de la transformation des modèles économiques des acteurs du marché.

La Fédération félicite le groupe de travail de l’OCDE de l’effort de recensement des options envisageables et appelle son attention sur la nécessité de mettre rapidement en œuvre les mesures d’équité entre acteurs et entre pays pour arrêter la concurrence déloyale qui sévit actuellement au profit de quelques entreprises qui captent dans des paradis fiscaux la valeur créée dans et par les pays de consommation, au détriment des finances publiques de très nombreux pays, y compris celles des pays complaisants se prêtant au jeu de techniques fiscales permettant une double non-imposition. Cette exigence d’un calendrier court nous semble indispensable dans une économie mondiale dont la dématérialisation des échanges s’accélère et déforme profondément ou détruit des pans entiers de l’économie des pays qui sont en butte à ces optimisations fiscales agressives.

Enfin, la FFTélécoms salue le travail positif de redéfinition des critères de l’établissement stable pour les entreprises à « activité numérique dématérialisée » introduisant la notion de « présence numérique significative » dans les pays de consommation, mais aussi la tentative de définition de « l’établissement stable virtuel ». Mais, que l’on mette en place la notion d’établissement virtuel, ou la redéfinition des critères de « l’établissement stable » ou tout autre solution progressiste, il nous semble essentiel que les critères de définition de ces notions soient simples, particulièrement robustes et testés dans de multiples configurations (faire des test cases) pour vérifier qu’ils s’appliquent à toutes les entreprises et permettent ainsi d’atteindre l’objectif de rétablir une concurrence loyale et parfaite, fondement même du système d’échanges et condition de croissance de l’économie mondiale.
English Translation of Fédération Française des Télécoms. These comments were translated from French by OECD; the original French version will be the official one.

The “Fédération Française des Telecoms” approves the decision of the Task Force on the Digital Economy of the OECD BEPS Action Plan not isolate the sector of the digital economy from the other economic sectors and not subject it to a specific tax regime.

Indeed, the federation considers that the isolation of the digital economy is not envisageable currently, and will not be possible in the future as the digital is spreading to all sectors. In tax matters, economic actors require stability, predictability and a uniform system across countries in order to avoid optimisation.

As a result, the Federation considers, as the Task Force of the OECD, that the Ottawa framework conditions on the taxation of electronic commerce must be followed:

The tax treatment of digital goods and services must be neutral and equitable with regard to conventional activities in order to avoid creating an imbalance that would be advantageous to one activity over another.

It must be clear and simple, efficient and fair, flexible and dynamic as defined in pages 63 and 64 of the Discussion Draft of the OECD. Considering the volatility and the extraordinary speed of the evolution of the digital activities, the FFTélécoms is in favour of defining a body of ‘intangible’ rules, but with application criteria that would adapt with time, in order to take into account the transformation of economic exchanges triggered by technological evolutions and the transformation of economic models.

The Federation would like to congratulate the Task Force on its overview of the potential options and recalls the need for the Task Force to rapidly put in place measures in order to put an end to the unfair competition currently taking place to the advantage of some businesses that locate the value created in and by countries where consumption takes place in tax havens. This occurs to the detriment of public finances, including in countries that contribute to the aggressive tax planning allowing double non-taxation. This short time-frame appears to us to be essential in a global economy where dematerialisation of exchanges is accelerating and profoundly distorting or destroying entire segments of countries’ economies that are confronted with aggressive tax optimisation practices.

Finally, the FFTélécoms welcomes the positive work on the redefining of the permanent establishment criteria for “fully dematerialised digital activity” introducing the concept of “significant digital presence” in the countries where consumption takes place, as well as the tentative definition of “virtual permanent establishment”. Whether a new concept of virtual permanent establishment is introduced or whether the criteria of a permanent establishment are defined or any other progressive solution, it appears essential to us that the criteria for defining these concepts be simple, and particularly robust and tested in multiple configurations (by conducting test cases). This will ensure that the criteria apply to all business and attain the objective of re-establishing fair competition, the foundation of economic growth and exchange in the global economy.
Dear Sir or Madam,

BDI refers to the OECD Discussion Draft “Address the Tax Challenges of the Digital Economy”, issued on 24 March 2014 and likes to thank you for the possibility to provide our comments and input at this stage of the process as this allows us to engage with you on this important issue.

Action item 1 of the Action Plan aims to “identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation”.

Before commenting on specific measures, we first of all would like to provide our views regarding some of the issues the OECD in particular asked for on page 7 of the draft.

- **Possibility to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules**

We believe that the separation of rules relating to the right to tax for the digital economy from other industry sectors is not a forward-looking approach as offerings in the digital economy are already embedded into many traditional businesses models and new business models in the digital economy evolve rapidly. There still is a customer/supplier relationship with a delivery of (valuable) content, whether in a digital or a physical manner.

Consequently, we reject any attempts to introduce a tax regime which is limited to MNEs of the digital economy and fully endorse the
conclusion drawn by the Task Force that “it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy”.

In addition, a separation of tax rules for digital economy from other industry sectors would particularly discriminate IT-companies and discourage them from investing in research and development (R&D) activities. Thus, a separate digital tax regime would, for example, conflict with one of the “Europe-2020-targets”, namely that 3% of the EU's Gross Domestic Product should be invested in R&D/innovation by the year 2020. Contrary, it needs to be ensured, that there are no constraints for the digital economy – or single business models – compared to the traditional business by introducing new tax regimes. Only this would ensure the tax neutrality among different business models.

**Key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account**

Nevertheless, the draft attempts to identify key-features – including mobility, reliance on data, network effects, use of multi-sided business models, tendency towards monopoly or oligopoly and volatility – that distinguish the digital economy from others and elaborates on measures especially designed to fit businesses of the “digital economy”.

In our view, the features identified in the draft are neither accurate nor limited to the digital economy. They may be relevant for some businesses in the digital economy, but they are not likely to be limited to the digital economy and to cover all aspects of the digitalization of the economy.

**Examples of new business models in the digital economy and whether (and if so which) other business models should be considered**

When looking at the business models emerging due to the IT development, we again would like to emphasize that the boundary between “traditional” versus “digital” economy is blurred. In most cases, multinational enterprises (MNEs) emerging in the digital economy do not establish completely new business models, but rather look for more efficient ways to deliver goods and services.

**Potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives**

We strongly reject the proposed modifications to the exemptions from the permanent establishment status as well as any attempts to introduce a – whatever defined – “virtual permanent establishment” status. We are concerned that the discussed options in the draft would lead to additional administrative and compliance burden for businesses and
substantially increase the risk for double taxation. To widen the scope of the permanent establishment concept would result in a completely new system for allocating international taxation rights across countries.

Furthermore, we would like to provide our comments on some specific issues proposed in the draft as follows.

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

An option which is discussed in the discussion draft is to impose a final withholding tax (WHT) on certain payments for digital goods or services provided by a foreign e-commerce provider. This would run counter to the principle not to grant the taxing right for royalties to the source country. The underlying reason for this principle, i.e. that the residence country had the burden of R&D costs and thus shall have the benefit of R&D income, is also valid in the case of digital economy transactions. There are various aspects which do not support imposing WHT. First of all, it would raise neutrality issues when treating transactions in digital services different from other transactions. There would be particularly the question how to define digital transactions, e.g. is music or software a digital product if downloaded but not if provided on a physical instrument like a CD. Most importantly, however, levying WHT could lead to a double taxation of the digital activities as the withholding tax will easily exceed the tax due on the net profits. Unless all taxes withheld in the source country would be fully creditable in the residence country, thus fully avoiding excess tax credits, WHT would result in an over-taxation. As a full tax credit would not be a realistic approach, the amounts of excess tax credits would substantially rise under a new source taxation regime. We therefore strongly recommend abandoning the idea to imposing WHT on interest and royalties.

- **Consumption tax options**

We acknowledge that consumption taxes might be the better option to tackle the issue that market jurisdictions do not obtain their desired share of revenue from digital providers. For instance, the new rules concerning the supply of electronic services entering into force in 2015 in the EU will extend the destination based principle to telecommunication, broadcasting and electronically provided services. This will ensure a fair and reliable procedure within the EU and will be combined with a Mini One Stop Shop (MOSS) to facilitate administration for businesses.

Yours faithfully,

Berthold Welling

Katja Kallert
April, 2014: Discussion draft on the OECD’s 'Tax Challenges of the Digital Economy'

We welcome the BEPS (Base Erosion Profit Shifting) project of the Organisation for Economic Co-operation and Development because it’s not in Ireland’s economic interest to be a facilitator of massive corporate tax avoidance while in these uncertain times, “tax is all about trust”¹ in the words of Pascal Saint-Amans, director, OECD Centre for Tax Policy and Administration.

Ireland has gained massively from globalisation in the last fifty years and besides international corporate tax avoidance being a beggar-my-neighbour practice, it also contributes to growing inequality and the imbalance between the rewards for capital and labour.²

There is also an inequity when the Irish Revenue aggressively investigates avoidance and evasion by domestic firms while a blind eye appears to be turned to multi-billion euro charges, used to mask profit transfers, in the accounts of foreign firms.

Ireland should not fear a transparent and integrity-based tax system.

In the following, we set out a) how Ireland facilitates corporate tax avoidance; b) we argue why it’s in Ireland’s economic interest to support reform - - in 2013, jobs in the Irish internationally tradeable goods and services sectors were below the level in 2000 despite a real (inflation-adjusted) rise in exports in the period of 59% and an increase of 22% in the size of the workforce;³ c) we comment on issues raised in the discussion document.

Simply, in a decade of escalating corporate tax avoidance, net job numbers in foreign firms in Ireland were almost static.

US companies reported that profits reflecting activities in Irish affiliates doubled between 1999 and 2002 from $13.4bn to $26.8bn, while profits in most of the rest of Europe fell.⁴ In the period since, services exports surged and by 2013 we estimate that at least €45bn ($57bn) or 48% of Ireland’s reported services exports of €94bn in 2013 are tax-related - - arising from diversions of global revenues to Ireland that are unrelated to economic activity in Ireland - - and are effectively fake exports.⁵

The escalation of US corporate tax avoidance over the past decade masked realities that while the foreign-owned sector had ceased being a jobs engine in 2000, the indigenous exporting sector had been performing below its potential for many decades.

¹ Tax is all about trust - - Pascal Saint-Amans, director, OECD Centre for Tax Policy and Administration
² US corporate profits rise to record in 2013; Real wages flat at Zero - - Finfacts
³ Irish Economy 2014: Jobless exports boom 2000-2013; What will change to 2020? - - Finfacts
⁴ Ireland top location for US Multinational Profits - - Finfacts, 2004
⁵ Irish Medium-Term Economic Strategy 2014-2020: Exports to plunge by €50bn - Part 1
Ireland facilitates corporate tax avoidance by:

1) Providing foreign firms with offshore non-tax resident Irish companies that are usually domiciled in Bermuda or the Cayman Islands where there are no corporate taxes - the transactions of these mailbox holding companies, including the details of intellectual property (IP) assets and “Double Irish Dutch Sandwich” scheme\(^{6}\) receipts, can be shielded from the public via unlimited status under Irish company law. The revelation in May 2013 by the US Senate’s Permanent Subcommittee on Investigations\(^{7}\) that Apple Inc. had for decades treated the Irish companies as having no tax domiciles or in effect being “stateless,” showed that the Irish authorities did not have any regulation of these entities. The domicile loophole was closed via the Finance (No. 2) Act 2013 and it stipulates that an Irish incorporated company must be considered tax-resident somewhere and cannot remain “stateless.”

2) While the Irish Government has stressed in recent times that the country isn’t a tax haven, an increasingly popular tax haven activity is for big firms, mainly American-based, to switch their domiciles to Ireland to avail of the low headline corporate tax rate of 12.5% and the only Irish activity of a firm of 100,000 staff maybe a small head office or even zero staff. Shares of King Digital Entertainment Plc, the maker of the hugely successful mobile video game ‘Candy Crush Saga’ began trading on the New York Stock Exchange on March 26, 2014. Last July in preparation for the initial public offering (IPO), King registered a holding company in Dublin.\(^{8}\) The registered office is at the address of the William Fry, a Dublin law firm; the shares are held by 7 nominee companies with addresses at the law firm’s office and the directors appear to be staff of William Fry. The company was founded in Sweden in 2002 and has game studios Stockholm, Barcelona, Bucharest, Malmö and London, with offices in San Francisco and Malta. On its US Securities and Exchange Commission regulatory filing\(^{9}\) it has the Fitzwilton House, Wilton Place, Dublin 2 address and the contact phone number has a London code. None of the real directors are Irish and the company has no staff in Ireland but it has become an Irish company and its activities are reflected in the Irish national accounts.\(^{10}\)

Massive tax avoidance is good capitalism?

Eric Schmidt, Google chairman, in December 2012 defended Google’s schemes to avoid tax and he said such schemes were legitimate and the company paid taxes “in the legally prescribed ways.”\(^{11}\)

“I am very proud of the structure that we set up. We did it based on the incentives that the governments offered us to operate,” he said.

\(^{6}\) IMF explains “Double Irish Dutch Sandwich” tax avoidance - - Finfacts
\(^{7}\) http://levin.senate.gov/download/exhibit1a_profitshiftingmemo_apple
\(^{8}\) King Digital Entertainment application to incorporate a company and Annual Return
\(^{9}\) http://www.sec.gov/Archives/edgar/data/1580732/000119312514056089/d564433df1.htm
\(^{10}\) The Effect of Redomiciled Plcs on GNP and the Irish Balance of Payments - - John FitzGerald, ESRI 2013
\(^{11}\) http://www.independent.co.uk/news/uk/home-news/google-boss-im-very-proud-of-our-tax-avoidance-scheme-8411974.html
He went on to suggest that Google would not turn down the opportunity to draw on the big savings allowed under the law in the countries it operates in: “It’s called capitalism. We are proudly capitalist. I’m not confused about this.”

Last year Prof John Kay wrote in his column12 in The Financial Times that “avoidance is facilitated and enhanced by corporate manipulation of the prices at which capital, goods and services are transferred across borders. The resulting accounts show profit being earned in low-tax jurisdictions in which little or no real business takes place. It is disingenuous for companies to claim they pay the tax legally due when their assessments are based on accounts that defy economic and business realities.

In the main, however, tax authorities have preferred to cut deals with big corporations rather than pursue costly legal action. They will not do the same for you and me. It makes no sense for a small company to pay an accountant to do anything but calculate the amount of tax that is properly due, or to incur legal fees resisting a challenge. The unacceptable outcome is an entirely correct perception that there is one law for the little guy and another for the big battalions. The potential effect of that perception on tax compliance is one that is well worth spending millions of pounds to avoid.

A serious reform agenda would involve a principled reappraisal of the basis for taxing corporations both nationally and globally, and a strategy for effective enforcement of existing rules. Such a strategy would make clear that executives of companies which present accounts to tax authorities that are essentially false, and the accountants who support them, will in future run serious risks. The door they hear closing behind them might be the door of a prison cell rather than the door of 10 Downing Street.”

Philip Stephens, an associate editor of The Financial Times, wrote13 that "As the Google boss (Eric Schmidt) will be well aware from his personal as well as his professional life thriving societies depend on more than strict adherence to the letter of the law. Communities work because citizens, institutions and, yes, even companies observe norms, conventions and mutual obligations that are nowhere on the statute book.

There is nothing new about this. If Mr Schmidt has any doubts, he should read the excellent new biography of the 18th-century philosopher Edmund Burke written by Jesse Norman, the Conservative MP.

To suggest that each and every responsibility and duty must be codified in statute is to invite a lurch towards totalitarianism - - the micromanagement by an over mighty state of every dimension of our myriad relationships.

There is no law (in Britain at least) that obliges me to join the back of a queue for, say, theatre tickets or a restaurant table rather than infiltrate myself at the front. I suspect, though, that Mr Schmidt would agree that queue-jumping is pretty antisocial.

To be legal, in this instance, is not to be right. Or would he suggest that the government should legislate?

12 http://www.ft.com/intl/cms/s/0/9bb6f2ec-d785-11e2-a26a-00144feab7de.html#axzz2xMAqXxRG
13 http://www.ft.com/intl/cms/s/0/28b783de-c857-11e2-acc6-00144feab7de.html#axzz2xMApXsRG
Then there is that fiduciary duty. Of course, companies should not pay ‘voluntary’ tax.

But they do not face the binary choice posited by Mr Schmidt. **Somewhere between charitable giving to the tax authorities and the setting up of Byzantine pyramids of shell companies in every tax haven known to man and womankind, there is what my lawyer friends call the wholly justifiable use of the tax code to protect shareholders.**

The odd thing is that, at times, Google seems to understand that it ought to look beyond the letter of the law. The company boasts about its many ‘good works’ in local communities. Presumably these are consistent with its fiduciary duty?

Yet when the company says that the billions in revenues garnered every year by its sales force in Britain are not liable to local tax because technically, the business is ‘closed’ in Dublin, it **frankly looks sleazy**. Someone, somewhere at Google headquarters would do well to apply the ‘what would any reasonable person’ think test?"

**Why Ireland should revert to a sleaze-free system**

Massive corporate tax avoidance has added to distortions in Ireland’s national accounts and masks the poor performance of the indigenous sector.

Like its predecessors, the current Irish Government had banked on the status quo being protected by a) the EU veto on tax harmonisation b) political gridlock in Washington DC. However, it has been left flat-footed by the sudden prospect of reform of international tax rules and it has been floundering with the help of the siren voices of professional services vested interests and others.

It’s not credible to claim that US Bureau of Economic Analysis data14 on profitability of US firms with Irish affiliates is invalid because it includes untaxed profits in Irish offshore companies in “other jurisdictions” that are usually routed through Ireland.15

Claims that the effective corporate tax rate is close to the headline rate of 12.5% are also bogus16 as is the claim of tax transparency when companies can shield all their Irish financial data from public view.17

Whether it’s King Digital Entertainment Plc with its headquarters in Ireland and based and the offices of a Dublin law firm or Microsoft Inc.’s Round Island One Unlimited, an Irish company, based at the Hamilton, Bermuda, offices of a local law firm,18 they are both engaged in exploiting loopholes to deprive other jurisdictions of lawful tax revenues.

In May 2013, Joe Nocera, New York Times columnist wrote:19

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14 US company profits per Irish employee at $970,000; Tax paid in Ireland at $25,000 – Finfacts
15 Corporate Tax 2014: Irish Government’s “flawed premise” on Apple’s avoidance – Finfacts
16 Corporate Tax 2014: Ireland’s effective rate for US companies in 2011 was 2.2% and Kenny’s bogus Irish effective tax rate claim – Finfacts
17 Apple, Anglo Irish Bank and Irish company law – Finfacts
18 Foreign government requests Bermuda to investigate Microsoft’s Irish subsidiaries – Finfacts
19 Here comes the sun – New York Times
“Question for the government of Ireland: Do you really want your country to be known as an offshore tax haven? Indeed, at a time when your citizens are dealing with the pain of an austerity program, how can you justify allowing Apple to pay virtually no taxes on a subsidiary established solely to avoid taxes in the United States? Just wondering.”

Ireland can prosper with the lowest national corporate tax rate of 12.5% among developed countries and with a half century of experience as a host for FDI (foreign direct investment) firms. Ireland also has low non-wage labour costs and with the exception of the UK, hourly pay compares favourably with most of Europe’s developed economies.20

In contrast, with the FDI sector, the indigenous internationally trading sector with similar low corporate and social security taxes including no obligation to provide staff with occupational pensions, has performed poorly over the period since Ireland first embraced globalisation in the 1950s.

FDI firms are responsible for about 90% of headline exports by the internationally tradeable goods and services sectors but the chart below shows that the indigenous sector provides as many jobs as the FDI sector - - it has the potential to provide many more.

| IRELAND 2000-2013: Internationally tradeable sectors |
|---------------------------------------------|--------|--------|--------|
| Employment '000s by category                | 2000   | 2012   | % +/-  |
| Industry                                   | 268    | 197    | -26%   |
| Services                                   | 88     | 140    | +59%   |
| Total                                      | 356    | 337    | -5%    |
| Employment '000s by ownership               | 2000   | 2013   |        |
| Indigenous firms                           | 172    | 174    | +1%    |
| Foreign-owned firms                         | 184    | 175    | -5%    |
| Total                                      | 356    | 349    | -2%    |
| Exports at current prices                   |        |        |        |
| Merchandise                                 | €80bn  | €62bn  | +2.5%  |
| Services                                   | €18bn  | €95bn  | +428%  |
| Total                                      | €98bn  | €177bn | +81%   |

The European Commission’s Ameco database shows that the real (inflation-adjusted) value of Irish exports of goods and services with 2005=100, rose 59% in the period 2000-2013.

Sources: CSO; Forfás via Finfacts

20 Hourly labour costs ranged from €3.7 to €40.1 across the EU28 Member States in 2013 - - Eurostat 2014
If total exports of €177bn in 2013 were discounted to €100bn to account for excess transfer pricing and fake services exports, total indigenous exports (including tourism and transport) would only amount to 24% of the resultant total.

Two-thirds of Irish private sector workers are in non-exporting sectors with “a huge amount” working in traditional sectors - - in Hotels and Restaurants, Wholesale and Retail, Business and Professional Services.  

Food and drink exports now account for two thirds of total indigenous exports and about 50% of total indigenous exports are to the UK market (including Northern Ireland).

In 1973 when Ireland joined the then European Economic Community, 55% of total Irish exports went to the UK.

In 2012, 18% of total headline exports from FDI and indigenous firms went to the UK and 79% went to Europe and the US.

The total export intensity of Irish-owned industry has increased from 37% in 2003 to 52% in 2012. In the period 2008 to 2012, domestic sales fell from €20.4bn to €13.3bn while exports have increased from €11.3bn to €14.2bn.

In the peak years of the property bubble 2001-2007, despite the workforce growing by 384,000 people or 22%, indigenous internationally trading firms added only 10,000 jobs, which was offset by a similar decline in job numbers in FDI firms.

The issue of distortions in the national accounts, including the impact of tax avoidance, not only exaggerates the performance of the economy but it also reduces pressure on policy makers to seriously address the challenges that face the indigenous sector - - which has the potential to have the highest impact in terms of employment.

Decisions on the destination of most exports from Ireland are not made locally but when government ministers speak of export opportunities in emerging markets, they invariably conflate data on exports by the FDI and indigenous sectors for public relations impact.

Eamon Gilmore, minister of foreign affairs and trade, and tánaiste (deputy prime minister), was in China in June 2013 leading a trade mission and he said in an interview in Beijing that China was key to Irish economic recovery. The claim was absurd as exports to China in 2012 accounted for about 2% of the headline value of total exports in 2012.
Last February a government report noted: “Computer Services: accounting for 40% of total services exports in 2012, realising a 49% growth over a five year period.”28

In February 2013, Michael Noonan, finance minister, at a Bloomberg event in London, attributed the jump in services exports to “the significant price and cost adjustments that have taken place in recent years.”29

The facts were that in 2012 two firms, Google and Microsoft, with less than 3,000 employees in Dublin, accounted for about 80% of what were classified as ‘computer services’ exports.

On labour competitiveness, while the headline data suggest that unit labour costs (productivity), will show a 21% relative improvement against the Eurozone average in 2008-2015,30 Eurostat, the EU’s statistics office, says Irish labour costs grew by 0.5% in 2008-201331 - - the difference is mainly explained by a jump in tax-related virtual output.

Irish GNP (gross national product) until recent times has been viewed as a better measure of Irish economic performance compared with GDP (gross domestic product) because the metric excludes the inflated profits of the FDI sector that are included in GDP. In 2011, the value of GDP exceeded GNP by 23% and by 18% in 2013, according to the CSO. In the early 1970s for example, GNP exceeded GDP because of emigrant remittances.

In 2013 while GDP growth fell 0.3%, GNP rose 3.4% but Finfacts has estimated that GNP growth may have been as low as 1%.

GNP is no longer a reliable metric and recent research has shown that the redomiciling of foreign firms in Ireland for tax purposes had boosted GNP growth by 2.9% in 2010 and by 1.1% in 2012.32 The official result was 3.4% - - the same level in 2013.

The European Commission noted in its 2013 EU Industrial R&D Scoreboard33 that Seagate Technology (12.6 %), Covidien (12.5%) and Accenture (11.2%), accounted for 60% of the R&D of companies based in Ireland. These are American companies that have their headquarters in Ireland and most of the sixteen entries for Ireland are in fact American.

The Global Innovation Index (GII) co-published by Cornell University, INSEAD, the French business school, and the World Intellectual Property Organization (WIPO, an agency of the United Nations) has also been misled by surging ICT services and Ireland was ranked the world’s 10th most innovative country in 201334 - - despite the dominant FDI sector not doing significant research and less than a third of firms spending on R&D.35

28 Irish Economy 2014: Gilmore launches Lilliputian wish-list on trade and tourism - - Finfacts
29 Speech by Michael Noonan, finance minister, London, February 2013 -- Department of Finance
30 Ireland’s continuing progress, March 2014 -- Department of Finance (page 12)
31 Hourly labour costs ranged from €3.7 to €40.1 across the EU28 Member States in 2013 -- Eurostat 2014
32 Irish adjusted GNP in 2013 estimated at 1% compared with official level of 3.4% -- Finfacts
33 The 2013 EU Industrial R&D Investment Scoreboard -- European Commission
34 The Global Innovation Index 2013
35 IDA Ireland Annual Report 2012 - - Page 6, client firms engaging in R&D at about 28% of total
Ireland should embrace corporate tax reform and have a national accounting system that presents the economic realities not a fantasy image, which provides bragging material for politicians.

If the current G20-OECD project fails, it would be foolish to bank on continued political gridlock in Washington DC.

In recent years the Obama Administration has proposed a minimum foreign profits tax to clamp down on the flow of profits to low-tax or no-tax jurisdictions. A rate wasn’t specified but if it was to be higher than the Irish headline corporate tax rate of 12.5%, the incentive would be made redundant for US firms.36

With the exception of independent members, it’s almost a taboo to raise the issue of corporate tax avoidance in the Oireachtas (the Houses of the Irish Parliament) because of fears that job creation would be put at risk.

In a speech at the US Chamber of Commerce headquarters in Washington DC on March 13, 2014,37 Enda Kenny, taoiseach/prime minister, told a group of business persons: “If you got a problem, you have an issue or anxiety or concern or a proposition or a proposal I want to hear it. My number is a public number you can call me anytime.”

The taoiseach’s assurance was consistent with a common belief, that with the exception of large indigenous firms, American firms, which are responsible for about two-thirds of FDI, always get priority attention compared with local SMEs.

The Irish Government ostensibly supports the BEPS project but it is undoubtedly sympathetic to the intense private lobbying from various vested interests that is currently underway.

The Clearing House Group is a forum chaired by the secretary general to the Government and comprises public officials, representatives of financial services companies that operate in the International Financial Services Centre (IFSC), Dublin’s offshore centre, and representatives of the Big 4 accounting firms.38

The group has a positive role in ensuring that the IFSC responds with speed to changes/new opportunities in international financial services but it also has a key lobbying role and according to The Financial Times, “before the 2012 budget, this group... recommended a series of 21 taxation and legal incentives sought by the finance industry, according to documents released under a freedom of information by an Irish MEP (Nessa Childers). Virtually all the changes were introduced in the subsequent budget.”

IFSC Ireland, which represents firms at the IFSC claims that it is “non-lobby and a-political.”

John Bruton, a former taoiseach/prime minister, is the president and in the common use of words it’s a lobbying organisation.

36 Corporate Tax 2014: US proposal of 17% rate for foreign profits -- Finfacts
37 Enda Kenny: ‘Call me anytime.’ - - Irish Independent
38 Minutes of an October 2013 meeting of the Clearing House Group at Government Buildings
The most important lobby group is the **American Chamber of Commerce in Ireland**, a unit of the powerful US Chamber of Commerce, and the FT report says that the Irish Government “amended its tax code following lobbying by US industry, reducing the tax burden on multinationals that funnel royalty payments to offshore tax havens.

The changes enabled some multinational companies to make royalty payments from their Irish-based operations directly to subsidiaries based in tax havens such as Bermuda or the Cayman Islands, without having to pay a 20% withholding tax on the royalties.”

**Pascal Saint-Amans, the director of the OECD’s tax centre**, confirmed in a briefing on April 02, 2014 that "Double Irish Dutch Sandwich" type tax schemes, which involve global revenues of services giants being routed through Ireland and transferred via the Netherlands to Irish offshore companies in Bermuda and the Cayman Islands, will be axed.

On April 07, 2014, Ireland's Department of Finance issued a technical paper on methodologies for determining the effective corporation tax rate in Ireland.

The paper gives a 'tour d'horizon' on several ways of calculating effective corporate tax rates **but the political purpose is to undermine the argument that US firms pay low single digit tax rates in Ireland.**

Questions are raised about the reliability of US Bureau of Economic Analysis data which includes Irish affiliate income in West Atlantic tax havens including large amounts from equity investments.

What is missing from this narrative is that when Google booked 41% of its 2012 global revenues in Ireland; Facebook booked 48% and in 2011/12, Microsoft diverted 24% of its global revenues, the tax due in Ireland was calculated after the booking of big charges to shift most of the profits tax-free to Irish offshore mailbox companies in Bermuda and the Cayman Islands.

The offshore companies are protected from public scrutiny through unlimited status under Irish company law.

Apple Inc. booked about $100bn in sales through Irish subsidiaries in 2013 but the Irish Government is bizarrely claiming that the Irish incorporated offshore affiliates are not Ireland's concern because they do not trade in Ireland.

**It does not make the same argument about the large redomiciled foreign companies that move to Ireland to avail of the low tax rate without having trading operations in the economy.**

Apple Inc. makes clear in its Form 10-K filing with the US Securities and Exchange Commission for year ending September 28, 2013, that most of the international revenues and profits were booked through Irish subsidiaries.

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39 Dublin cut tax burden on multinationals after US lobbying - Financial Times 2013
40 IMF explains “Double Irish Dutch Sandwich” tax avoidance - Finfacts 2013
41 Corporate Tax: OECD’s Saint-Amans says “Double Irish Dutch” sandwich tax scheme will be axed - Finfacts 2014
42 Effective Rates of Corporation Tax in Ireland: Technical Paper, April 2014 -- Department of Finance
Apple said: “During 2013, the Company’s domestic and international net sales accounted for 39% and 61%, respectively, of total net sales...The Company is subject to taxes in the US and numerous foreign jurisdictions, including Ireland, where a number of the Company’s subsidiaries are organized...The foreign provision for income taxes is based on foreign pre-tax earnings of $30.5bn, $36.8bn and $24.0bn in 2013, 2012 and 2011, respectively...Substantially all of the Company’s undistributed international earnings intended to be indefinitely reinvested in operations outside the US were generated by subsidiaries organized in Ireland, which has a statutory tax rate of 12.5.”43

The foreign earnings tax rate was 1.9% in 2012 and 3.8% in 2013.

The tax rate in Apple’s big foreign markets is a multiple of the Irish 12.5%.

In 2013, the average OECD rate weighted for GDP was 32.5% and a simple average of 25.5%.44

In 2012 Google Ireland paid €17m tax on €137m profit - - a 12.4% rate.

However the total Google Inc. net income was at a ratio of 22% of revenues and Irish reported revenues of €15.5bn should have produced €3.4bn in income using a ratio of 22% but big charges from Irish affiliates in Bermuda ensured that most of the profit was transferred tax-free.

Apple Inc. did not have to use the Double Irish Dutch Sandwich scheme because it classified the Irish subsidiaries as “stateless” with no tax residency anywhere. That loophole was closed by a change in Irish company law late last year.

The BEPS also provides for reform of transfer pricing which may impact profit shifting by pharmaceutical firms to Ireland.

Looking ahead, a reduction in employment by big service giants that currently centralise European services in Ireland can be offset by development of the indigenous sector.

As Ireland is unable to meet the demand for multilingual staff, a company such as Google has about 2,500 employed in Dublin and about 70% are from overseas.45

Intel, the US chip giant, is twenty five years in Ireland this year46 and its decision to open a plant in Ireland was a crucial trigger for the best decade for FDI - - the 1990s.

It disclosed in March that it had invested $5bn in upgrading its Leixlip campus in the past three years, which underlines its commitment to Ireland.

Craig Barrett, the former Intel CEO, was asked in a newspaper interview earlier this year if Ireland could attract the really valuable Google and Twitter type R&D and innovation functions as well as supplying hewers of wood and drawers of water?

43 Apple Inc. Form 10-K year end September 28, 2013 - - Page 64
45 Google was never meant to be this big in Ireland – but plans change - - Sunday Independent 2014
46 Intel 25 years in Ireland; Employs 2,800 not 4,500 - - Finfacts 2014
"No," Barrett replied. "I think to a degree it's a matter of numbers. You can have an Intel invested here as a creator of jobs but it's primarily a manufacturing investment."

"Those are good paying jobs and I think the Irish are very happy to have them and Intel is happy to be here. Intel also has engineering applications here with 300 employed in Shannon. But that's small compared to the engineering base it has in Santa Clara or Portland or Arizona, for example, and that's just a matter of numbers.

"The multinationals are going to go where the resources are. And the bulk of resources are not in Ireland because it's a small country of four or five million people. Look at it on the positive side at least they're putting their HQs here."47

This highlights the serious flaw in the flagship enterprise policy, which was first launched in 2006 with the goal that Ireland by 2013 would be recognised as a "world-class knowledge economy." When that wasn't achievable it was replaced with the more audacious target "in which Ireland in 2020 is the best country in the world for scientific research excellence and impact."48

The universities were to produce the research and while the private sector lead by foreign firms would raise the level of innovation done in the Irish economy.49

Following public spending of an inflation-adjusted €24bn on science policy in a decade, publication citations have risen, patent filings are at a 30-year low while science and technology educational output has improved.

The current policy objectives will not be met despite the number of business claims for the 25% R&D tax credit and it remains unrealistic for Ireland to expect to emulate Israel's success in creating a research base over 60 years.50

Nevertheless, there will always be durable demand for food and drink - - sectors where Ireland has sustainable strengths.

In 2013 Ireland's agri-food exports were valued at €8.7bn, compared with €16bn in Denmark (population 5.5m) and €79bn in the Netherlands (population 17m).

As a ratio of total merchandise exports, Ireland was at 11%, Denmark 20% and the Netherlands ratio excluding re-exports was at 25%.

The trade surplus as a ratio of exports in the sector was lowest in Ireland at 19%; it was 37% in Denmark and 32% in the Netherlands.

The Netherlands in particular is a leader in agri-food innovation and during the April 2014 state visit of Xi Jinping, China's president, an agreement was signed on helping China to boost milk production.

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48 Irish Science Policy: 2020 replaces 2013 as target to be 'best country in...world for scientific research' - - Finfacts 2012
49 Irish Innovation: Evidence of science policy failure mounts - - Finfacts 2013
50 Irish Innovation: Israel as Startup Nation, why not Ireland? - - Finfacts 2014
With as many workers in the indigenous exporting sector as in FDI firms despite the huge gap in ex-tax avoidance output, there is significant potential for job creation with improved policy making.

The OECD's 'Tax Challenges of the Digital Economy'

Ideally, there should be a balance between compliance and regulation but it’s crucial to be aware that high-paid tax accountants and lawyers will exploit flexibility in rules while politicians in many countries will continue to lean on revenue authorities.

It’s well to remember recent history that massive tax avoidance by US companies was triggered by the unintended consequences of a well-meaning goal of the US Treasury Department in 1996 to ease regulatory compliance.

The “check-the-box” loophole introduced by the Treasury enables US companies to strip profits from operations in high-tax countries simply by marking an Internal Revenue Service form that transforms subsidiaries into what the agency terms a “disregarded entity.”

A Congressional Research Service report\(^51\) says that on average very little tax is paid on the foreign source income of US firms while the cost of check-the-box to the US alone has been estimated from $10 to $60bn per year.

In 2011 a joint report by ProPublica, a US public interest media organisation and the financial Times\(^52\) said:

"within days of its announcement in 1996, tax lawyers were on the phone saying the Treasury Department had overlooked the international ramifications. Inadvertently, the government had provided a way for companies to move profits from subsidiaries in high-tax countries like Germany to Luxembourg, the Caymans or other jurisdictions with lower or no taxes on certain kinds of income. Often, this is done by making royalty or interest payments between operations in different countries.

For decades, the IRS has had anti-abuse rules to make sure such payments could be subject to taxes. However, these rules generally don’t apply to payments made within a corporation. Check-the-box made it simple for a company to designate a subsidiary as a branch, with no U.S. tax consequences for the income unless it is repatriated.

Joseph Guttentag, international tax counsel at Treasury when check-the-box was introduced, said the government may not have understood, but tax lawyers quickly “saw all the avoidance goodies they could do.”

Countries like the UK and Germany quickly raised concerns that the rule was stripping earnings from their tax bases. By early 1998, the US said check-the-box was being used to “circumvent” anti-abuse rules.

Treasury proposed new regulations—and corporate America erupted.


\(^{52}\) Corporations couldn’t wait to ‘check the box’ on huge tax break - - ProPublica/The Financial Times 2011
General Electric, PepsiCo, Morgan Stanley, Merrill Lynch, Monsanto and other major companies urged Congress to resist the change. The US, they said, was trying to be ‘the tax policeman for the world.’ Allies in Congress dug in and Treasury quickly rescinded the proposal.

What followed was a check-the-box boom as multinationals and tax advisers around the globe embraced its benefits."

In 1998, Ireland’s Department of Finance in response to pressure from the European Union acknowledged that Irish registered non-resident (IRNR) companies "are regularly advertised ‘for sale’ in international magazines, often alongside companies which are incorporated in tax havens and jurisdictions with relaxed regulatory regimes. Many IRNR companies have little or no connection with the country and some may be used for tax evasion, money laundering and fraud."53

In 1999 the Irish Government planned to have all Irish incorporated companies tax resident. However, with corporate America in control of a valuable Pandora’s Box that would bring huge short-term gains, Ireland agreed to an exemption under pressure from the American Chamber of Commerce in Ireland to maintain the offshore facility for US companies. So the Finance Bill of that year provided that an offshore company which was tax resident in a double-tax agreement country could maintain its status while a new non-tax resident company could be setup if it was related to an existing firm with Irish operations -- in practice this latter provision was easy to abuse.

Permanente Establishment: On Page 2 we provided an example of how a holding company with just a mailbox registered office in Dublin can impact Ireland’s national accounts while providing little of value to the local economy.

On April 2nd, the European Parliament supported the European Commission’s Parent Subsidiary Directive,54 which is designed to prevent the double taxation of same-group companies in Europe.

The existing general anti-abuse rule is replaced and a new rule which provides that a transaction is considered to be artificial if it does not reflect economic reality. The benefits under the Parent Subsidiary Directive will not apply if “an artificial arrangement or an artificial series of arrangements which have been put into place for the essential purpose of obtaining an improper tax advantage under the Directive and which defeats the object, spirit and purpose of the tax provisions invoked.” Five examples that qualify transactions as artificial have been included in the rule.

a) Businesses should have a choice between local incorporation and a withholding tax while operations with a "significant presence" should be required to incorporate. So a giant like Amazon.com would not be able to treat its biggest European markets as depots for its Luxembourg operation55;

b) A withholding tax via transactions with credit card companies regulated in a jurisdiction would be necessary to foreclose on ecommerce companies using a multiplicity of companies that would

53 Irish Registered Non-Resident Companies - - Department of Finance Ireland 1998
54 Parent Subsidiary Directive proposal - - European Commission 2013
55 UK MPs to question Google, Amazon and Starbucks on corporate tax strategies - - Finfacts 2012
receive payments from different customers, to make it difficult for tax authorities to track transactions;

C) On thresholds for VAT, low-value consignment relief, and the requirements on digital products and services suppliers, the draft document has two options i) to reduce or eliminate the generally available exemptions for imports of low valued goods ii) require a non-resident supplier to register and account for the VAT on supplies sold in the jurisdiction of the consumer. The draft acknowledges the compliance burden involved and recommends simplified registration regimes and registration thresholds. In addition, the draft says enhanced governmental enforcement activities related to non-resident suppliers would likely be required, involving exchange of information, assistance in recovery and simultaneous audits.

The proposal that suppliers of digital products and services register and account for VAT in the countries in which their consumers are located would be the more preferable solution and EU member countries support this model.

From January 1, 2015, EU suppliers of digital products and services will be subject to the same rules as non-EU suppliers. To minimise administration, the EU is working on a “one-stop shop” whereby a business registers for VAT in only one EU member state, and accounts for all the VAT arising in other EU member states to that home state for onward payment.

d) While acknowledging that the some businesses always have been able to sell products and services into a country without having a physical presence, The OECD says ICT has significantly increased the scope for businesses to do so. The think-tank makes clear that it is not ring-fencing the digital economy as a separate sector and applying specific tax rules.

So other BEPS initiatives such as Action 6 (Prevent Treaty Abuse) and Action 7 (Prevent the Artificial Avoidance of PE Status) will also bolster source taxation and compliance.

e) Artificial transactions such as allocating intellectual property (IP) to island tax havens or jurisdictions that did not produce it, have no place in a credible tax system.
April 6, 2014

To:
The Task Force on the Digital Economy
Committee of Fiscal Affairs
OECD Paris

Email: CTP.BEPS@oecd.org


On March 24, 2014, the OECD published draft proposals for tightening the taxation of multinational concerns that operate internationally in the digital economy.

The problem is that some of the well-known big ones pay little or no tax anywhere under existing rules.

But the OECD proposals, if adopted, will be bad for many high tech firms and a better, fairer approach exists, as explained below.

We are an accountancy firm with much experience of international taxation of high tech firms.

Background:
According to the OECD proposals, the digital economy has changed the way companies do business and it is now far easier to supply services via e-commerce to consumers with minimal physical presence in the consumer countries. And if the multinational uses an offshore supply company to hold intellectual property and accept commercial risks, the profits may accrue offshore tax free. Consequently, the OECD was asked by onshore member countries to look into ways of tackling so-called “Base Erosion Profit Shifting” (BEPS) and the digital economy is one area the OECD is looking into as part of its BEPS action plan. The plan should be fully developed by the end of 2015.

All this is due to the development of information and communication technology (ICT) of many types, including personal computing devices, cloud computing, software development, use of data regarding consumers, the internet of things (putting your fridge and other devices on the internet), advanced robotics, 3D printing, online and credit card payments and much more. Not only large multinationals have adapted their business models, so have most businesses and “the digital economy is becoming the economy itself” according to the
OECD. Also there is a move to providing digital products as an online service for a monthly subscription fee or similar – this is referred to as XaaS (X as a service).

The proposals include some interesting statistics. In 2012, business to consumer (B2C) e-commerce sales were estimated to exceed USD 1 trillion, and business-to-business (B2B) e-commerce was estimated at USD 12.4 trillion. And the major OECD exporters of "ICT services" in 2012 were: India (USD 13.5bn), Ireland (USD 12.7bn), USA (USD 8.0bn), Germany (USD 7.3bn), UK (USD 7.0 bn). Israel is in tenth place at USD 2.7bn.

The Problem:
The OECD proposals are couched in diplomatic language and replete with jargon. It was rumored the OECD task force had trouble reaching a consensus. But all had in mind statements by various politicians.

For example, In May 2013, in a memo to the Permanent Subcommittee on Investigations of the US Senate Homeland Security and Government Affairs Committee, US Senators Carl Levin and John McCain wrote: “For example, Apple Inc. established an offshore subsidiary, Apple Operations International, which from 2009 to 2012 reported net income of $30 billion, but declined to declare any tax residence, filed no corporate income tax return, and paid no corporate income taxes to any national government for five years. A second Irish affiliate, Apple Sales International, received $74 billion in sales income over four years, but due in part to its alleged status as a nontax resident, paid taxes on only a tiny fraction of that income.”

Strong remarks were made in the UK House of Commons about other well-known companies, not all in the digital sector (e.g. coffee, books, etc). On December 3, 2012, Margaret Hodge MP, Chair of the Committee of Public Accounts, said: "Global companies with huge operations in the UK generating significant amounts of income are getting away with paying little or no corporation tax here. This is outrageous and an insult to British businesses and individuals who pay their fair share."

Aims of the OECD Proposals?
Actually there are no proposals or recommendations. The report refers to "options".

The stated aims of the OECD proposals (or options) are: neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. These aims were adopted by OECD ministers in Ottawa in 1998 at after reviewing an earlier OECD report "Electronic Commerce: Taxation Framework Conditions".

What is proposed?
First, the OECD Task Force proposes as a "potential option" that an enterprise engaged in "fully dematerialized activities" would have a taxable permanent establishment if it maintained a "significant digital presence" in the economy of another country.

A "fully dematerialized activity" would include: digital goods or service core activity; no physical element other than servers and websites and commercialization of location relevant data; contracts concluded exclusively by internet or phone; online electronic or credit card
payments; relationships only via websites; vast majority of profits from digital goods or services; residence and location disregarded by the customer; use via computer, mobile device or other IT tools.

A "significant digital presence" in a country would include "for example": Significant number of customer contracts signed remotely; digital goods or services widely used or consumed in the country; substantial payments from clients for digital goods or services; or an existing branch offers related functions such as marketing and consulting.

Second, the OECD task force proposes to treat as a permanent establishment a significant business in a country using personal data obtained by regular and systematic monitoring of Internet users in that country using "multi-sided business models" (which link different activities).

Third, the OECD Task Force mentions the possibility of a "virtual permanent establishment" in a country. There are several variations: (1) a virtual fixed place of business - a website in a country, (2) a virtual agency – contracts habitually concluded through technological means in a country (3) on-site business presence – at the customer's location.

Fourth, it is proposed to stipulate that financial institutions could become required to withhold tax from credit card and electronic payments.

Fifth, it is proposed to scrap VAT exemptions for imports of low value goods.

Sixth, it is proposed to simplify VAT registration procedures.

Our Comments:

The Task Force is clearly hesitant. In our opinion, based on practical experience, the proposed "options" won't work and fresh options are called for (see below).

First, initiative and innovation will be stifled. High tech firms from Alabama to Zimbabwe may have to register and pay VAT and income tax in every country where they happen to have "significant" users, even if they have nothing physical in those countries. It is unclear how many is "significant".

If the internet makes it easy to reach overseas markets from the home country, why penalize those companies with tax and bureaucracy?

Second, there is no mention of extending the rules for avoiding double taxation (foreign tax credit or exemption). Not every multinational avoids tax everywhere.

Third, the rules discriminate against companies in the digital sector. No mention is made of other sectors.

Fourth, this will be little more than a cat and mouse game. It will be easy to change a few things in the business model of a multinational to avoid meeting the new taxation "options", for example by adding a small physical element.

Fifth, we note there is no estimate of the expected improvement in tax revenues.
Sixth, the "options" appear to contravene free trade principles as administered by the World Trade Organization. These principles essentially provide that customs duty and other taxes should not be used to impede exports from one country to another, to protect businesses in the importing country. Instead, exporters with a competitive advantage in each country should be allowed to flourish without tax impediment in order to increase overall prosperity.

Seventh, the tried and tested principle is that a company from one country should only pay tax in another country if it does business IN that other country not WITH that other country. The case for breaking that principle is not clearly stated. It is not enough to say that business is conducted differently, that was also the case when the fax machine and PC were first introduced.

Eighth, it is unclear how much income should be allocated to a particular country. What about the value of technology provided and management time and resources devoted outside that country? Further proposals are apparently still in the pipeline.

Our Recommendations:

The secret of success is in Paragraph 102 of the draft proposals: "First, skills and talent remain a critical resource in the digital economy....managers, developers, software architects and designers...remain instrumental".

Instead of seeking to impose tax on machines, tax should be imposed where "mind and management" is exercised by humans.

This is generally referred to as "effective management" and should be easy to apply.

This is because "effective management" is an existing accepted principle for determining fiscal residency of a company in cases of doubt, according to the OECD model tax convention.

Moreover, many countries around the world apply similar related principle known as "central management and control", including the UK, Canada and Australia, and the USA is said to be considering following suit.

How would it work? The existing effective "management test" would be combined with existing transfer pricing principles (which have regard to functions, assets and risks) to allocate fairly profits and taxing rights between supply and demand countries for digital services and goods. The focus should simply be on the human element, not the machinery.

This should avoid the need for start-ups and others to register for income tax purposes in every country where they have users.

What about VAT? If the OECD is smart enough to propose recently an international one-stop information exchange facility between banks of different countries, it should also be possible to devise an international one-stop VAT reporting facility for international business concerns.

Since VAT is ultimately a tax on consumers, a dispensation might be granted for paying VAT on B2B transactions as in the EU in most cases.
This should avoid the need for start-ups and others to register for VAT purposes in every country where they have users.

We would be happy to answer any questions arising.

Yours Truly,

Leon Harris, CPA (Israel), FCA(UK)

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Submission on the OECD Discussion Draft on addressing the tax challenges of the digital economy
14 April 2014
Dear Sir/Madam,

Ibec thanks the OECD for the opportunity to comment on opinions outlined in the OECD draft discussion on ‘addressing the tax challenges of the digital economy’ (BEPS Action 1). Ibec represents the interests of Irish business including indigenous and multinational enterprises, and SMEs, spanning all sectors of the Irish economy. Ibec and its sector associations, which include ICT Ireland and the Irish Software Association, work with government and policy makers at national and international level to shape business conditions and drive economic growth. Ibec is also a member of BIAC and Business Europe and broadly supports the views communicated by these partners in their written submissions on the OECD discussion draft.

General comments

Work on the BEPS digital economy action is intrinsically linked with consultations currently underway across OECD Working Groups on other BEPS actions. Ibec looks forward to reviewing the outcomes and recommendations of ongoing work on specific actions, and assessing the implications of these for the digital economy.

Ibec welcomes the conclusion in the discussion draft that there should not be a separate taxation regime for the digital economy. Establishing a separate framework for taxation to be levied on the digital economy would not only be unfair but would become increasingly unworkable as growing numbers of ‘pre-digital’ businesses diversify their activities to offer more choice and better services to consumers.

Ibec considers that the digital economy has become an intrinsic element of the broader global economy and of many businesses driven by business and consumer activity. Many of the previous boundaries that existed between digital and ‘traditional’ or ‘bricks and mortar’ service providers are rapidly dissolving as enterprises across all sectors increase their online presence/services to generate more business by reaching new customers and markets but also to reduce costs.

It is also important to highlight a number of key points about the scope and reach of the digital economy;

- the digital economy delivers greater choice, competitiveness/price benefits and convenience to consumers, particularly in remote locations or to groups of customers who may face difficulty in physically accessing ‘traditional’ services;
digital and e-commerce services provide more and more users across the world with easy and cost-effective access to information services and to key resources in areas including education and health which can make a real and positive difference;

for many young people, the consumption of online and related services exceeds that of non-digital services (but usage of digital services across all population sectors is growing);

the digital economy gives many young people an opportunity to start their own business or secure skilled employment in a dynamic and growing sector of the economy at a time when youth unemployment levels in many EU and OECD states remain stubbornly high;

the digital economy promotes cross-border trade and contributes to more sustainable growth and competition in a globalised economy;

the sector has enormous potential to grow further

It is therefore of critical importance that tax rules do not discourage businesses to trade, grow and deliver services to customers and markets by complicating or amending regulation that would specifically target digital enterprises.

The discussion draft contains references to the taxation of sales into markets where a digital business has no physical presence. Ibec believes that the best way to allocate tax income between states where income-producing activities take place and states where the sale/consumption of services occurs is through a combination of origin-based income tax and destination-based VAT. The application of other types of hybrid tax systems would generate complexity and uncertainty for business, consumers and tax authorities and could lead to double taxation.

II. Information and Communication Technology and its impact on the economy

Ibec notes the detailed summary in Chapter II of the draft discussion document which traces the evolution of ICT in recent decades, paving the way for today’s dynamic digital economy. In ongoing discussions about the digital economy, it is important to look to the future and ensure that tax policy facilitates and supports continued future growth.

III. The Digital Economy, its key features and the emergence of new business models

Ibec supports the assertion in the discussion draft that ‘...the digital economy is increasingly becoming the economy itself’, and considers that it would be therefore impossible/unworkable to separate it from the broader economy for taxation purposes. But in many sections of the discussion draft, including Section III, proposals are outlined that seek to identify features of the digital economy that might differentiate it from the ‘traditional’ economy for taxation purposes. These assertions are, often over-stated and/or are applicable to approaches taken by many other ‘non digital’ business sectors.

The business models prevalent in today’s digital economy are neither radical nor new (as suggested in Section III), but are, in many instances, traditional business practices that have been modified to support the growth and development of the digital economy, just as other core business practices have historically been adapted or evolved to take account of factors including new technologies, changing social and demographic trends etc.

The discussion draft should have placed a greater emphasis on issues such as the considerable R&D and innovation investment necessary to survive and thrive in the digital economy, the high levels of financial investment and risk involved in starting many new e-commerce enterprises, and the level of volatility in the sector driven by new and constantly evolving technology advances.

Some of the specific points made in this chapter of the discussion draft also tend to be too narrowly
focussed, including a suggestion that most digital/ICT/e-commerce companies operating in the digital economy have lower costs than ‘traditional’ service providers. Internet and e-commerce businesses may have lower costs in some areas than non-digital business peers, but expenditure in other areas including developing, designing and hosting online services/platforms and on research, innovation and related and associated costs tend to be substantially higher in the digital economy.

The six key features of the digital economy listed from paragraph 91 of the discussion draft are not specific to the digital economy. Ibec also disagrees with the generalised assertion that many businesses operating in the digital economy maintain commercial activity with ‘minimal need for personnel present’; internet and e-commerce companies employ large numbers of highly skilled/skill-specialised personnel. The levels of revenue per employee figures included in the discussion draft (figure 8) do not automatically translate into high levels of profit.

The reference (paragraph 101) to ICT/e-commerce companies selecting the best locations to establish productive activities and assets which may be distant from the location of customers or production is valid, but such choices are normally made by any business seeking to expand internationally and are not limited to the digital economy.

Those engaged in digital business, like all businesspeople, consider a broad range of factors to inform decisions on the location of bases including local tax regimes and incentives, ease of doing business, availability and costs of skilled personnel, quality of infrastructure, political stability and other issues.

In summary, Ibec disagrees with the points in Section III which, taken together, suggest that digital enterprises are distinctly different to other sectors of the economy and can grow for low cost with minimal personnel, particularly outside bases where the company has its main operations.

IV. Identifying opportunities for BEPS in the Digital Economy
Ibec supports the need for fair tax strategies including to avoid tax compliant companies being put at an unfair competitive disadvantage. Ibec also notes the comment in the discussion draft that strategies used to achieve BEPS by some digital businesses are similar to the nature of strategies used by some ‘traditional’ businesses. But the references in paragraph 126 suggest that there is systematic abuse by enterprises in relation to the provision of information for tax assessment; Ibec does not believe that this is the case.

Ibec considers that the issue of a business providing customers with goods/services (digital or otherwise) in a market/jurisdiction without a physical presence is not unusual (particularly for smaller destination markets) and should not be an issue that requires any major deviations from current international tax policy. Income tax should not be based on the customer’s location (although the country where the customer is located may choose to impose a consumption tax). Any moves which would alter current taxation rights away from a country which, under existing tax principles, can levy tax based on the function, assets and risks of a business, to other jurisdictions based on where consumption occurs, would have serious implications. Economies such as Ireland’s and many other European states of similar size with strong export bases but small domestic markets would face major difficulties. For business, the danger of double taxation would increase.

V. Tackling BEPS in the Digital Economy
Work and consultations currently underway on other BEPS actions must be concluded before definitive decisions are taken in relation to taxation and the digital economy. In this regard, Ibec looks forward to continuing to engage with the OECD on other BEPS-related actions. Ibec and its members would, however, call for the conclusion of early decisions on improved resolution
mechanisms and processes which will ensure that disputes are addressed swiftly to promote greater certainty and clarity for business and avoid problems that could negatively impact on international trade.

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

Ibec questions the emphasis placed on assertions in the discussion draft that suggest that certain activities are more prevalent in the digital economy; the examples cited in paragraphs 155/156 on intra-group financing take place in all parts of the economy, not just in the digital economy. The proposal in paragraph 157 indicates a move towards formulary apportionment which runs counter to the OECD’s core principles in relation to the BEPS process.

*Counter harmful tax practices more effectively*

With reference to the points made in paragraphs 158/159, if countries develop specific tax incentives to attract investment, then taxpayers should be free to avail of these incentives. If the policies and regimes operated by a country are judged to be harmful, the countries should take immediate corrective action to tackle problematic elements.

*Global value chains and profit methods*

Ibec is concerned that the proposal outlined in paragraph 166 could contribute to an erosion of the arms length principle and potentially result in the risk of double taxation, damaging international trade.

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

Paragraphs 167-169 refer to CFC rules in relation to the taxation of mobile income generated by the digital economy. Given the continuing rise of remote sales of goods and services by e-commerce/digital enterprises, and the fact that this type of business is neither new nor limited to the digital economy, it would seem unfair to ring-fence income from digital economy remote sales transactions for new CFC rules.

**VI. Broader tax challenges raised by the digital economy**

The assertion in paragraph 173 that ‘the development of digital technologies has the potential to enable economic actors to operate in ways that avoid, remove, or significantly reduce, their tax liability within these bases’ is over-exaggerated. Paragraphs 178-182 should also emphasize the strong and positive competitiveness and knowledge benefits that the digital economy delivers to business and consumers in smaller and remote markets. Tax rules should support and encourage such access; new tax and administrative burdens unrelated to local profit or activity could achieve the opposite effect. It is important to note in relation to paragraphs 183-185, that the value of data is mostly only unlocked through a heavy investment in skilled personnel and technology to analyse, interpret and manage high volumes of raw data.

*Collection of VAT in the Digital Economy*

Ibec looks forward to continued engagement at OECD level between governments and business to assess VAT/GST through the relevant Technical Advisory Group (TAG). It is important that solutions adopted take account of the value of transactions balanced against the administrative burdens of collection/administration for business and local tax authorities.

**VII. Potential options to address the broader tax challenges raised by the digital economy**

Ibec notes that the proposals in this chapter on the digital economy have been put forward by stakeholders for discussion and that no conclusions have been reached on the issues raised.
Ibec supports the continued application of the Ottawa Taxation Framework principles which, supplemented as necessary, can provide a useful framework for evaluating future Task Force discussions on options. The Ottawa principles include guaranteeing fairness and neutrality, and Ibec considers that in this regard, the application of distinct rules for the digital economy would not be appropriate (and, in any event, would be difficult to implement given the scale and growth of the digital economy).

**Modifications to the exemptions from Permanent Establishment status**
Ibec would be greatly concerned at any proposed amendment to Article 5 (paragraph 4) of the OECD Model Convention on permanent establishments which could potentially generate considerable uncertainty and substantially increased administrative burdens for business. Ibec looks forward to submitting views to the OECD on Permanent Establishment status as part of BEPS Action Plan 7.

**A new Nexus based on significant digital presence**
Ibec considers that the suggested nexus function runs counter to the Ottawa principles by proposing rules that would delineate ‘traditional’ business from the digital economy, therefore violating the neutrality principle. If income tax on ‘fully dematerialized digital activities’ were applied, it could potentially result in double taxation and also affect the provision of digital economy goods and services to smaller markets or more remote economies. The application of VAT on a broader range of deliveries of digital goods and services would be a better option of taxation than the proposals outlined.

**Virtual Permanent Establishment**
Ibec considers that a country should not tax income where there is no actual nexus to that same country. The measures proposed would also run contrary to the Ottawa principles by ring-fencing the digital economy for tax purposes from the broader economy, and would also generate significant increases in administrative burdens for business and augment the risk of double taxation.

**Creation of a withholding tax on digital transactions**
This proposal again raises the issue of singling out specific types of payments which is effectively ring-fencing the digital economy. The options outlined could also lead to double taxation and, given the low values of transactions, could be administratively burdensome. VAT or a broad consumption tax which does not differentiate between digital and non-digital services or the origin (domestic/foreign) of providers would be preferable.

**Concluding remarks**
Ibec considers that the discussion draft does not make a case for developing specific tax rules for the digital economy sector. Ibec will continue to engage with the OECD on other broad BEPS actions which may have implications for the digital economy.

Ibec sincerely thanks the OECD for the opportunity provided to outline the views of its members on this extensive and detailed draft discussion paper and would be pleased to elaborate on the issues raised in this submission if required. Ibec looks forward to further future engagement with the OECD on BEPS actions and initiatives.

Yours sincerely,

Fergal O’Brien
Head of Policy and Chief Economist
BEPS ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY

ICAEW welcomes the opportunity to comment on the public discussion draft BEPS Action 1: Address the tax challenges of the digital economy published by OECD on 24 March 2014.

This response of 12 April 2014 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty’s Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

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ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW’s regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 142,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
GENERAL COMMENTS

1. We believe that the Digital Economy should not be treated as separate from the “real” economy. In response to the first bullet-point in paragraph 10 we do not believe it is possible to ring-fence the digital economy from the rest of the economy.

2. All parts of the economy demonstrate, or use, to some extent digital methods in carrying on business and some more so than others.

3. Many businesses which use digital carry on their business in a great number of different countries without satisfying the traditional OECD definitions of a Permanent Establishment (PE) and so, under current rules, fail to create a taxable presence in the source country.

4. We do not believe that the solution to this problem should be a major reworking of the existing rules which could have, as an end result, that multinational are deemed to have PEs in a very considerable number of countries and an obligation to make returns in those countries.

5. But it is clear that some multinational business do have a commercial presence in countries which is an integral and essential part of their business model but which do not currently, for instance, meet the conditions to be deemed to have a PE in such countries.

6. We accept that some redefinition of PE is required.

SOUND PRINCIPLES OF TAXATION POLICY

7. We do also very much support the Ottawa taxation framework principles, mentioned in the final bullet-point of paragraph 10, and set out in a Box in paragraph 6.

8. The ICAEW Tax Faculty formulated its own Ten Tenets Towards a Better Tax System in the late 1990s, which are reproduced in Appendix 1 to this response. More recently these have been taken up by the UK Parliament’s Treasury Select Committee in its 2011 Report Principles of Tax Policy http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/753/753.pdf in which it concluded that tax policy should:
   - be fair;
   - support growth and encourage competition’
   - provide certainty;
   - provide stability; and
   - be practicable.

MODIFICATION OF THE EXEMPTIONS FROM PERMANENT ESTABLISHMENT STATUS

9. Various options are put forward in paragraph 211 as to how one could modify the exceptions contained in paragraph 4 of Article 5 of the OECD Model Tax Convention.

10. We support qualifying the Article 5(4)(a)-(d) exceptions to a PE to limit this to where the maintenance of a stock of goods, warehouse etc is itself of a preparatory or auxiliary character, and not an integral feature of the business in question.

11. If there is to be a change of definition then we urge OECD to introduce a number of further examples in the Commentary so that it will be clearer as to what sort of activities will be considered to be of a preparatory or auxiliary character.
A NEW NEXUS BASED ON SIGNIFICANT DIGITAL PRESENCE

12. We are not in favour of extending the PE definition to create a taxable presence because a business has a “significant digital presence”.

13. We are also not in favour of extending the PE definition to the other examples included in paragraph 217 under the heading Virtual Permanent Establishment.

CONSUMPTION TAX OPTION

14. The discussion draft identifies the opportunities presented by the digital economy to make significant sales, cross-border, without creating a taxable presence in the country of consumption.

15. The EU has adopted the 2003 OECD E-commerce guidelines in respect of sales from third countries into the EU but very few, only about 1,000 companies, have registered and account for VAT, and compliance and administration present very great difficulties.

16. The EU is changing its place of supply rules in relation to telecommunications, broadcasting and electronically supplied services within the EU from 1 January 2015 so that from that date the place of supply will be the country of the consumer rather than the producer. VAT is a tax on the value of the sales rather than tax on profit so this is a different taxation approach than direct taxation and we would not recommend it as an immediate option not least because of the difficulty of administering it in practice. But we believe the developments in the EU need to be kept under review by OECD to determine whether such a development may be capable of introduction on a wider geographical front.
APPENDIX 1

ICAEW TAX FACULTY’S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person’s tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax-tax-faculty/-/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)
Dear Sirs,

Base Erosion and Profit Shifting (BEPS) Action 1

Address the Tax Challenges of the Digital Economy

Informa plc welcomes the OECD’s request for input on BEPS Action 1, “Address the Tax Challenges of the Digital Economy” following the Public Discussion Draft issued on 24 March 2014.

Informa previously responded to the 22 November 2013 discussion document. Background information on the company is included as an appendix to this document.

We are pleased to provide input as follows:

1. The document specifically asks for comments on the following three areas:
   
   • Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules;
   
   • The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account;
   
   • The examples of new business models in the digital economy and whether (and if so which) other business models should be considered.
   
2. In our view, Parts II and III of the document provide good background information on the development and influence of information and communication technology, and how the “digital economy” has increasingly become the economy itself. The key features of the digital economy and its business models are identified and analysed well. These parts of the document illustrate that the “digital economy” has increasingly become simply “the economy”.

14 April 2014

OECD
BEPS Project
via e-mail: CTP.BEPS@oecd.org
3. The document also asks for comment on

- The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy;

- Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones.

4. Parts IV & V of the document illustrate that BEPS is a feature of mismatches and missing elements in the international tax system. Some multi-national enterprises that work in areas of the economy which have seen the greatest impact of digital technology may be well placed to take advantage of such mismatches and missing elements; however, none of the BEPS issues are exclusive to such companies. We are not aware of BEPS concerns that are specific to companies creating digital products.

5. Accordingly, the other actions contemplated by the BEPS project will thus address BEPS for digital and non-digital companies alike. We do not see any value in other measures beyond those identified for direct taxation. The current work on VAT/GST should also address BEPS concerns.

6. The document finally asks for comments around broader taxation challenges of the digital economy as follows:

- The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation;

- The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft;

- The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives;
• Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

7. Addressing the final bullet first, we agree the Ottawa taxation framework principles are the appropriate framework for analysing these tax challenges.

8. The broader challenges of the Digital Economy raised in Part VI of the paper would exist if the mismatches and missing elements of the current system were all eliminated. These challenges do not involve base erosion or profit shifting – they are a consequence of advances in technology.

9. We do not under-estimate these challenges, nor suggest they should not be tackled. However, in our view they open up profound questions of how taxation should operate in a world of largely digital commerce. These questions need to be discussed and debated outside the framework of the BEPS project.

10. What is not addressed in the document is the extent to which tax challenges are perceived to be greater in countries that have been somewhat slower to adopt digital technologies, and thus may have a lower level of “digital exports”. The document does not, in our view, sufficiently question whether the tax challenges of the digital economy could be more a matter of timing due to different rates of digital development rather than permanent changes to tax bases, and as digital exports become more evenly spread, the challenges may recede.

11. If the challenges are a “timing issue”, any adaptations to the international tax system that entrench the current differences between economies are likely to lead to issues persisting rather than being solved.

12. Part VII of the document sets out potential options to address the tax challenges raised by the digital economy. We propose these should be debated separately from the BEPS action points. None of these recommendations should be introduced under the BEPS umbrella, as they are not addressing profits of base erosion or profit shifting.
In relation to the specific proposals in Part VII we would make the following comments:

- An over-arching point we would make is that in our field in particular the move from traditional print based business to digital based business has not affected our core “mission” – we are still delivering information into the same markets, just in a more technologically advanced manner. From our perspective, the supply chain may have shortened, but the value in our product is still created prior to the point of delivery.

- We would thus find it surprising that moving from printed to digital delivery of the same product, used by the same customers in the same markets would lead to profoundly different tax results for us.

- The “New Nexus based on significant digital presence” represents a tax on an attributed profit based on revenue in a place of sale. This goes against the principle that value is created in where a product is created, not simply by a market for that product; it would represent a fundamental shift in the international tax system to adopt such an approach.

- Such a system would also be very complex to administer. It would substantially increase compliance costs for business through increasing the number of returns required and the complexity of attributing profit to various jurisdictions.

- The approach does also not fit well with a central concept of the BEPS project as a whole which is that value is created where significant people functions are located.

- This is particularly relevant if a digital presence is considered to be created from collecting data – data collection itself, however massive, does not create any value. Data only has value when analysed. Such analysis is done by people or by algorithms designed by people. The value is thus created where people analyse the data or where people created the analysis tools.
Three “virtual PE” models are described. The first is surely now rendered impractical by technologies that allow transactions to be made from multiple server locations. The second seems to be a restatement of the “New Nexus” concept and shares the same problems; and the third would seem to be a logical extension of current rules, but would be of limited application.

Another approach put forward is applying a withholding tax to digital transactions. This raises similar concerns to the “New Nexus” approach mentioned above. It marks a shift in taxation to where sales are made from where product is created.

Any withholding tax above a low single digit number is likely to result in double taxation. Under current principles a state where a product is created is unlikely to give enough double tax relief on profits on that product for a withholding tax on revenue from that product to be fully compensated. If greater credit for such withholding tax is given in future, producer states, where value has traditionally been considered to be created, will lose out.

If withholding tax results in double taxation, producers are likely to increase prices to compensate for this effect, with detrimental impact on the consumer economy.

A withholding tax also transfers the burden of compliance/payment from producer to consumer, with the difficulties noted in the document.

None of the options proposed address the question of increasing “digital exports” in those countries currently lagging behind. Such an increase is likely to reduce international tensions over taxation of the digital economy, and we would suggest the focus should be on increasing digital trade, and encouraging digital product to be developed in economies which have been slower to adapt.

14. We would broadly agree that the principal effective consumption tax option is to require non-resident suppliers to register and account for VAT in states of consumption. This process should be made as simple as possible.
15. There is one specific challenge of the digital economy which the document does not address. This is differential consumption tax rates on physical and digital versions of the same product.

16. In general, this is an area where governments potentially benefit from significantly increased tax revenues on the same product; effectively the reverse of base erosion.

17. We face specific challenges in our businesses when dealing with non-VAT registered consumers.

18. Consumers regard printed and digital versions of the same information as essentially the same product. Some digital products may contain features that cannot be present in print, and these may be valued by the consumer; but the premium they are prepared to pay is small (and may be non-existent).

19. The non-VAT registered consumer is focused on the price they pay – the pre VAT price is irrelevant to them.

20. We have therefore experienced the need to discount digital certain products where the consumers are non-VAT registered against the printed product price, so that the consumers pay broadly the same price.

21. The beneficiary of such discounts is the taxing authority, not the consumer. In the Digital Economy, the challenges are not confined to loss of tax revenues – governments are often gaining revenues from a shift from print to digital delivery.

We trust the OECD will find these comments helpful as it continues its work on BEPS Action Point 1.

Yours faithfully,

GLYN FULLELOVE

Group Tax Director, Informa plc

cc: Zoe Leung-Hubbard, UK Government HM Treasury – zoe.leung-hubbard@hmtreasury.gsi.gov.uk
APPENDIX

Information on Informa plc

Informa plc is a broad based, resilient business to business media group. We operate in three main areas; Global Events, which incorporates a range of face to face media businesses, including exhibitions, conferences and awards; Business Intelligence, which delivers high value proprietary content to a number of industries including healthcare, pharmaceuticals, financial services, maritime, commodities, telecoms and insurance and the legal profession; and Academic Publishing, which produces books and journals for the academic market, including university libraries.

We have over 6,000 employees in over 100 offices in 25 countries; we also run events and sell digital products in many more countries.

We pride ourselves on our digital expertise, which runs across all our businesses. The vast majority of our publishing products have now transitioned to digital platforms and approximately three-quarters of our publishing revenues are from digital product. In the Events business, we have seen social media becoming a powerful marketing tool, and have invested in technology used “within events”.

**We see our mission as Bringing Knowledge to Life:** Businesses, professionals and academics worldwide turn to Informa for unparalleled knowledge, up-to-the minute information and highly specialist skills and services. Our ability to deliver high quality knowledge and services through multiple media channels, in dynamic and rapidly changing environments, makes our offer unique and extremely valuable to individuals and organisations.
April 14, 2014

Tax Challenges of the Digital Economy
Comments by the Insurance Company Working Group on BEPS

1. Introduction and Summary of Comments

These comments are being submitted to the OECD by the Insurance Company Working Group on Base Erosion and Profit Shifting (BEPS), which consists of insurance companies conducting international business, in response to the OECD’s Public Discussion Draft, BEPS Action 1: Address the Tax Challenges of the Digital Economy (March 24, 2014).

Our comments on the Discussion Draft may be summarized as follows:

- We believe that it is important for the OECD to refrain from making any recommendations that are specific to the digital economy until all stakeholders can evaluate, at a future time, the effectiveness of the recommended measures developed in the course of the BEPS Project, as well as recommendations stemming from work currently being done on VAT/GST.

- We are concerned about the potential option of a new, alternative type of permanent establishment based on a “significant digital presence” in a jurisdiction. We do not see how this concept could be developed successfully, from either a theoretical perspective or a practical perspective.

- While acknowledging that VAT/GST measures may be appropriate for many types of businesses, we wish to highlight that VAT/GST is not an appropriate option for the insurance industry.

2. Need for future evaluation of the effectiveness of anti-BEPS measures

The Discussion Draft acknowledges that the tax issues related to the sale of digitized products and services by nonresident sellers are not essentially different from the tax issues arising from sales of physical goods and other transactions between nonresident providers and consumers located in a jurisdiction where the provider has no physical presence. Advances in information and communication technology have simply made direct interactions between providers and consumers in different jurisdictions more efficient, while enabling the delivery of a variety of products and services in digitized form through telecommunications. From an income tax perspective, therefore, the digital economy does not appear to raise new issues. Rather, it has raised the stakes regarding BEPS and the various elements of the existing international tax regime that permit BEPS to occur.
As suggested in Section V, paragraph 146, of the Discussion Draft, the overall aim of the BEPS Action Plan is to “ensure that, once the different measures are implemented in a coordinated manner, taxation is more aligned with where economic activities take place.” Indeed, all of Section V is devoted to a discussion of “how the work on the implementation of the BEPS Action Plan, as well as the work on consumption taxes, is expected to address” the BEPS concerns that are enlarged by key features of the digital economy such as mobility of functions, assets and people. The discussion covers measures designed to restore taxation in market jurisdictions, measures aimed at restoring taxation in both market and ultimate parent jurisdictions, measures that will restore taxation in the jurisdiction of the ultimate parent, and measures to address BEPS in the consumption tax area.

In paragraph 208 of the Discussion Draft, it is noted, appropriately, that “it is expected that as described in Section V, the development of the measures envisaged in the BEPS Action Plan will effectively address the BEPS concerns that arise in the digital economy.” Given this expectation, it seems clear that the OECD should not, at this stage, make any recommendations pursuant to Action 1, which relates only to the digital economy. Instead, all stakeholders should have the opportunity to evaluate the effectiveness of the measures implemented as a result of the BEPS project before any decision is made to develop recommendations that are specific to the digital economy.

3. “Significant digital presence”

The Discussion Draft discusses, as a potential option, an alternative standard of taxable nexus, namely that an enterprise engaged in fully dematerialized digital activities would be deemed to have a permanent establishment in a jurisdiction for tax purposes if the enterprise had a “significant digital presence” in the jurisdiction. Examples given in the Discussion Draft of what might give rise to such a presence include:

- The existence of a significant number of contracts for digital goods or services that were remotely signed between the enterprise and customers resident in the jurisdiction;
- Widespread consumption of digital goods or services of the enterprise within the jurisdiction;
- Substantial payments by customers resident in the jurisdiction for digital goods or services delivered as part of the enterprise’s core business;
- The performance of secondary functions such as marketing and consulting in the jurisdiction by a branch of the enterprise; and
- The enterprise’s use of personal data, obtained by systematic monitoring of internet users in the jurisdiction, to do a substantial amount of business.

There is no discernible principle of tax policy underpinning the idea that any of the above examples should give rise to a taxable presence of an enterprise that has no employees, agents, or
tangible assets in the jurisdiction. An enterprise selling physical goods to customers in a jurisdiction where the seller has no physical presence does not become taxable in the jurisdiction due to the existence of numerous remotely signed contracts with residents, or widespread consumption of the seller’s products in the jurisdiction, or the receipt of substantial sales revenue from residents, or the performance of secondary functions through a local branch, or the use of data obtained from residents. Why should there be a different result when the enterprise is selling digitized products rather than physical products?

In the insurance industry, streams of data flowing cross border are extremely common. In Europe, for example, it is normal business practice, sanctioned through the EU freedom of services directives, to allow an insurance business authorized by one member state to carry out its insurance activities throughout the European Union. The existence of a data flow from the country in which the risk is located to the country in which the insurance is being written should not create a new type of taxable presence.

It seems clear, therefore, that the threshold for a PE, particularly for our industry, will be further reduced if not effectively eliminated by the creation of a digital PE standard. Moreover, from a practical standpoint, a digital PE will be difficult to define in a way that will not lead to more, rather than less controversy.

In our view, the discussion of this idea in the Discussion Draft (paragraphs 212-217) is not persuasive from a policy standpoint. In addition to lacking any policy basis, it would most likely be very difficult to administer as a practical matter, both for taxpayers required to comply with it and for tax administrators attempting to implement it.

4. Consumption tax options

Given that established tax policy principles allow a foreign seller of physical goods to make an unlimited number of sales, free of income tax, to residents of a jurisdiction where the seller has no physical presence or dependent agent, it appears that for some industries, a consumption tax, rather than income tax, may be the appropriate area for the OECD to focus on in developing potential options for addressing tax challenges posed by the digital economy. We would note, however, that this would not represent an effective or practical option in the financial services context, in light of the extraordinary and widely recognized difficulty of disaggregating the services component of conventional financial transactions. For insurance companies specifically, the inability to pass through and completely recover VAT from the consumer of our products means that the insurance company will have to at least in part suffer the burden of the consumption tax.

We understand that work is ongoing within the OECD and elsewhere with regard to improving the administration of consumption taxes on cross-border transactions. We suggest that it would be appropriate to await the results of that work and evaluate any relevant recommendations that
may be made before proceeding to formulate specific options under Action 1 of the BEPS Action Plan.
7 April 2014

To: OECD Task Force on the Digital Economy
(sent via email to CTP.BEPS@oecd.org)

Dear Sir,

**BEPS Action 1: Address the challenges of the digital economy**

IHG welcomes the opportunity to submit comments on the OECD Discussion Draft on BEPS Action 1: Address the challenges of the digital economy ('The Discussion Draft').

IHG is a global organisation with a broad portfolio of nine hotel brands including InterContinental® Hotels & Resorts, Hotel Indigo®, Crowne Plaza® Hotels & Resorts, Holiday Inn® Hotels and Resorts, Holiday Inn Express®, Staybridge Suites®, Candlewood Suites®, EVEN™ Hotels and HUALUXE™ Hotels & Resorts. IHG franchises, leases, manages or owns almost 4,700 hotels and 687,000 guest rooms in nearly 100 countries and territories. Our primary franchise and management business involves providing a package of services and rights to enable third-party hotel owners to deliver hotel services which reflect the standards and character of the particular IHG brand concerned.

IHG would like to commend the Task Force on the Digital Economy (the "Task Force") on producing a thorough and useful summary of what it regards as the "digital economy" as well as the rapid evolution of Information and Communication Technology ("ICT") (essentially Parts II and III of the Discussion Draft). We respectfully note also that the Task Force acknowledges that further work will be required in this area, but that comments are also welcome at this stage to test opinion and potentially shape future decisions in this area.

With the above in mind, we make the following high level comments on the Discussion Draft:

- Firstly, comments have been requested as to whether it is possible to ring-fence the digital economy from the rest of the economy and, if not, whether specific types of digital transactions could be identified and addressed through specific rules.

- We agree with, and welcome, the findings of the Task Force (at paragraph 59) that it is practically impossible to ring-fence the digital economy. In our view there is not a discrete "digital economy" but rather just digital functionality which pervades all business models to a greater or lesser extent. Technology touches all aspects of modern business, whether that business takes the form of a traditional business (e.g. manufacturing) or a more modern one (e.g. delivering digital services). There is thus a continuous spectrum reflecting a greater or lesser role for digital functionality in driving profits of different business types rather than a determinable boundary line.
• We therefore believe the Task Force is right to exercise extreme caution rather than reaching an early conclusion that special measures which attempt to target the ‘digital economy’ are appropriate. Because there is no discrete boundary between businesses which have digital related activities as their core profit source, and businesses where digital activities may either play a cost centre function or a role in a lower margin peripheral profit function, we believe that any such special measures will almost certainly have an unintended and disproportionate impact outside their intended target area.

• We thus concur with the view of the Task Force (paragraph 208 refers) that digital economy challenges may well be sufficiently dealt with by the other actions of the BEPS project. Indeed, some of the BEPS actions will no doubt specifically consider and help address these challenges, most notably those actions that relate to transfer pricing and the definition of permanent establishments. Given the likelihood noted above of specific measures designed to target the ‘digital economy’ having an unintended and disproportionate effect on broader business, we agree with the conclusion of paragraph 208 that it should first be considered what is expected to be achieved by those actions and whether any additional action is needed. We note that the timetable for arriving at a conclusion in this respect will need to be adjusted so that the nature and expected impact of other relevant actions can first be assessed.

• We think it is essential that, if the review suggested in paragraph 208 concludes that additional measures are needed, then that review should clearly set out: (i) The nature and source of the concerns which remain; (ii) Why those concerns are not capable of being addressed by the other BEPS Actions; and (iii) What objectives those additional measures are designed to achieve. This will then give clear metrics against which to consider the necessity and appropriateness of any additional measures proposed. In our view it is particularly important to give clarity as to the reason for, and intended extent of, any re-allocation of taxing rights to customer jurisdictions —and to ensure that any measures have the effect of correcting misallocations rather than going beyond that and creating excessive allocations of taxing rights to customer jurisdictions.

• We are very doubtful that well targeted and practical measures of the types described in Part VII 3.2 to 3.4 could be designed because of the boundary issues discussed above and/or the impracticality of a withholding tax solution. We believe that digital or virtual permanent establishment solutions of the types suggested in 3.2 and 3.3 are also likely to result in a misallocation of excessive taxing rights to the customer jurisdiction if they are based off traditional net income principles —because a basis for calculation of net income is not available which takes into account the significant contribution to value creation made from outside the jurisdiction. If the objective is to allocate some additional taxing rights to the customer jurisdiction then we suggest consideration is given to a local revenue based self-assessment charge which is then creditable in the home jurisdiction. That of course assumes that an acceptable solution can first be found to difficulties of boundary definition.
• We favour the approach suggested in Part VII 3.1 of modifying the standard paragraph 4 Article 5 wording and commentary. In our view it is appropriate that this should make clear that an activity will only be excepted as being preparatory or auxiliary if it is preparatory or auxiliary when considered in the context of the particular business which it plays a role in. In our understanding that means that the activity must fit within one of the listed descriptions (carried out individually or together) but it must also be the case that, for the particular business model concerned, there are substantial additional functions or activities which need to be carried out outside the jurisdiction in order to secure a profit and that there is associated entrepreneurial risk involved in securing that profit rather than the local activity in itself giving a reasonable certainty of profit. We believe that this limited clarification is all that is needed rather than more substantive changes. We presume that this may in any case be dealt with under Action 7 rather than requiring specific ‘digital’ action.

• With regard to using VAT to address the challenges of the digital economy, we certainly recognise that VAT aspects may have a key role. However, we also note that VAT is not a complete solution in itself and therefore should not replace a properly imposed tax on profits. Likewise, careful consideration is needed to ensure that, to the extent VAT is used on digital flows, it is capable of being consistently applied, collected and enforced across territories, otherwise there is a significant risk that compliant businesses will be placed in a less competitive position than remote businesses that are non-compliant. We therefore agree that further work is required on many aspects of VAT as applied to the digital economy. We also agree that VAT should be levied in the place of consumption, and at the rate applicable to that place.

• Finally, IHG supports the Discussion Draft’s reference to the Ottawa Taxation Framework (from 1998) principles – neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility – as suitable principles upon which future tax policy should be decided upon.

We would be happy to provide additional explanation and comment whether within the forum of the proposed public consultation or otherwise.

Yours faithfully,

C.P. Garwood
Head of Group Tax
April 14, 2014

VIA E-MAIL

Mr. Pascal Saint-Amans
Director
Centre for Tax Policy & Administration
Organisation for Economic Co-operation and Development
2, rue André-Pascal
75016 Paris
France
CTP.BEPS@oecd.org

Re:  Comments on Discussion Draft on BEPS Action 1:  Tax Challenges of the Digital Economy

Dear Mr. Saint-Amans:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of about two dozen major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, mining, telecommunications, oilfield services, transportation, luxury goods, computer technology, energy, pharmaceuticals, heavy equipment, entertainment, software, beverages, automotive, IT systems, publishing, electronics, and advertising. The group’s purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

The Alliance appreciates the opportunity to provide input to the OECD and its Digital Economy Task Force with respect to the Discussion Draft on Tax Challenges of the Digital Economy (Discussion Draft) released on March 24, 2014. Our comments are set forth in Annex 1 to this letter.

As you know, the IAPT submitted comments on Action 1 of the July 2013 BEPS Action Plan on October 16, 2013, and we include copies of those comments as Annex 2 to this letter for reference.
In our comments, we identify our areas of support for and concern with the analysis put forth in the Discussion Draft. We address each of the options described in Chapter VII of the Discussion Draft, which we understand to be non-consensus options presented to the Task Force. As companies that operate in a variety of traditional businesses, but whose operations increasingly include activities that rely on information and communication technology, the members of the IAPT approach these options from the perspective of how these “potential options to address the broader challenges of the digital economy” could affect our businesses. Finally, we provide our views on the various issues on which the Task Force specifically requested comments.

Once again, the Alliance appreciates the opportunity to comment on this important element of the BEPS project and stands ready to respond to any questions or to provide further input as the work of the OECD on this item continues.

Sincerely yours on behalf of the Alliance,

Mary C. Bennett
Baker & McKenzie LLP
Counsel to the Alliance

Annex 1: Comments on the March 24, 2014 Discussion Draft
Annex 2: October 16, 2013 comments on Action Item 1 of the July 2013 BEPS Action Plan
ANNEX 1

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON MARCH 24, 2014 DISCUSSION DRAFT ON TAX CHALLENGES FOR THE DIGITAL ECONOMY

APRIL 14, 2014
IAPT Comments on the March 24, 2014 Discussion Draft on BEPS Action 1: Address the Tax Challenges of the Digital Economy

1. Introduction

1. The IAPT would like to commend the OECD’s Digital Economy Task Force on its thorough examination of the digital economy and its thoughtful analysis of the tax challenges and issues the digital economy presents. This type of careful, fact-based evaluation of the nature of a particular problem and implications of different ways of addressing it which is reflected in the March 24, 2014 Discussion Draft on the Tax Challenges of the Digital Economy (the Discussion Draft) is the hallmark of the OECD’s best working methods.

2. We are also pleased to note that there are a number of points on which we can express strong agreement with the Discussion Draft. These include the following:

   • That the Ottawa Taxation Framework Principles (i.e., neutrality; efficiency; certainty and simplicity; effectiveness and fairness; and flexibility) provide an appropriate framework for evaluating the options to address the tax challenges of the digital economy;
   • That it is not feasible or appropriate to try to ring-fence the digital economy from the rest of the economy and apply separate tax rules to it;
   • That digital economy business models frequently have parallels in traditional business models;
   • That tax structures used by digital companies are similar to those used by companies in more traditional businesses;
   • The work being done on many of the other BEPS Action Plan items will address most if not all of the concerns the Discussion Draft raises with respect to the digital economy; and
   • That it is appropriate to consider indirect taxation as a potential approach to deal with perceived under-taxation in market jurisdictions where there is no or very limited physical nexus.

3. We also have, however, certain concerns about various aspects of the Discussion Draft, on which we will comment in more detail below. These are centered around the following concerns:

   • That each of the options in Chapter VII presents serious challenges from the point of view of principle and administrability; and
   • That the description of digital economy activities inappropriately suggests routine noncompliance and understates the significance of people functions to the business models.
2. Comments on the Chapter VII Options

4. As noted above, the IAPT supports the general framework suggested for evaluating the options described in Chapter VII of the Discussion Draft. As companies that operate in a variety of traditional businesses, but whose operations increasingly include activities that rely on information and communication technology (ICT), the members of the IAPT approach these options from the perspective of how these “potential options to address the broader challenges of the digital economy” could affect our businesses. We see implications for our businesses in each of the options described, as outlined below.

2.1 Modifications to Article 5(4)

5. The OECD Model Tax Convention has included language, such as that currently found in Article 5(4), which excludes certain activities from permanent establishment (PE) status since it was first published over 50 years ago in 1963, reflecting what was already then established treaty practice among governments. Having PE exceptions for preparatory and auxiliary activities is a sensible mechanism to avoid triggering compliance obligations and revenue disputes with respect to operations that may be necessary to conduct business but do not typically reflect business drivers attracting material returns. Businesses across all sectors have relied on the Article 5(4) exceptions for decades, and the availability of those exceptions will continue to be important to them.

6. Complete elimination of Article 5(4) would severely affect normal business operations in many sectors and give rise to difficult and costly disputes about profit attribution based on the most minor incursions into the economy of a host jurisdiction, thereby creating a real chilling effect on cross-border trade. The effect on tax administrations would also be detrimental, as it would require them to devote resources to policing thousands (or more) new taxpayers with generally minimal (and potentially hard to calculate) revenue generation.

7. The elimination of paragraphs (a) – (d) of Article 5(4)\(^1\) would lead to difficult debates about whether the types of routine business operations listed in those paragraphs are “preparatory or auxiliary”

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\(^1\) Article 5(4)(a) – (d) currently provides that the following activities are deemed not to create a PE:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; [and]
in particular cases and are therefore eligible for a general exception for activities falling into that category. As noted by the Commentary on Article 5(4), “It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not.” For businesses across all sectors of the economy, the elimination of those subparagraphs would create substantial uncertainty and potential exposure, without commensurate benefits to the host jurisdictions. Indeed, the cost to host jurisdictions of having to devote resources to making these kinds of difficult determinations in what are frequently cases involving minimal taxable income should not be underestimated.

8. It should be noted that paragraphs (a) – (d) of Article 5(4) are already subject to the overall condition that carrying on a combination of the specified activities at a fixed place of business will be excepted from PE status only if the overall activity of that fixed place of business is of a preparatory or auxiliary character. Moreover, paragraph 27.1 of the Commentary on Article 5 already contains a rule against fragmenting complementary activities into separate locations in order to argue that each is excepted from PE status as preparatory or auxiliary. In other words, if host jurisdictions are concerned that foreign enterprises are using the Article 5(4) exceptions to carry on a number of activities in their country, whether or not at a single location, that go beyond preparatory and auxiliary activities but are said to fall within the exceptions, it is important to understand that the existing rules already provide sufficient weapons for those jurisdictions to use to assert that the line has been crossed and PE status has resulted. There is no need to create doubt about the status of every activity traditionally excepted by Article 5(4) to combat that type of problem.

9. If the OECD chose to maintain the availability of Article 5(4) exceptions but limit them to activities whose overall character is preparatory or auxiliary, it should provide further guidance on the Commentary’s concept that an activity is not preparatory or auxiliary if the activity “in itself forms an essential and significant part of the activity of the enterprise as a whole”. For example, is an activity like storage “essential” because it needs to be done to carry on a business, or “non-essential” because it can easily be, and often is, outsourced to a third party provider? Is an activity like delivery “significant” because it represents the entirety of an enterprise’s activity in a particular jurisdiction or because it attains certain volume levels, or “not significant” because it represents a small portion of the enterprise’s overall cost structure or can easily be, and often is, outsourced to a third party provider? These are issues that affect businesses operating in all sectors of the economy, and introduction of substantial new ambiguity about the tax treatment of these routine business operations through the need to make these kinds of determinations would be very detrimental to the day-to-day conduct of international trade.

10. We think the changes suggested by this option would create widespread uncertainty about whether PE’s exist for enterprises with relatively minor activities being conducted in a host country. The
changes would either have to apply to all business sectors, in which case their effects would be very far-reaching indeed, or would have to be limited to the digital economy sector, which would violate the stated goal of neutrality and introduce difficult and potentially arbitrary line-drawing. Alternatively, if the changed rules made it clear that PE’s did exist in the types of situations currently excepted by Article 5(4), we think it would often be difficult to determine how much of a foreign enterprise’s profits were attributable to those types of activities. This is especially true because these activities are by their nature so frequently far removed from the real drivers of the business. We are concerned that the perception that creating PE’s out of these activities would somehow solve a BEPS revenue problem would tend to encourage tax administrations to attribute more profits to these activities than a true evaluation of their functions, assets, and risks could justify, leading to contentious disputes.

2.2 A New Nexus based on Significant Digital Presence

11. As an initial point, we note that this proposal appears contrary to the Task Force’s conclusion that “Attempting 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.” This proposal clearly seems aimed at crafting a separate rule for a particular “digital” economy situation, and we think it is ill-advised on that ground alone.

12. Moreover, the concept of “fully dematerialized digital activities” appears to reflect the bias that enterprises in the digital economy do not conduct significant people functions. For example, it is difficult to conceive of a business that matches the description: “No physical elements or activities are involved in the value chain other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialization of location-relevant data.” The reality is that even so-called “pureplay” internet businesses typically have substantial workforces engaged in constant innovation, programming, research, marketing, customer service, etc. If the cited description was intended to refer to the activities of an entire enterprise, it reflects a misunderstanding of how business is conducted in the current business models and what functions, assets, and risks are important to the value chain. On the other hand, if it was intended to refer only to an enterprise’s activities in any one of the many jurisdictions from which it might be receiving revenues, it could sweep in all kinds of business models from a wide variety of sectors.

13. Depending on how many of the other factors for identifying “fully dematerialized digital activities” are taken into account, the concept could also sweep in a very wide range of businesses. For example, one can imagine a great number of businesses about which it could be said:

- “Contracts are concluded exclusively remotely via the Internet or by telephone”;
- “Payments are made solely through credit cards or other electronic payments using on-line forms or platforms linked or integrated to the relative websites”; or
- “The legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices”.

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14. In other words, the concept of “fully dematerialized digital activities” is either so narrow as to be non-existent or potentially extremely broad.

15. The uncertainty created by the scope of that concept is compounded by the definition of “significant digital presence”, which would include elements now common to the operations of businesses in a wide range of sectors, such as:

- “A significant number of contracts for the provision of fully dematerialized digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country”;
- “Digital goods or services of the enterprise are widely used or consumed in the country”;
- “Substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise’s core business”; or
- “An existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise.”

16. In effect, the concept of a “significant digital presence” is so broadly drafted that it could effectively cause many businesses to have new PEs in jurisdictions all over the world, merely because they have customers there. The alternative definition for a “significant digital presence” (i.e., “an enterprise engaged in a fully dematerialized digital activity does a significant business in the country using personal data obtained by regular and systematic monitoring of Internet users in that country through the use of multi-sided business models”) is vague and unworkable. For example, what does it mean to “do a significant business in the country”? 

17. As noted in the discussion draft, changing the PE definition to adopt these concepts would require a fundamental re-thinking of the current principles on PE profit attribution (which are highly dependent on the location of “significant people functions”), as well as a determination of whether any such revised PE profit attribution concepts would apply only to this particular category of enterprise or to all international business. We note that it took twelve years (from 1998 to 2010) for the OECD to complete its project of laying out the principles for the attribution of profits to permanent establishments, which were grounded in an analogy to existing guidance on the arm’s length principle found in the OECD’s Transfer Pricing Guidelines. It is difficult to see how a fair application of those principles would generate much revenue for a jurisdiction that chose to change its PE definition to incorporate this proposal from Chapter VII. On the other hand, the idea of throwing those principles out the window just four years after they were finalized and trying to get international consensus on a wholly new approach is extremely worrisome to business, which cannot operate successfully without some stability and predictability in the rules that will apply to them and some guarantee that widespread disputes and/or double taxation can be avoided.
2.3 Virtual Permanent Establishment

18. The “virtual fixed place of business PE”, which would create a permanent establishment when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website, would render the PE threshold almost meaningless for a very wide swath of businesses and would similarly raise questions about the need for a fundamental revision of PE profit attribution principles.

19. The “virtual agency PE”, which would seek to extend the existing dependent agent PE concept to circumstances in which contracts are habitually concluded on behalf of an enterprise with persons located in the jurisdiction through technological means, rather than through a person, would do the same.

20. The “on-site business presence PE”, which would look at the economic presence of an enterprise within a jurisdiction in circumstances in which the foreign enterprise provides on-site services or other business interface at the customer’s location, has already been addressed through the OECD’s work on the services PE alternative, which would allow countries that wish to include a services PE definition in their treaties to do so in accordance with the well-developed guidelines set out in the Commentary on Article 5. There does not seem to be any need to revisit that topic so soon after the relevant work was completed (2008) to come up with some new approach for the digital economy.

2.4 Creation of a Withholding Tax on Digital Transactions

21. Imposing a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider would fundamentally violate the neutrality principle by treating transactions in digital goods or services different from transactions in comparable non-digital goods or services. It could also raise difficult definitional issues as to what is and is not “digital” (e.g., is a lawyer’s opinion a “digital” service if it is delivered by e-mail, but not if it is printed and mailed or couriered to a client? Is software or music a “digital” product if it is downloaded, but not if it is provided to a customer on a CD?).

22. Equally problematically, it could lead to systematic over-taxing of the digital sector if the withholding tax exceeds what would be the tax on net profits. This would clearly violate the neutrality objective which was central to the Ottawa Taxation Framework Principles.

23. As noted in the Discussion Draft, it would also raise issues about compliance with trade obligations as well as enforceability issues, especially in B2C transactions. There is a reason that countries legitimately avoid enacting tax laws that have little chance of being enforceable. Adopting rules that are unenforceable risks undermining respect for the tax system. It implicitly favors noncompliant over compliant taxpayers and erodes the latter’s commitment to adherence with the rules.

2.5 Consumption Tax Options

24. As a general matter, the IAPT supports the idea of addressing issues of market jurisdiction non-taxation, if necessary, through consumption tax options. If there is a concern that market
jurisdictions are unable to obtain a desired amount of revenue from digital providers due to the latter’s lack of taxable nexus with those jurisdictions, the proper solution would be to impose a consumption tax on those transactions, rather than to distort income tax principles.

25. Regarding the issue of exemptions for imports of low valued goods, we acknowledge that this is an issue worth considering in the interest of providing a level playing field. We note, however, that it is not an issue limited to the digital economy.

26. Moreover, we would stress the need for streamlined, simplified registration and compliance procedures for a nonresident supplier if a system of collecting consumption taxes on such transactions is to be workable. We should also note that while this may be achievable in some regions, we have some doubts that adequately simplified procedures can be developed to make such approaches acceptable on a global basis.

27. Regarding the issue of subjecting remote digital supplies to consumers to indirect taxation, our comments are similar.

3. Comments on Specific Issues Identified by the Digital Economy Task Force

28. In this final section, we provide our comments on the issues specifically identified in the Discussion Draft as ones on which the Task Force was seeking comments.

3.1 Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules

29. As indicated above, it is our view that digital transactions pervade all business sectors, and that it is not feasible to ring-fence the digital economy. Accordingly, we would discourage any effort to prescribe specific rules for specific types of digital transactions.

3.2 The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account

30. On this topic, our main concern, which is alluded to above, is that the description of the digital economy tends to understate the significance of people functions in the conduct of a successful digital business. We believe this tends to distort the understanding that is conveyed of the nature of the value chain of that type of business, and where the business drivers in the nature of assets and activities can actually be found.

3.3 The examples of new business models in the digital economy and whether (and if so which) other business models should be considered

31. We believe the Task Force has done a good job of covering all the relevant business models in operation at this time.
3.4 The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy

32. It is our impression that the main issues of concern seem to involve stateless income and non-taxation in market jurisdictions, and we believe that the OECD’s work under other BEPS Action Plan items, as well as its indirect taxation work, will adequately address any BEPS concerns arising from those issues.

3.5 Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones

33. We do not have further measures to suggest, as it is our firm view that the work which is already slated to be done under the other BEPS Action Plan items and through the OECD’s indirect taxation activities will provide solutions to the BEPS concerns in the digital economy.

3.6 The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation;

34. On the issue of nexus, we believe the Discussion Draft may reinforce the misimpression that market jurisdictions are losing significant revenue from lack of nexus. In our view, deeming nexus to exist based on the level of presence that there is in many market jurisdictions would not have the result of attributing significant profits to those jurisdictions, at least in the absence of a fundamental redesign of the principles for attributing profits to PE’s.

35. Regarding data, we support the Task Force’s conclusion that raw data has little value, and that it is the work done to collect, analyze, and exploit the data that is the value driver.

36. With respect to the challenges posed by characterization of income from transactions, we support the work done by the Treaty Characterization TAG several years ago. We believe the principles developed there are still relevant for purposes of addressing characterization issues arising from the current business models.

37. Regarding VAT challenges, we acknowledge the need for a solution to VAT leakage in remote B2C supplies and commend the OECD’s efforts to work towards such a solution.

3.7 The options to address these broader tax challenges discussed by the Task Force and summarized in the Discussion Draft

38. We have laid out our views on those options in section 2 of this submission.

3.8 The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternative

39. The cost of compliance, along with enforceability, should be very relevant criteria, in line with the Ottawa principles. We would note that unduly costly procedures will operate as a clear barrier to
entry for smaller businesses, which will be contrary to the growth interests of many governments. It is also worth pointing out that a significant cost of compliance can arise from the uncertainty and disputes that can be the result of the introduction of untested concepts around which there is no consensus or only a fragile one.

3.9 Whether the Ottawa taxation framework principles identified above are an appropriate framework for analyzing options to address the tax challenges, and whether and how they should be supplemented.

40. As indicated above, in our view they still remain valid today.
ANNEX 2

INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

COMMENTS ON ACTION ITEM 1 OF THE JULY 19, 2013 BEPS ACTION PLAN

OCTOBER 16, 2013
IAPT Comments on BEPS Action #1 (Address the tax challenges of the digital economy)

**ACTION 1**

**Address the tax challenges of the digital economy**

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.

Action 1 of the Action Plan indicates that “tax challenges” relating to the “digital economy” will be identified and studied as part of the OECD / G20 BEPS project. This Action differs from the others in that it contemplates an initial period of study and analysis that is to conclude with the identification of “detailed options” for consideration, rather than with specific proposed changes or recommendations. The IAPT believes that this two-step approach reflects a wise recognition by OECD and G20 tax policymakers that the digital economy issues are of a nature and scope that require additional analysis and consideration.

We appreciate that it is the prerogative of tax policymakers to revisit and reconsider current rules and policies and that there is currently political pressure in a number of jurisdictions to do so particularly with respect to what has been called the “digital economy.” However, the issues noted for examination in Action 1—the lack of nexus under current rules based on “digital presence” alone, the “attribution of value” created by the generation of certain types of data, the characterization and source of income from new business models, and the consumption taxation of cross-border supplies of digital goods and services—raise a series of difficult factual, tax policy, and administration issues that are worthy of careful analysis and consideration. They also seem different in nature from the base erosion and profit shifting issues addressed elsewhere in the Action Plan. It is, therefore, particularly welcome that the Action Plan resists the temptation to propose immediate actions that could involve major changes to current treaty and domestic law principles and provides at least some opportunity for development of a deeper understanding of current business models and a more deliberative consideration of these issues.
IAPT member companies generally have subsidiaries, branches, or other physical operations in most or all of our market jurisdictions. However, we are concerned that the work on the digital economy could have broad negative implications for international business and for international trade and investment in the jurisdictions where we reside and operate. We summarize these concerns below in the interest of avoiding consequences that may not be intended or appropriate.

- **A Clear Definition of the “Digital Economy” Would Be Essential If It Were Subjected to Special Rules, but Difficult to Establish**

Defining clear and administrable criteria to identify “digital economy” enterprises to which a special set of rules would apply would be essential for tax administration and compliance purposes. However, the Action Plan itself suggests that this would prove conceptually and administratively difficult. On the one hand, the Action Plan refers to companies with a “significant digital presence” but no nexus in the market jurisdiction under current tax rules, which would include a very small subset of the international business community, if “nexus” here is meant to include the taxable presence of separate affiliated entities established in such jurisdictions. On the other hand, as used in the Action Plan, a “digital presence” appears to refer to any data, website, or electronic service that a customer may access from a nonresident enterprise resident in another jurisdiction, which could reach every international business. The continuing changes in business models and technologies increase the inherent difficulty of reaching and delineating a clear consensus on even a narrow definition of the digital economy and make it more likely that any effort to do so at this point would unintentionally sweep in other businesses that are increasingly using the same technologies.

Under a broad interpretation, an enterprise that manufactures tangible goods in one jurisdiction and sources materials for these goods in another jurisdiction through online interfaces might be considered to have a digital presence in that other jurisdiction. So might an educational enterprise in one jurisdiction that posts a banner advertisement soliciting students on a website visible from another jurisdiction, or a medical center in one jurisdiction that outsources the review of electronic patient records to a service provider in another jurisdiction. In other words, a focus on digital presence alone could reach far beyond the oft-cited examples of the online retailer or the Australian mining company selling ore to customers in China over the internet. Even if narrowed to apply only to sales of goods or services which are contracted for electronically, special rules based on digital presence could apply to companies in business sectors as diverse as automotive, consumer products, telecommunications, mining, electronics, telecommunications, aerospace, beverages, chemicals, defense, IT systems, publishing, retail, software, computer technology, energy, pharmaceuticals, media, and consulting.

Action 1 also undertakes to address “new business models” in the digital economy context. This could likewise reach an even wider spectrum of businesses, especially if the focus is on novel ways of doing business even in the absence of a “significant” market presence.
We would suggest, therefore, that if special rules are considered for the “digital economy”, it will be critical to define their scope very carefully to avoid overbroad or inconsistent application or interpretations that could turn an intended exception into the general rule.

- **Sector-Specific Rules Should Be Considered With Great Caution**

Regardless of how the affected business sector is defined, sector-specific changes to fundamental international tax principles would be a rare departure from international practice that could raise potentially serious administrative and policy issues. They should, therefore, be considered very carefully.

As the above examples indicate, there is a risk that most if not all businesses could have some portion of their operations viewed as digital economy operations. The application of two different taxation frameworks to a single company in such cases would raise obvious bifurcation issues for both tax administrators and taxpayers that would surely create new uncertainty and controversy. This is especially so, given the difficulty of applying new and untested standards for what does and does not constitute being part of the digital economy. Even if digital economy measures were very narrowly targeted, tax administrations called upon to audit, determine, and collect tax from an enterprise which has no physical presence in their taxing jurisdiction would encounter unprecedented practical hurdles.

Special digital economy rules that create new nexus or other income taxation rights could also present policy challenges for jurisdictions that wish to preserve their rights to impose tax on other income on existing residence or source grounds. In their broadest reading, the key issues identified for discussion in Action 1 are whether tax should be imposed solely on the basis of the location of the customer or market even in the absence of personnel or assets of the nonresident enterprise, and whether expanded consumption or other gross-basis taxation, with its potential tariff-like nature, should be imposed on cross-border deliveries of goods or services.

The arguments suggested by the Action Plan in support of special digital economy rules closely echo those advanced by some jurisdictions, particularly some emerging economies, for significantly expanded taxation in their jurisdictions. Both sets of arguments reject the economic “creation of wealth” analysis on which the current international balance between source and residence taxation is based and seek instead to allocate taxing jurisdiction based on factors relating to the market, such as location savings, other location-specific advantages, or even the mere existence of the market.

It is not clear how such arguments regarding the digital economy could be distinguished, either conceptually or politically, from the arguments advanced more broadly by jurisdictions seeking to redefine concepts of “value creation” to support general changes to the current source-residence balance. Jurisdictions that do not favor such a material change may, therefore, wish to weigh the potential collateral implications of arguments regarding the digital economy and of the association of these issues with the BEPS project.
A Fundamental Rethinking of the Principles for Attribution of Profits to PEs Would Be Required

As the Action Plan acknowledges, any movement towards abandoning the physical presence requirement for establishing taxing jurisdiction would require a fundamental rethinking of the principles for the attribution of profits to permanent establishments. These principles were very recently the subject of substantial work by the OECD, which places substantial emphasis on the location of “significant people functions” for attributing profits. In other contexts, including in its BEPS-related transfer pricing work, the OECD is also clearly emphasizing the contribution of people functions.

In contrast, a virtual PE concept would necessarily be divorced from the presence of labor and assets in a jurisdiction and would require a fundamental rethinking of the principles for attributing profits to a PE for affected businesses. Even where there is a physical presence that clearly gives rise to a PE in a country it is, of course, important not to apply an overbroad “force of attraction” approach to attribute profits to that PE if the profits are not sufficiently closely related to the activities carried on at the location of the physical presence. It would be conceptually more challenging but equally important to avoid the over-attribution of profits to a virtual PE. If the work on the digital economy should take the virtual PE path, careful consideration would need to be given to how profits could be attributed in a principled, consistent, and predictable manner.

We would note that any new profit attribution rules for virtual PEs would need to take into account and properly allocate start-up and other losses to any virtual PE found in the jurisdiction. These losses can be substantial, can arise before sales into the jurisdiction commence, and can extend over many years in some internet-enabled sectors.

Conclusion

Given all of these challenges, the IAPT agrees with the Action Plan’s statement that it will be important for tax policymakers to first gain a more complete understanding of internet-enabled technologies and business models to inform their judgments as they consider issues relating to the digital economy. We respectfully suggest that the most effective means of developing such an understanding within the very limited time available is through substantial, ongoing input from and dialogue with potentially affected sectors of the business community.

Finally, if the work on Action 1 results in the further consideration of separate and unique rules for the digital economy, we would urge that any options identified should be evaluated against their ability to provide certainty and clarity to taxpayers and to be applied in a principled and consistent manner by both taxpayers and tax administrations, and should apply with prospective effect only.
IBA Taxes Committee Comments on the OECD Public Discussion Draft

BEPS ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY

24 March 2014 – 14 April 2014

The IBA Taxes Committee Working Group (“the Group”) includes

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1. Introduction

As an introduction to the Group’s comments we wish to refer to the comments made by the same group which was filed with the OECD in December 2012. Therein we clearly demonstrate that most of the commercial activities carried out in the “digital economy” in reality are just different ways of using the new technology for more effective distribution. Furthermore, we would also like to reiterate a few of the initial comments made by the OECD in the Discussion Draft issued March 24, 2014, on page 6 and onwards, viz.

“Against this background, the BEPS Action Plan includes the following description of the work to be undertaken in relation to the digital economy:

ACTION 1 – Address the Tax Challenges of the Digital Economy

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Issues to be examined include, but are not limited to, the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules, the attribution of value created from the generation of marketable location relevant data through the use of digital products and services, the characterisation of income derived from new business models, the application of related source rules, and how to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services. Such work will require a thorough analysis of the various business models in this sector.
In particular, the Task Force discussed the outcomes of the 1998 Ottawa Ministerial Conference on Electronic Commerce where Ministers welcomed the 1998 CFA Report “Electronic Commerce: Taxation Framework Conditions” setting out the following taxation principles that should apply to electronic commerce.

Ottawa Taxation Framework Conditions – Principles

Neutral: Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency: Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and Simplicity: The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

Effectiveness and Fairness: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to the risks involved.

Flexibility: The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

“The Task Force considers that these principles are still relevant today and, supplemented as necessary, can constitute the basis to evaluate options to address the tax challenges of the digital economy. In addition, the Task Force discussed the post-Ottawa body of work and in particular the work of the Technical Advisory Group on Business Profits relating to the attribution of profits to permanent establishments, the place of effective management concept and treaty rules in the context of e-commerce. For an overview of this prior work, please refer to Annex 1.”

The above quotes have been included in the Groups comments as we believe that they are – in particular the 1998 Ottawa Taxation Framework – highly relevant in most of the tax areas, not only the digital economy. It is our firm opinion that neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility are all key elements for any business whether digital or “analogue”. The long term credibility of any system – legal, tax or other – must (still) rest on those factors. This is also our strongest argument in our previous comments as well as our comments in this document.
In the Discussion Draft subject to our below comments the OECD listed a number of bullet points – all in all 9 – which we will comment further upon below. To the extent possible we will keep our comments to the individual bullet point and any further comments we may have will be included in the final summary below.

2. The Group’s Summary

2.1 The Group still maintains that the risk is that special legislation for what is perceived as the “digital economy” will just put an extra strain and restriction on what is in reality just a different – modern - way of carrying out a traditional commercial activity. Only a minority of the “digital economy” is in reality something new and there is therefore no point in creating new rules. Also these activities should thus be covered by the existing rules, possibly as modified by other parts of the BEPS Action plan.

2.2 Furthermore, the Group is of the opinion that the Ottawa Taxation Framework is still highly relevant in order to secure a fair, neutral and foreseeable tax system applicable to all taxpayers.

2.3 Many of the recommendations proposed by the Task Force go hand-in-hand with other action plans such as Permanent Establishment (PE), Attribution of profits to PE, CFC etc. Therefore, there is a need for a synchronised approach.

3. The OECD Public Discussion Draft request comments on the following issues addressed in the discussion draft:

3.1 Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules;

3.1.1 The Group has in its comments made in December clearly responded to this question – based on our analysis and experience the fact is that most of the commercial activities carried out in what some refer to as the digital economy is primarily better and more efficient logistics. It entails both quicker and eco-friendlier methods of the distribution/shipment of products as well as – in many cases – more effective marketing and sales chains to the benefit of the customers. Those arguing for “ring-fencing” and special rules for the digital economy are in reality looking at very visible (e.g. Google) but still clearly just a small fraction of the digital world as such. The group is of the opinion that ring-fencing a larger group of commercial activities in order to address a perceived issue with a smaller group will risk to seriously harming the commercial activities now being developed with the help of the new technology as well as the global economy and the development.
3.1.2 Further, if ring-fencing in some way would be considered it is necessary to clearly identify exactly those situations where a commercial activity would be considered being part of the “digital economy” and possible special tax rules applicable for that activity, and also the safe harbour rules applicable to avoid such special taxation. In the opinion of the Group this is not something that can be done easily and definitely not something that can be achieved simply by modifying the OECD Guidelines.

3.1.3 The Discussion Draft raises the issue of whether an alternative would be to introduce “virtual permanent establishments” in the definition of the OECD Guidelines. What must be considered when looking at the PE-concept as such is that the current definition of permanent establishment is being aggressively tested by the tax authorities in a number of countries – OECD members as well as non-members – with the result that sales activities into a country by a foreign resident is in fact deemed to be a PE at a far earlier stage than envisaged before. Also here an introduction of a “virtual PE”-concept would require a very clear set of rules so as to avoid the normal commercial activities being caught in the virtual PE-net. Again, based on the experience of the Group this is a very difficult task and the risk that local tax authorities will tax the normal commercial activities using modern technology is in our opinion very high.

3.2 The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account;

3.2.1 The Group believes that the critical feature in the digital economy is the dramatically reduced costs of entry. Certain aspects of the digital economy (e.g. provision of hosting services) clearly are capital intensive, but the barriers to entry for a developer of digital media, applications or services are much lower than they were prior to the development of the digital economy. The costs of maintaining even massive quantities of data on a server and transferring large files are significantly lower than the costs of maintaining warehouses of products and shipping products to consumers.

3.2.2 The result of this shift is that most of the value in many digital businesses is in their intellectual property or other intangible assets. Distribution networks carry significantly less value than they did even 20 years ago, and far less physical presence is required in a country to effectively distribute goods to that country.
3.2.3 The reduced capital needs make it much easier for a sophisticated business to plan to minimize its taxes. Where it once may have been critical to maintain warehouses near customer locations, for instance, it may not be necessary to maintain servers close to customers, or even in the same country. In certain cases, such as streaming video or high-speed trading, network latency may dictate server location, but often there are no such restrictions and servers may be placed wherever a company wishes. For instance, a mail-order bookseller (or even an online bookseller that deals in physical books) might need to place a warehouse in Europe to serve its European customers, but a digital bookseller can maintain its master files on servers in a low-tax jurisdiction, with no physical presence anywhere near its customers.

3.2.4 This reduced barrier to entry also means that even small content developers are selling software and media globally. Traditionally international commerce was the near-exclusive domain of large businesses that had significant in-house tax capabilities, and hired sophisticated international tax advisers, to help them plan their operational structures and manage compliance. Such sophisticated organizations could manage complex rules and heavier compliance burdens, but creating tax rules with such organizations in mind could produce “traps for the unwary” that stifle the development of the small businesses that now represent a significant part of the digital economy. This is a particular issue in the case of a “virtual permanent establishment.”

3.2.5 Another significant change is a shift away from ownership of property to licensing. In the case of digital downloads, one often receives only a “license” to use the property that is revocable upon a number of circumstances, rather than receiving outright ownership of the property the way one would with, for instance, a hard-bound book. This model has been prevalent in the software industry, where even physical delivery of software on discs often is treated as a license only, rather than an outright sale. Many taxing jurisdictions historically have viewed these licenses as sufficiently ‘sale-like’ to justify treatment as a sale for tax purposes.

3.2.6 The current shift toward the “cloud” is another shift away from ownership of property. Rather than transfer physical goods, a customer pays for access to materials or software on a remote server, analogous to the “thin client” common in the early days of computing. The customer has no knowledge of where the server is based - and in some cases neither does the vendor. The customer may access the server from multiple different locations over the course of a contract. If the vendor is to be taxed based on the location of the customer, this tracking may prove especially complex. Some members of the Group, for instance, regularly travel internationally on business, and while traveling access cloud-based research services for which they have prepaid. In the Group’s view, conventions and presumptions are required regarding sourcing of services and locations of customers in order to facilitate tax administration.
3.2.7 In a virtual PE concept, scattered points of presence across countries may lead to multiple PEs and would aggravate the issue of attribution of profits and the need to allocate profits of a single trade across a number of jurisdictions. The problem would get further amplified since in many cases some parts of a business involved in a particular trade may not be visible or it may not be practically feasible to rationally allocate profits amongst various functions – whose significance for a business may vary from time to time.

3.3 The examples of new business models in the digital economy and whether (and if so which) other business models should be considered;

3.3.1 As noted above, the Group believes that what is referred to as the digital economy is in reality little more than improved logistics. As such the digital economy does not represent a new business model. Instead, is instead better viewed as an evolution of existing business models which takes advantage of the new tools that have become available. For example, a consumer in a particular country that is looking to purchase furniture has options beyond a local retail establishment or a mail order catalogue. Now, that consumer can also purchase furniture through the websites of numerous other furniture distributors. For other commercial goods, such as movies or books, the physical product now also has digital analogues that are widely available, further simplifying distribution. The same is true of many types of services.

3.3.2 Generally, the Group believes that the digital economy has been extremely positive for consumers and ought to be encouraged. The improved logistics that is the digital economy means that less capital is required to bring goods and services to consumers. This reduces the barriers to entry, increasing competition and reducing prices.

3.3.3 The Group also believes that tax authorities have had and continue to have the tools needed to properly tax the digital economy. Generally, income tax authorities in OECD jurisdictions look to align revenue with the assets and expenses that relate to the generation of this revenue. The Group continues to believe that this is the appropriate approach and that existing legislation generally is sufficient to carry out this approach to taxation. Indeed, it would be extremely difficult to develop new tax regimes specifically applicable to the digital economy without creating a tremendous amount of confusion and uncertainty. In addition, and consistent with observations made elsewhere in this document, the impact on newer, less well capitalized market participants would need to be kept to a minimum. The presence of these enterprises has generally been positive for consumers.
3.3.4 With that said, the Group believes that two areas of recent discussion are appropriate for continued development. The first relates to the development of consumer-related intangibles. It is now significantly easier to gather data on the preferences and habits of individual and groups of consumers. The value of this data, and the question of whether current income tax regimes adequately capture this, is unclear. While it is likely the case that existing tax regimes are sufficient, and there are significant concerns around the administrability of the alternative proposals currently being considered, this is a topic worthy of further analysis.

3.3.5 A second area that bears further discussion is the enhanced ability within the digital economy of suppliers to generate new sales from previously sold products. As one example, when a consumer purchases a digital product (e.g., an app), it is common for that product to have embedded within it the opportunity for the consumer to purchase additional products. These additional products might be upgrades or enhancements to the product originally purchased. Alternatively, these products might be suggested to the consumer based on that consumer’s activity within the product originally purchased. The Group believes there is a certain lack of clarity around the proper taxation of these subsequent sales and that some guidance would be appropriate. However, the Group notes that follow-on sales of add-ons, upgrades, and the like occur in the physical economy as well, and that while the digital economy facilitates follow-on sales, any rules should apply to follow-on sales in both the digital and physical economies. The Group would welcome the opportunity to participate in these discussions.

3.4 The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy;

3.4.1. The EU has taken significant steps to address issues in the digital economy. These show significant promise as a tool to address VAT/GST issues. These steps are reviewed below.

(a) The EU VAT system makes a distinction between supplies of goods and supplies of services. Generally speaking, in the framework of digital economy, telecommunications, broadcasting services and electronically supplied services do not involve transactions with tangible goods and are considered as supplies of services. The EU Directives establish that in B2C sales of goods, if the supplier is established in the EU, the supply is taxable at its place of establishment, whilst if it is domiciled outside the EU, the transaction is not taxable. Where non-EU established suppliers carry out B2C services transactions with customers domiciled in the EU, the service is taxable where the recipient is domiciled. In this latter case, an optional regime has been established so that non-EU entrepreneurs are VAT registered in only one
Member State, where they file VAT returns, including VAT charged corresponding to each specific MS in which they have customers domiciled (one-stop shop). These rules have led compliant non-EU entrepreneurs either to establish places of business in the EU (in the countries with lower tax rates) or, to a lesser extent, to make use of the one-stop shop system.

(b) As of January 2015, all services subject to VAT will be taxed in the jurisdiction of the recipient, regardless of the place of establishment of the supplier. The one-stop shop currently available for non-EU entrepreneurs will be extended for EU businesses so that a level playing field will be established.

(c) The Commission services have published explanatory notes on these new rules that can be found at:


3.4.2 The EU’s focus on the place of consumption, which makes the system more neutral and consistent, has promise, but it is unclear at this time whether the compliance burdens on the supplier are manageable and whether Member States can establish the necessary control systems. The possibility to involve third countries in the one-stop shop – so that non-EU entrepreneurs may pay EU VAT in their country of establishment - has been suggested and presents its merits in being further discussed but the system should be workable and fair collection of taxes guaranteed. The Group believes that the “one stop shop” rule is extremely helpful in managing compliance, but notes that it poses significant problems outside the EU, where there is no broad-based international agreement on how to tax or collect VAT – nor is there likely to be such an agreement in the near term.

3.4.3 There are other challenges that the EU has not yet clearly addressed, such as ensuring that an equal treatment is provided to supplies that are equivalent in nature regardless of the means in which they are supplied. For instance, some printed materials may be taxed at a reduced rate, whilst if supplied online, they are taxed at the general rate. In this latter context, the rules within the EU to “distance sales” (in a B2C context) are based on the principle of taxation at destination, to which the extension of the one-stop shop system should also be considered (today there is a need to register in the country where the goods are sold, to the extent that a certain threshold is exceeded) thus increasing the administrative burdens for the suppliers which need to be addressed. Similarly, exemptions on imports of small consignments may need to be revisited to avoid different taxation regimes on equivalent goods.
3.4.4 Given the distinctions between taxation of goods and services, it is critical that an indirect tax regime for digital economy clearly define whether a given supply is to be treated as that of ‘good’ or ‘service’. Unlike in some jurisdictions where the same unified tax regime is triggered in both scenarios, in many other countries such as India, in the absence of comprehensive GST regime, the taxing approach, authority and jurisdiction varies depending on whether a transaction is seen as that of a sale of good or provision of service. With the increased overlap between these laws, it is becoming common for both taxes to be charged on the same transaction. We are uncertain as to whether the better approach is to consistently tax goods and services, or to establish rules clearly and consistently establishing what are goods and what are services, but one approach or the other is necessary to avoid double taxation.

3.5 Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones;

3.5.1 The Group considers that the comments which are made under other sections in this document will also suffice as comments to this issue.

3.6 The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation;

3.6.1 The Task Force correctly observes that the digital economy generally does not create truly new challenges. Rather, the digital economy represents one aspect of a continuing shift of emphasis from capital to intellectual property. This shift means that assets are more mobile, and that without strong protections it is easy to shift income-producing assets from high-tax to low- or no-tax jurisdictions.

3.6.2 The Group notes, however, that the digital economy is far from the only aspect of this shift. For instance, a famous coffee chain recently was subject of intense public scrutiny in the UK over its showing a net loss despite very high turnover, partly as a result of its intellectual property licensing arrangements using low-tax jurisdictions as the licensors. The Group believes that it is dangerous to create a special set of rules for the digital economy, such as a "virtual PE".

3.6.3 Even apparently new developments such as “marketable location-based intangibles,” however, are merely a furtherance of “customer-based intangibles” that are present in the old “physical” economy, and that can be developed even in non-digital businesses. As such, the Group believes that it is inappropriate to create special rules specifically for the digital economy.
3.6.4 Instead, the Group recommends focusing on four existing tools: transfer pricing for transfers of intellectual property; controlled foreign company or related-party transfer rules; withholding taxes on payments made to foreign vendors, particularly when paired with treaty anti-abuse rules; and indirect taxes such as VAT/GST or sales taxes.

(a) Proper transfer pricing on transfers of intellectual property, taking into account projected value as well as risk, can create a significant financial disincentive to transferring intellectual property to a low- or no-tax jurisdiction, when all the work to develop the intellectual property is conducted in a high-tax jurisdiction.

(b) Transfer pricing rules are most effective when paired with a robust set of rules regarding transfers to related parties and transactions among controlled foreign companies. These rules serve to protect both the digital and the “physical” economy against potential tax abuses.

(c) Withholding taxes could serve to protect the financial interest of the “customer” country. Withholding taxes generally have been limited to royalties or lease payments, but countries may wish to impose withholding taxes on payments for services, perhaps by changing the source rule to the location of the customer. This obviously raises some significant issues, and if not carefully designed such a withholding rule could shift too much of the revenue from the producer to the consumer country. Additionally, in order to work such a withholding rule would need to include presumptions (such as defining the location of the customer as the customer’s primary residence or place of business), and would need to be managed by financial institutions to ensure compliance. To the extent that withholding is reduced or eliminated by applicable treaties, the treaties should include rules protecting against abuses, such as “conduit” payments.

(d) In our view, though, VAT/GST and similar taxes likely are a better way to protect the financial interests of the “consumer” country. The Group acknowledges that consumers often add value in the digital economy in a way that they do not in other areas (such as with social media, or social media-type functions such as “recommendation engines” at digital media sites). VAT/GST has the advantage of naturally being tied to the consumer’s location. The Working Group expressed concern that compliance may be “voluntary” in the case of a non-resident supplier, but in our experience companies that are made aware of VAT/GST compliance obligations will take reasonable steps to comply – particularly given that their obligations and tax liability are far more certain than they would be in a “virtual PE” or “digital nexus” situation.

3.7 The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft;
3.7.1 As noted above, the Group appreciates the Task Force’s focus on anti-avoidance rules of general application, and believes that approach is vastly preferable to creating special rules for the digital economy.

3.7.2 The Group is particularly concerned with “virtual permanent establishment” and its variations, for several reasons. We are concerned that such rules may be administrable. Even if the rules are theoretically administrable, and compliance is possible for large concerns, we are concerned that the compliance costs could be overwhelming for small businesses and push them out of the marketplace.

3.7.3 The Group believes that creating special rules for a “dematerialised business” will involve significant degree of subjectivity, and is more likely to be observed in the breach, particularly among small companies. Whatever noncompliance risks exist in the VAT/GST is amplified significantly in the direct tax context, particularly when “significance” or “substance” tests are applied. The Group believes that a wiser course would be to focus on a more robust VAT/GST.

3.7.4 A withholding tax on digital transactions holds more promise, as long as responsibility is, as suggested, with financial institutions, rather than consumers. However, as discussed above, we have some concern that a withholding tax could shift too much of the tax revenue from the producer to the consumer jurisdiction.

3.8 The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives;

3.8.1 The Group’s concern is that the current focus is on what in reality is just a small group of financially very successful commercial activities, and that special rules will be introduced affecting a large number of smaller enterprises where the use of modern technology makes it possible to carry out business effectively and globally. Whether new tax rules or modification of e.g. the rules on permanent establishment it can be assumed that the cost of compliance will simply be too high, in particular also taking into account the draconian penalties applied in many countries for non-compliance, whether intended or not.

3.8.2 One of the magics of the new technologies is that a very small company that historically only had a few local customers by applying the new technologies can create a global market. There are many examples – but one is Pebble, a recent Kick-starter success which would not exist had a few entrepreneurs not used all of the available modern technologies for developing, manufacturing and marketing a “smart-watch”. Had special rules and virtual PE been in place it is very likely that such companies would not have made it. The
cost of operating in a global economy where each country suddenly can claim reporting — including verified allocation of profits - is simply unacceptable to a normal – small or midsized company. Combining this with the normal cost of compliance what is perceived as the “digital economy” is likely to be something only for the very large and financially strong companies.

3.9 Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

3.9.1 The Ottawa taxation framework principles were discussed and set out in 1998 as the basis to evaluate the tax challenges of the digital economy. Those principles are sufficiently broad and comprehensive to be the basis for the substantial amendments to be implemented in the digital economy and e-commerce tax framework.

3.9.2 In the last decade, the use of e-commerce, and information and communication technologies generally, has evolved substantially, giving rise to a significant number of new business models. In spite of these changes, however, the Ottawa principles are fully applicable and are still a valid framework to evaluate the challenges of the digital economy and e-commerce in the new century.

3.9.3 However, in our opinion, as set out in the BEPS action plan, the challenges of the digital economy must be addressed taking a holistic approach, considering both direct and indirect tax matters in a coherent and integrated manner. Although this principle may implicitly stem from the Ottawa principles, we believe that a specific mention is worth considering.
Dear Sir/Madam

Thank you for inviting comments on OECD Discussion Draft on BEPS Action 1. We appreciate the opportunity to provide input into options for addressing the tax challenges of the digital economy.

The International Underwriting Association of London (IUA) represents international and wholesale insurance and reinsurance companies operating in or through London. Its purpose is to promote and enhance the business environment for its members. We estimate that premium income for the London company market in 2012 was £24.225bn.

General comments

We agree with the view that the digital economy should not be treated as a separate sector with its own tax rules. We also support the position in the paper that any issues raised by digital transactions should be dealt with under the other relevant 14 BEPS actions. The insurance industry is one which relies heavily on developments in information and communication technology to create value and generate operational efficiencies. As examples, big data is used in the design of new insurance products, in insurance risk modelling for actuarial pricing and reserving and in claims management systems, but that does not in itself appear to raise new issues for income tax.

We agree with the key features of the digital economy identified in paragraph 91 and see mobility and reliance on data as particularly relevant to the global insurance industry. Developments in the digital economy allow global insurers to interact more easily and more frequently with their worldwide customers and brokers and also within their own worldwide group through digital means, such as websites and applications, in addition to through a physical presence. Broadly defined, all businesses are now digital in one way or another.

Chapter V of the draft discusses how work on the various actions of the BEPS Action Plan will address BEPS issues arising in the digital economy. The measures discussed are intended to restore taxation in the market jurisdiction and in the ultimate parent jurisdiction. We do not see that developments in the digital economy change the basic principles that taxation should be aligned with where economic activities take place and where value is created and that the allocation of income
within a global group should be in line with the relative value created in each location.

The analysis of where economic activity takes place is made more difficult by the increasing tendency for the individual members of a global workforce to travel frequently, across tax jurisdictions, while continuing to carry on their locally-based role through digital means such as laptop or mobile telephone. Measures to prevent artificial avoidance should take account of such travel, particularly where it is ad hoc and not in connection with artificial avoidance.

Chapter VI of the draft considers broader tax challenges of the digital economy. For the general insurance industry, the flexibility to choose where substantial business activities take place or to move existing functions to a new location removed both from the ultimate market jurisdiction and from the location of other business functions is a relevant business issue. Decisions on location are typically driven by regulatory and cost considerations. We consider it important that the issues of nexus and data be considered in this context.

Given all of the above, we believe it is important for the OECD not to make specific recommendations on the digital economy until other measures in the BEPS project have been evaluated.

Specific options

Indirect taxes

The comment is made at paragraph 210 that, while certain options are framed as modifications of income tax rules, they could also be reframed as indirect taxes. We would ask you to keep in mind that VAT is intended to be a tax on the consumption of goods and services and not the businesses that supply them. In the context of BEPS and the digital economy, we consider that dealing with areas of imbalance in current tax legislation such as this would be helpful alongside tackling areas of perceived abuse.

Consumption taxes proposed in paragraphs 219 to 224 would require non-resident suppliers to register and account for VAT in the state of consumption (similar to US “use tax”). That would require a fundamental change to the framework for indirect taxes. Given the work being conducted by the EU on place of supply rules and changes to those relating to electronic and telecommunications from 2015, we recommend that indirect taxes should be considered in the context of those changes.

Exemptions from PE status

We consider it important to maintain an exemption for the activities described in Article 5(4) of the Model Convention. The suggestion in paragraph 211 that some of these activities could constitute core functions of a business should be considered as part of Action 7 (Artificial Avoidance of PE Status). If the preparatory or auxiliary exemption is to be eliminated, it should only be for enterprises whose primary source of income is one of the other Article 5(4) activities. We support the policy that businesses should be subject to tax in the jurisdictions where their core functions take place. However, in the mobile, digitally enabled business world of today, it is important that a practical, clearly understood threshold of activity should be regarded as not constituting the activities of a PE.
**Significant digital presence**

The suggestion in paragraph 212 for a new nexus for significant digital presence appears to contradict the view in paragraph 205 that ring-fencing the digital economy as a separate sector is neither appropriate nor feasible. There is no discernible principle of tax policy underpinning the idea that any of the examples of significant digital presence in the draft should give rise to a taxable presence of an enterprise that has no employees, agents, or tangible assets in the jurisdiction. For example in Europe, it is normal business practice, as laid out in EU directives, to permit an insurance business authorised by one member state to carry out insurance activities throughout the EU under the rules on the freedom to provide services. It is accepted that operating on a freedom of services basis in this manner should not generally create a taxable presence in the jurisdiction where the insurance risk is located. The existence of a data flow from the country in which the risk is located to the country in which the insurance is written should not create a new type of taxable presence.

It seems clear that the threshold for a PE, particularly for the insurance industry, will be further reduced, if not effectively eliminated, by the creation of a digital PE standard and we do not see that that has a persuasive policy basis.

**Conclusion**

We note that the issues raised in this discussion draft are being addressed by the other BEPS Actions and we welcome that. As there is a strong view that the digital economy should not be considered a separate economy, we recommend that the options which emerge as a result of this consultation process be dealt with as an integral part of those other BEPS Actions. This document could then serve as the technical analysis supporting the view that the digital economy is an integral part of the wider economy.

We hope you will find this submission helpful and would be happy to provide you with further comments.

Yours faithfully

W. J. Lowe

Nick Lowe
Director of Government Affairs
Irish Tax Institute

Response to OECD Discussion Draft: Address the Tax Challenges of the Digital Economy

April 2014
About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland’s AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.
The Irish Tax Institute welcomes the opportunity to contribute to the debate on BEPS Action 1 – Addressing the Tax Challenges of the Digital Economy.

This particular Discussion Draft is a comprehensive paper that outlines the OECD’s research into:

- The Definition of the Digital Economy;
- Ways in which base erosion and profit shifting can arise within a digital economy;
- How the wider BEPS Actions will address problems arising in the digital economy;
- The broader challenges associated specifically with the digital economy; and
- Options to address these broader challenges.

The “digital economy” is a source of opportunity

Businesses make enormous capital and human investment every year in digitizing their business. Such advances in technology and developments in the digitisation of the overall economy provide tremendous opportunities for development and growth for OECD countries. In reviewing the tax framework for businesses operating within the digital economy, it is important to recognise the huge potential for expansion and ensure that measures taken do not create unnecessary barriers or complexity which could restrict this development.

The difficulty of defining the “digital economy”

The challenge of defining the “digital economy” occupies half of the entire 68 page analysis within this Discussion Draft document – what does the term “digital economy” actually mean?

Unless we can clearly define what the digital economy means, it is very difficult to see how the OECD can seek to apply separate and specific rules to it e.g. do the rules apply only to businesses supplying certain types of digital goods and services; do they apply to businesses carrying out their activities through certain digital means and media etc?

It is acknowledged in the Discussion Draft itself that it is difficult, if not impossible, to isolate a separate digital economy, given than digital business is now fundamentally embedded into business generally.

Paragraph 59 of the Discussion Draft concludes that:

“As digital technology is adopted across the economy, segmenting the digital economy is increasingly difficult. In other words, 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. Attempting 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.”
The difficulty of trying to separately deal with the digital economy has also been recognised by the Irish government in our Minister for Finance’s recent comments on the Discussion Draft:

“The digital economy is not a specific sector of the economy anymore rather the whole economy is becoming digitised”.

And the European Commission’s paper\(^1\) published by the Expert Group on the Digital Economy states:

“Because of the ever-changing technologies of the ICT sector and because of the widespread diffusion of the digital economy within the whole economy, it can no longer be described as a separate part, or subset, of the mainstream economy…..Given that the digital business models are present in more and more sectors of the economy it is not possible to come up with the size of the digital economy as a percentage of GDP”.

The Commission’s paper also references the explosive growth in the Internet of Things, whereby:

“…nearly every aspect of human life and economic activity is being equipped with networked sensors and actuators that monitor the surrounding environment, report their status, receive instructions and even take action based on received information.”

If experts cannot even measure the size of the digital economy, then how can we separately tax it?

**Focus on the overall international tax framework**

The quest to segment the digital economy from the larger economy is fraught with difficulty and risk. Technology changes on a daily basis and a business that is not in the digital economy today, could be part of it in 3 or 6 months’ time under an arbitrary definition. Therefore the exercise of trying to ring-fence the digital economy is one that will require refinement and review on an almost continuous basis.

In our view, the efforts of the international community would be much better served by working together to reform the general rules and framework of international taxation, within which all businesses operate, including digital businesses. This is the overall goal of the BEPS project and one which the Irish government is firmly committed to.

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“Ireland welcomes the BEPS project and also the co-ordinated effort at OECD/G20 level to deal with the challenges BEPS poses.”

The broad range of Actions 2 – 15 in the BEPS Action Plan, deal with the fundamental principles of international taxation i.e. CFC rules, treaty abuse, permanent establishment, transfer pricing, mismatches etc. This Discussion Draft on Action 1 rightly highlights that the process of reforming these fundamental principles will itself change the way in which digital businesses are taxed.

These work streams in the Action Plan are focused on refining the approach of the current source based system of taxation for income taxes to achieve outcomes whereby the recognition of taxable profits is aligned with substance and activity. We consider this source based approach to be the correct one for income taxes and to be equally applicable to businesses which have limited physical presence in the market of the consumer.

We believe that the combination of a source based income tax system with the adoption of a destination based VAT or indirect tax system should adequately address concerns about base erosion in consumer markets. We believe that this combination of approaches builds on existing principles and provides a framework to support the evolution of and future growth potential for businesses participating in the digital economy.

The Irish Tax Institute believes that this focus on the overall tax framework is the correct way to approach the challenges of the digital economy. The BEPS Action Plan is due to be completed by the end of 2015 and is likely to represent the biggest reform to international tax rules in 70 years. Businesses will require time to adjust to this level of reform. The way that businesses operate will no doubt change as a result of this work and we believe that this process of change should be allowed to take place and the results reviewed before it is determined whether any additional actions are needed to address the tax challenges of the digital economy.

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Dear Sirs and Madams,

Comments on the "Public Discussion Draft of BEPS Action 1: Address the Tax Challenges of the Digital Economy"

We would like to thank you for the opportunity to provide comments on the Public Discussion Draft of BEPS Action 1: Address the Tax Challenges of the Digital Economy.

A. About Japan Association of New Economy ("JANE")

JANE is an organisation aimed at strengthening Japan's competitiveness through promoting the development of various new industries including the internet and e-business industries and encouraging innovation, entrepreneurship, and globalisation. The objectives of JANE also include promoting in-depth constructive discussions and contributing to an environmental maintenance, as well as a framework in Japan through policy suggestions regarding: actualisation of innovation and growth strategies in all industries that would make up the e-business as a core; actualisation of a fair competitive environment; increased participation of people in politics and more efficient administrative processes; and vitalisation
of regional communities. Membership of JANE as of 2 April 2014 is 621 (including 294 general members and 327 supporting members).

The current JANE Board of Directors members includes representatives from the following five companies in Japan:

Rakuten, Inc. is one of the world’s leading internet service companies, providing a variety of consumer and business-focused services including e-commerce, travel, banking, securities, credit card, e-money, e-book, portal & media, online marketing, and professional sports. Rakuten is expanding globally and currently has operations throughout Asia, Western Europe and America.

CyberAgent, Inc. is a leading worldwide developer, publisher and distributor of interactive entertainment for PCs, handhelds and wireless devices. Founded in 1998, the company has provided many types of services in Japan; it is one of the largest social game providers, running a blog-based communication service (Ameba) as well as a corporate venture-capital. CyberAgent is headquartered in Tokyo, and maintains operations in the United States, China, Vietnam, Indonesia, Taiwan, Korea, and Japan.

Future Architect, Inc., headquartered in Tokyo, is an innovator in IT and business consulting services with a proven track record of providing the most advanced systems since its establishment in 1989. The company mainly operates in three business segments: IT Consulting, Package & Services, and Corporation Revitalisation. The company also engages in multiple business sectors including internet media, security, and investment.

GMO Internet Group, headquartered in Tokyo, is a leading force in the internet industry offering one of the most comprehensive ranges of internet services worldwide. The company was founded on a desire to bring the possibilities the internet offers to as many people as possible. The GMO Group operates mainly in four business segments: Web Infrastructure & e-commerce, Internet Media, Internet Securities, and Social & Smartphone.

Cisco Systems G.K. designs, manufactures, and delivers Internet Protocol (“IP”) and other products related to the communications and information technology industry. This involves switching products including modular switches, storage products, workstations,
IP phones, access points, and servers. The company was founded in 1992 and is based in Tokyo.

**B. Nature of Activities Undertaken by JANE Member Companies**

Our members are involved in a wide range of businesses on a global scale, including:

- Online marketplaces for consumers and retailers.
- Online platforms through which consumers and businesses interact to share information, enjoy entertainment (music, electronic books, videos, etc.), and networks.
- Subscription-based and free content to consumers and businesses.
- Developing, marketing, and selling business and consumer-oriented search, advertising, hardware, and software.

**C. Executive Summary**

We provide comments below in response to each question included on Page 7 of the Discussion Draft. In summary, we will focus on the following areas:

**Support for Digitalisation and Growth of the Economy**

1. First and foremost, JANE supports digitalisation and promotes it globally. Digitalisation occurs in almost all countries and a significant number of digital companies are emerging all over the world. The options being discussed here will affect companies resident in many jurisdictions, including Japan. We recommend further research, analysis, and discussions be undertaken in order to consider the various facts and circumstances that impact businesses in various jurisdictions.

2. In our view, digitalisation generates the following benefits:

   - Providing opportunities for individuals to venture into new segments or start new businesses. Digitalisation can reduce the cost and time involved in setting up a new business. We believe digitalisation helps to empower individuals and venture companies.
   - Contributing to growth of the economy. Globalisation can be achieved more easily with digitalisation. Small businesses are now able to expand on a global scale with lower barriers of entry. For example, a company can sell digital books, music, and videos to people around the world.
   - Creating new business models which also contribute significantly to growth of
the global economy.

- Supporting an eco-friendly economy: digitalisation reduces the usage of raw materials, such as paper and plastic, as well as the negative impact of transportation on the environment.

3. To promote digitalisation, tax rules and regulations should not discriminate against digital transactions by imposing additional tax burdens. Such unfair practices do not support neutrality, one of the essential principles recognised by the Ottawa Framework. We believe that such unfair rules and regulations will have a negative impact on the growth of the economy, which is not in line with OECD’s goal.

**Approach to the Digital Economy**

4. Separating the digital economy from the traditional economy is challenging, as it can be difficult to distinguish between the two. Security of payment and maintenance of logistics networks are some of the most recognised and valued functions of internet shopping platforms. Therefore, electronic and conventional forms of commerce are linked. As a result, attempting to segregate electronic commerce from conventional economies may create taxation disparities. We provide further comments on these issues in our response to question 1.

**Neutrality/Fairness**

5. We must maintain neutrality and fairness between the conventional and electronic forms of commerce. In addition, we should also remain neutral and fair among inbound and outbound transactions in order to foster competitive markets.

6. We believe that imposing heavy compliance burdens on parties conducting electronic commerce transactions as compared to traditional commerce transactions should be avoided. As a general rule, the heavier the reporting and/or withholding requirements are, the more the growth of businesses would be suppressed and as a result, it may lead to domestic companies relocating to other countries where such regulatory measures are more favourable.

**Efficiency, Simplicity, and Predictability**

7. Without sharing a common principle and policy of taxation across the world, cases of double taxation are likely to increase. For example, the complexity of mutual agreement procedures is likely to increase in the field of transfer pricing.
VAT Double Taxation and VAT Double Non-Taxation

8. Governments are increasingly relying on indirect taxes to finance their budgets. We note that in many countries, the rate of VAT/GST is increasing, and sometimes double taxation or non-recoverable VAT/GST is incurred.

9. Currently businesses are facing increased competition, with pressure to lower their price of goods and services, resulting in minimal profit to remain competitive. In these circumstances, if double taxation occurs, businesses end up recording losses, resulting in an increase in the burden for businesses.

10. We believe companies should not be burdened with double taxation, which occurs when there are different rules and practices taken by various jurisdictions. We support OECD's effort to provide guidance on the application of VAT/GST on international trade.

11. Clear guidelines will contribute to improving current VAT/GST rules and facilitating cross-border trade, which will lead to further economic growth. In the meantime, there should be measures to reduce double taxations. For example, if there is VAT/GST in the country where the customer is located, there should be an exemption from VAT/GST applied where the transaction originated (i.e., in the country of a non-resident supplier).

12. We also appreciate there are benefits in allowing exemptions for imports of low valued goods. These exemptions in many jurisdictions were established before the advent and growth of the digital economy. As we saw in the case of the Channel Islands, there are a lot of criticisms against the practices of using these exemptions. The low value consignment relief for goods imported from the Channel Islands was abolished, but this was only a partial measure and similar practices remain. Further discussions should be held to better understand the comprehensive measures to ensure competitive distortions are minimised.

D. Comments

Question 1 - Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules.
13. It is unfeasible to ring-fence the digital economy from the rest of the economy. Enterprises that employ digital models operate in all sectors of the global economy, and these enterprises constitute the so-called digital economy. Traditional companies, including manufacturing companies, sometimes conduct digital transactions, while e-commerce companies often have non-digital transactions.

14. Non-digital transactions are often related to digital transactions. For example, an e-book service provider sells both e-book readers (devices) and e-book contents (digital contents). As discussed in the Discussion Draft, a company may allow a loss from hardware sales in order to record profits from the digital contents. As noted in the Paragraph 15 of the Discussion Draft, in many cases, companies now use hardware devices as loss leaders in their business model, aimed at expanding the market of customers for goods and services available through those devices, or otherwise leveraging their growing network of end users. Companies expect content sales to be the profitable segment of their business. In this sense, hardware device sales and content sales (or digital services) complement each other. Customer feedback from the sale of contents is also used to improve hardware (devices) specifications.

15. Technically, as they are not tangible, there may be more detailed definitions and considerations for a consistent administration of digital transactions to avoid differences in interpretations. For example, “electronically provided services” should be clearly defined and regarded as “services” for withholding tax (“WHT”) and VAT purposes. Specifically, digital content purchases or rentals, where users pay per item of download (e-books, videos, and music) should be treated as a service under WHT and VAT tax rules, following the report “Tax Treaty Characterisation Issues Arising from e-commerce” by the Technical Advisory Group on Treaty Characterisation of Electronic Commerce Payments dated 1 February 2001. There are many countries that already recognise these transactions as a service. If other countries take a different position, or fail to provide clear guidance and the tax authorities decide case-by-case, this may result in double taxation.

Question 2 - The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account.

16. The Task Force understands the key features of the digital economy. The identified
key features are helpful to consider what measures should be developed over the course of the work on other aspects of the BEPS Action Plan to address issues in the digital economy (e.g. VAT/GST). This is discussed further in our response to question 5.

17. Other key features may emerge in the future as the digital economy continues to expand, but these can be hard to predict.

**Question 3 - The examples of new business models in the digital economy and whether (and if so which) other business models should be considered.**

18. The Task Force identified some of the major business models of the digital economy. There are, however, other models as discussed in our response to question 6.

19. As mentioned above, we need to consider the measures developed on other aspects of the BEPS Action Plan in order to address issues in the digital economy.

20. Once again, it is hard to predict all of the major business models as the digital economy continue to expand exponentially.

**Question 4 - The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy.**

21. As noted in the Executive Summary, we support OECD's effort to provide guidance on the application of VAT/GST on international trade. Clear guidelines will contribute to improving current VAT/GST rules and facilitating cross-border trade, which will lead to further economic growth.

22. The current guidelines define the core feature of VAT/GST, clearly identifying that the purpose of these indirect taxes is to impose a tax on final consumption by households and will support a greater understanding of the technical details.

23. We support OECD International VAT/GST Guidelines (draft) stating that “Their design and consistent implementation is intended to serve as a basis for countries to frame their own laws and administrative practice, reduce impediments to international trade and improve the neutrality of VAT regimes worldwide while
reducing opportunities for tax avoidance and creating more certainty for business and tax authorities."

**B2B Transactions**

24. For B2B digital services, the reverse charge system should be the most effective system. It is necessary that a foreign business can identify whether the client is an individual or a business, and using a VAT-ID could be an option.

**B2C Transactions**

25. For B2C digital services, we believe that having the non-resident supplier to collect and remit VAT as opposed to having individual customers to remit VAT is effective. As noted in the Discussion Draft, consumer self-assessment has proven to be largely ineffective and as result, it is unlikely that any VAT would be paid by the consumer.

26. There should be benefits or incentives for the non-resident supplier to be compliant, and/or a penalty for non-compliance, as this method depends on the non-resident supplier complying with the requirement to collect and remit VAT. Otherwise, the suppliers will only consider administrative costs, which may lead to differences between large corporations who want to be compliant and small businesses who may decide not to be compliant.

27. For example, a government could issue a VAT registration number to the non-resident supplier who correctly registers, collects and remits VAT, so that the business can show the number on their website identifying they are VAT compliant in the respective country. Governments should encourage people in their country to buy digital contents from registered businesses, rather than non-complying businesses.

28. There may be other measures to promote voluntary compliance. Start-up companies typically focus on their businesses in the first few years without allocating sufficient resources to compliance. The local tax authorities should encourage “voluntary” compliance once the business becomes more stable. The authorities should not penalise companies if the start-up provides sufficient reasoning for their non-compliant period. Other measures may include implementing penalties and/or sanctions on consumers, leading them to be “coliable” for VAT/GST.
29. Another option would be to introduce a fiscal representative system and make the representatives co-liable for VAT/GST. Non-resident suppliers should designate fiscal representatives in the target market to file, collect and remit VAT/GST. Hiring such fiscal representatives would reduce the administrative burden on the corresponding non-resident supplier. It is also important to make sure that such fiscal representative for VAT compliance purposes should not be regarded as a PE of the non-resident supplier.

30. Government should also establish a taxpayer-friendly automated compliance system, so businesses do not have to invest to register and be compliant. In addition, an efficient automated system will be useful for smooth and timely deregistration. It may take several months or years to obtain VAT clearance and deregister the VAT number from each jurisdiction. Markets are extremely competitive and businesses must be flexible and agile in order to survive. It is impractical to expect companies to maintain legal entities which are no longer required, for the sole purpose of waiting for VAT clearance. Utilising digital information and advanced technologies, these issues should be resolved in a timelier manner.

Main Rules and Special Rules

31. Where regulations differ by country, companies have difficulties interpreting the rules, especially where certain countries have exceptions from or relaxation in its main rules. With regard to special rules, these rules must be clearly defined and it should only be possible, in certain situations, where they cannot be avoided. Firstly, the special rules may not have much advantage vis-à-vis the main rule, as it would be difficult to provide evidence that the requirements for the special rules are met and the rules may not be consistent with the business’s structure and processes.

32. Secondly, the broad definition creates too high a risk of a mismatch due to different interpretations by countries that both apply the Guideline in principle, but define the scope very differently. In Chapter 3 of the Guideline, we recommend including more concrete examples so that taxpayers are able to determine by themselves whether any supply of services or intangibles they provide, fall under the main rule (customer’s location) or a special rule.
Compliance Burden

33. Draft Guideline 2.6 specifies that where specific administrative requirements for foreign businesses are deemed necessary, they should not create a disproportionate or unreasonable compliance burden for the businesses. Likewise, there should not be a disproportionate or unreasonable compliance burden for digital transactions vis-à-vis non-digital transactions.

Neutrality of VAT in Cross-Border Trade

34. We understand the Committee on Fiscal Affairs intends to develop guidelines by the end of 2014 on the place of taxation for cross-border supplies of services and intangibles to final consumers (“B2C”) and the objective is to arrive at a complete set of guidelines applying to cross-border trade in services and intangibles. Although we would like to obtain these guidelines, we provide some preliminary comments below.

35. We also appreciate there are some VAT non-taxation cases, including exemptions for importation of low-valued goods. Paragraph 220 in the Discussion Draft stated that “the thresholds in many jurisdictions were established before the advent and growth of the digital economy and may require a review to ensure that they are still appropriate”. In addition to the compliance burden, it is important to consider the neutrality of VAT in the context of cross-border trade, between domestic companies and foreign companies, as well as between digital transactions and non-digital transactions. Further discussions should be held to better understand the comprehensive measures to ensure competitive distortions are minimised. We also believe that aligning the taxation principles of goods and services would help to simplify the tax system.

36. As noted in the Executive Summary, we recommend relief from double taxation of VAT/GST due to different rules and practices taken in various jurisdictions. We support OECD's effort to provide guidance on the application of VAT/GST on international trade. Clear guidelines will contribute to improving current VAT/GST rules and facilitating cross-border trade, which will lead to further economic growth. In the meantime, measures to reduce double taxation, such as VAT exemption for export should be introduced.
Question 5 - Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones.

37. As noted in the beginning of this document, the digital economy is perhaps just an example of the economy, and it could relate to all aspects of BEPS Action Plan. These action items will also address the tax challenges of the digital economy. In addition, one action item could impact on another action item, therefore we believe that any options developed under Action 1 should not be further considered until all other actions have been identified, defined or implemented.

38. Particularly, among others, the following aspects may be relevant:
   • Action Item 3: Strengthen Controlled Foreign Company (CFC) Rules
   • Action Item 4: Limit Base Erosion via Interest Deduction and Other Financial Payments
   • Action Item 5: Counter Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance
   • Action Item 6: Prevent Treaty Abuse
   • Action Item 7: Prevent the Artificial Avoidance of PE Status
   • Action Item 8: Transfer Pricing: Intangibles
   • Action Item 9: Transfer Pricing: Risk and Capital
   • Action Item 10: Transfer Pricing: Other High-Risk Transactions
   • Action Item 15: Develop a Multilateral Instrument

Question 6 - The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation.

39. First and foremost, simplified and consistent registration regimes across jurisdictions are important. Current BEPS issues are coming from the non-consistent rules and practices across jurisdictions. Simplified registration regime is also important to minimise the potential compliance burden on businesses.

40. In addition, there needs to be an environment supporting compliance. For example, governments should encourage people to support VAT-compliant suppliers as discussed above.
41. Paragraph 175 of the Discussion Draft notes that “Advances in business practice, coupled with advances in ICT and liberalisation of trade policy, have allowed businesses to centrally manage many functions that previously required local presence, rendering the traditional model of doing business in market economies obsolete”. Please note that this distinction is not between pure digital companies versus non-digital companies. The business models of some non-digital companies are more globally centralised, while e-commerce companies may be more of a decentralised or localised business model. Although businesses may allocate functions based on technological feasibility, they would typically consider other factors such as cultural background, style of governance, and above all, each unique business model.

42. Paragraph 95 of the Discussion Draft “3.1.3. Mobility of Business Functions” may not reflect the whole digital economy, and occur in only limited situations. One example is Rakuten's marketplace business. The mission of the marketplace is to empower local small and mid-sized merchants to maintain their sites and create relationships with consumers. In order to reach out and help these local merchants, Rakuten has e-commerce consultants (“ECC”) in local countries. Consumer life is becoming more centered on the digital economy; however each region and country has many distinct local cultural habits, languages, regulatory and legal environments, which need to be considered. Through the above practices, Rakuten is accelerating growth overseas by utilising knowledge and experience from each country.

**Nexus and the Ability to have a Significant Presence without Being Liable to Tax**

43. The Discussion Draft highlights in Paragraph 180 that “it is therefore important not to overstate the issue of nexus as in many cases large MNEs will indeed have a taxable presence in the country where customers are located”. The Discussion Draft further states that “nevertheless, the fact that it is possible to generate a large quantity of sales without a taxable presence should not be understated either”. Companies typically employ different business models and some companies, even in conducting e-commerce, may want to ensure high quality of services and have a direct relationship with key clients which results in a desire to have a taxable presence in the country where the customers are located.

44. This nexus question relates to the definition of permanent establishment for treaty purposes and the related profit attribution rules. We are therefore interested in
seeing the development of the discussions on these other issues. OECD should not propose any PE rule changes without identifying the result of profit attribution, especially for the virtual PE option where there is no precedent or guidance.

**Data and the Attribution of Value Created from the Generation of Marketable Location-Relevant Data through the Use of Digital Products and Services**

45. Data is one of the key issues identified in the Discussion Draft. As stated, the key accounting and tax challenge is the attribution of the value to data, and the extent of this value relative to the systems, software and people that gather, analyse and make use of the data to develop or deliver products and services. Companies may gather a range of data from different sources for multiple purposes and combined to create value, making tracing the source of data challenging.

46. There should be an appropriate definition of what is valuable. In certain situations, the tax authorities assume data has value; however raw data itself does not have any significant value. A customer list in the digital economy is a type of data, however the customers can easily move to another supplier, and the list no longer has any significant value at that point. In addition, there are even cases where individuals are registered and use the services for free, but monetising activities have not yet commenced. When this occurs, the raw data does not have value, but instead, developing a business model to monetise it.

47. Further analysis would be required to comment in detail on the questions raised. For example, in regards to big data for e-commerce, it would be of value to have an index that would contribute to an increase in sales and a technological ability to scale out the index.

**Characterisation of Income Derived from New Business Model**

48. The Discussion Draft notes there is often no specific guidance on how to treat new digital services. As noted above in our response to question 1, the Technical Advisory Group on Treaty Characterisation of Electronic Commerce Payments published a report on 1 February 2001 called “Tax Treaty Characterisation Issues Arising from e-commerce”. This report provides an analysis and conclusion on business profits and payments for the right to use a copyright; business profits and payments for know-how; business profits and payments for the right to use industrial, commercial or scientific equipment; provision of services; technical fees; and mixed
payments. Annex 2 provides an analysis of 28 categories of typical e-commerce transactions, including, electronic order processing of tangible products, electronic ordering and downloading of digital products, application hosting, software maintenance, data warehousing, etc. These remain valid today and there is no need to create different characterisation rules.

49. It is important that a consistent treatment across various jurisdictions be implemented, not only for corporate income tax purposes, but also for withholding tax and VAT/GST. Otherwise there is a risk of double taxation.

Collection of VAT in the Digital Economy
50. As mentioned earlier, Paragraph 220 of the Discussion Draft poses a question about the thresholds in various jurisdictions. For the time being, mirroring the existing practice in various jurisdictions is the most practical approach. However, businesses have difficulties when rules differ by jurisdiction. Ultimately, there should be simpler, consistent, and defined administrative rules across borders so it is clear when a taxpayer is compliant.

Question 7 - The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft.

51. As noted above in our response to question 1, we do not think it is feasible to ring-fence the digital economy from the rest of the economy. Enterprises that employ digital models operate in all sectors of the global economy, and these enterprises constitute the digital economy. Therefore, any options for addressing the digital economy should apply fairly and equally across all businesses.

52. In addition, businesses should not be burdened with too much compliance duties. As noted in the beginning, we believe that digitalisation brings various benefits. Unfair measures would have a negative impact on the growth of businesses that are utilising digitalisation to monetise their products and expand overseas.

7-1. Modification to the Exemptions from Permanent Establishment Status
53. Simply modifying the exemptions from permanent establishment status alone would only increase the compliance cost and risk of double taxation. This would not be helpful for globalisation or growth in the economy, not only of digital business but
also for other business lines.

7-2. A New Nexus based on Significant Digital Presence

54. Again, creating a new nexus would only increase the compliance cost and risk of double taxation, and it would not be helpful for globalisation or growth in the economy.

55. Creating a new nexus based on significant digital presence might result in double taxation, if not clearly and consistently defined and applied by all countries, for both the source country and the resident country.

56. One of the challenges in creating a new nexus based on significant digital presence would be how to define the location of the digital presence (i.e. cloud computing). In addition, there is a difference between simply having a digital presence (e.g., data), and conducting business activities to monetise the data. With a new nexus, there may be jurisdictions imposing unfair "income" taxes based on the mere "digital presence", along with deemed profits.

57. There is insufficient justification for market jurisdictions to tax profits arising from economic activity that takes place entirely outside that jurisdiction, and creating tax nexus for the business simply because they make sales in a certain jurisdiction is unreasonable. Creating such rules for the digital economy only would not be fair on these entities.

7-3. Virtual Permanent Establishment

58. Firstly, it would be very difficult to define a virtual PE. With an increase in cloud applications, it would be even more difficult and unfeasible to define such PE. The Business Profits TAG considers an alternative view on the "economic presence" of an entity, but what would be the exact definition of the "economic presence"? If there is a single customer in a jurisdiction, does an enterprise have an economic presence within that jurisdiction?

7-4. Creation of a Withholding Tax on Digital Transactions

59. Currently withholding tax rates differ significantly due to different local laws and the relevant income tax treaty between two countries.
60. Requiring withholding tax on digital transactions only, may not be neutral. We have concerns that some countries may misuse it to aggressively withhold taxes on all transactions which are only part digital.

61. In addition, if withholding tax is imposed on the gross transaction, businesses are forced to pay taxes even if they are making losses. Such gross based withholding taxes are inappropriate to impose on ordinary business income, since the tax does not reflect expenses incurred to produce income. It would be a significant burden for businesses, especially in the early stage of start-up who are recording losses, and such measure discourages investments into new ventures.

62. There is also a question of addressing the challenges of withholding tax in the case of transactions with individual consumers. The Discussion Draft discusses one option to consider regarding withholding by financial institutions involved in those payments. In practice, there are various payment methods other than credit cards. Thus applying the withholding tax only on credit card transactions (and some other forms of payment) may be unfair. It is also a challenge for financial institutions to identify the country of residence or country of establishment of the payment recipient.

7-5. Consumption Tax Options

63. In the past few years, there were numerous discussions in Japan about the most effective and efficient approach on collection of Japanese Consumption Tax ("JCT") (similar to VAT) on cross-border B2C digital services.

64. As discussed above in our response to question 4 regarding B2B digital services, we believe the reverse charge system would be the most effective system. It is necessary for a foreign business to be able to identify whether the client is an individual or a business, and using a VAT-ID would be an option.

65. For B2C digital services, asking a non-resident supplier to collect and remit VAT rather than requiring individual customers to remit VAT is effective. As noted in the Discussion Draft, consumer self-assessment has proven to be largely ineffective and as result, it is unlikely VAT would be paid by the consumer.
66. For exemptions on imports of low-valued goods, it is unfair to allow exemption for non-digital goods only. In addition, the thresholds for these exemptions vary widely across jurisdictions. In theory, these thresholds should be removed, as variations from the main rule may complicate the practices. In reality, there are administrative burdens to consider, and we forecast that exemptions for imports of low-valued goods will remain for a foreseeable future. In the meantime, the same exemption should be allowed for digital services to ensure consistency in all economies. As discussed earlier, we strongly believe that digitalisation provides a lot of benefits to the economy, and we do not support unfair measures on digital transactions.

Question 8 - The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives.

67. It is true there is a cost to being compliant. As discussed above in our response to question 4, there should be benefits or incentives for non-resident suppliers to be compliant, and/or a penalty for non-compliance, as this method depends on the non-resident supplier complying with the requirement to collect and remit the VAT. Otherwise, the supplier would only consider the administrative cost, and there may be differences between large corporations who want to be compliant and small businesses who choose not to be.

68. In the current digital economy, businesses are volatile and sometimes changes are required. Often VAT registration can be quite burdensome. For example, in the process of reorganisation when a business liquidates several legal entities, VAT deregistration may take much longer than other forms of deregistrations. This process may last several months or years to deregister the VAT number from each country, and the business must not conduct any commercial activities using these legal entities during this time. Taking advantage of the digital information and advanced technologies, such issues should be resolved in a shorter period of time.

69. From a business standpoint, we would welcome the establishment of simplified registration regimes to minimise the potential compliance burden on businesses. Currently businesses struggle with variations in practice to be VAT compliant. If consistent information is requested in each of the relevant countries, it would help business have a more simplified system to be VAT compliant. It would be effective
and efficient if all countries introduced a similar registration and compliance system, including the taxpayer number and items to be reported on the tax return.

Question 9 - Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

70. We believe the outcome of the 1998 Ottawa Ministerial Conference on Electronic Commerce, referred to as the Ottawa Taxation Framework, is still relevant today and is an appropriate framework for analysing options to address the tax challenges of the digital economy.

We hope our remarks will contribute to further development of OECD’s work on BEPS. We are happy to discuss any comments or questions you may have regarding our comments. Please do not hesitate to contact us.

Yours faithfully,

JANE Board of Directors
April 14, 2014

Committee on Fiscal Affairs
The Organisation for Economic Co-operation and Development

International Tax Committee
Japan Machinery Center for Trade and Investment

Comments on BEPS Action 1 Public Discussion Draft on ‘ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY’

Japan Machinery Center for Trade and Investment (“JMC”) is a non-profit organisation established in 1952 to promote the sound development of international trade in machinery by Japanese multi-national entities. Its members include major machinery manufacturers, trading companies and engineering companies. Its International Tax Committee was established at the beginning of 1990 in order to enhance the international competitiveness of machinery industry in Japan and has been active in studying, and contributing to, the development of domestic and foreign international taxation systems.

URL: http://www.jmcti.org/jmchomepage/english/index.htm

JMC is submitting its opinion on Action 1 of the Action Plan on BEPS because it potentially has a significant impact on the members of JMC that are engaged in the export of, and investment in, wide-ranging machinery.

The comments of JMC

<General comments>

JMC recognises that the digital economy has widely and deeply permeated the economic activities surrounding ‘hardware’ machinery and requests that the outcome of possible solutions presented in Public Discussion Draft on BEPS ACTION 1: ADDRESS THE TAX CHALLENGES OF THE DIGITAL ECONOMY will contribute to keeping compliance costs under control. JMC hopes that it will help resolving the unfairness in competition between
resident and non-resident businesses due to the different tax treatment of VAT/GST. Furthermore, JMC believes that solutions to BEPS issues should not only lead to more taxation by every tax authorities but also to the realisation of fair taxation on businesses and the resolution of double taxation.

JMC would like to thank the OECD for assembling the background the context on information and communication technologies and the digital economy related to Action 1 as the development of the digital economy could have an important implication to international taxation.

The development of the digital economy makes economic activities more efficient and, even if there are issues that should be addressed by the BEPS project, they should be regarded as the side effects of the digital economy. There should be recognition that the development of the digital economy is desirable. Then, it will be very important that any possible tax measures should avoid imposing excessive compliance costs that could hamper the development of the digital economy. If a country imposes, for example, periodical reporting and withholding tax obligations excessively, businesses could move to a country where there are no such unnecessary regulatory obligations.

JMC observes that some of the proposed measures in the draft, such as the expansion of the concept of PE and the creation of withholding tax on electronic transactions, do not seem to be useful from a practical point of view, or could impose excessive administrative burden on businesses for compliance, and that they could have an impact on the treatment of other transactions or have an distorting effect that could result in new double taxation.

<Specific comments>

(1) **Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules**

It is impossible to ring-fence the digital economy in an appropriate manner because the digital economy has permeated widely and deeply to the economic activities of the traditional and hardware sector as machinery.

In reality, some business models are hard to be classified in or outside the digital economy. For example, the most valuable part of an internet shopping site could be
secure settlement or the development and maintenance of a logistics network. In that business model, a traditional sales and service model is mixed with the digital economy. Thus, arbitrary ring-fencing of the digital economy could result in distortion in taxation.

Let us take cloud computing services as another example. As a variety of intangible assets are employed in a complex manner, it is inevitable that some intangible assets are employed both in the digital economy and in the rest of the economy. Any taxation on the consideration for such use of intangible assets should, therefore, be consistent and fair between the digital economy and the rest of the economy.

In addition, from the point of view of flexibility, one of the five principles endorsed in the 1998 Ottawa Ministerial Conference, ‘the systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments’, a harm could be done by separating the two economies because the digital economy and the rest of the economy are being increasingly integrated as technology develops.

As the paragraph 120 of the draft states, the nature of the strategies used to achieve BEPS in digital businesses is similar to the nature of strategies used to achieve BEPS in more traditional businesses. It should be, therefore, unnecessary to take measures specifically targeting the digital economy.

It is necessary, however, to set a certain rule in order to address the existing competitive unfairness resulting from the different VAT treatment when digital contents are downloaded from the internet website of a resident business or a non-resident business.

Furthermore, the treatment of transactions in services that do not depend on the internet, that are commissioned by a resident business to a non-resident business and that are executed outside the country should be maintained as services provided outside the country.

(2) **The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account**

JMC does not have specific comments.

(3) **The examples of new business models in the digital economy and whether (and if so which) other business models should be considered**
JMC does not have specific comments.

(4) **The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy**

Although some of the measures developed in the course of the BEPS Project and the current work on VAT/GST may be applicable to BEPS concerns in the digital economy, JMC believes that the highest priority should be given to setting a certain new rule in order to address the existing competitive unfairness resulting from different VAT treatment when digital contents are downloaded from the internet website of a resident business or a non-resident business.

(5) **Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones**

Other measures in the BEPS Action Plan can be applied to address BEPS concerns in the digital economy. It is understood that the digital economy has been raised in Action 1 in order to present typical issues in the current BEPS concerns as a whole. If the work in Action 1 is carried out as stand-alone, it could lead to inconsistency in a larger picture. The approach to the digital economy, therefore, should be a synthesis of individual issues such as the definition of PE, intangible assets and CFC rules.

For example, it appears that Action 2 (Neutralise the effects of hybrid mismatch arrangements), Action 3 (Strengthen CFC rules), Action 7 (Prevent the artificial avoidance of PE status), Action 8 (Assure that transfer pricing outcomes are in line with value creation: intangibles) and Action 12 (Require taxpayers to disclose their aggressive tax planning arrangements) are applicable to the digital economy. Concerning transfer pricing taxation, particularly the issue of intangibles that is discussed in other Action and the concept of a distinction between intangibles and service provisions that is part of the former, should be discussed in common.

Except for transactions concerning the downloading of digital contents from an internet website, measures specific to the digital economy should not be hastily adopted. Although the deadline of the output of Action 1 is September 2014, instead of giving a definitive conclusion of Action 1 by then, it will be more appropriate to seek an output that is consistent with work done in other Actions.
(6) **The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation (Section VI)**

Concerning direct taxation, an expansion of the concept of PE status or the creation of a withholding tax on digital transactions should not be lightly introduced. Because it is impossible to ring-fence the digital economy from the rest of the economy, measures to prevent BEPS applicable to the traditional economy should also be applicable to the digital economy.

Concerning indirect taxation, it is necessary to set a certain new rule in order to address the existing competitive unfairness resulting from different VAT treatment when digital contents are downloaded from the internet website of a resident business or a non-resident business. In addition, it will be necessary to create a mechanism to prevent double taxation because there is no treaty relief for indirect taxation and the amount of double taxation could be large due to gross taxation.

(7) **The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft (Section VII)**

JMC believes that the options to expand the concept of PE that are discussed in 3.1 Modifications to the Exemptions from Permanent Establishment Status, in 3.2 A New Nexus based on Significant Digital Presence and in 3.3 Virtual Permanent Establishment are not viable options. The Business Profit TAG worked on the concept of PE in the digital economy meticulously since 1998, which resulted in the changes to the Commentary on Article 5 of the OECD Model Tax Convention. In addition, work on PE status will also be done in Action 7 of the BEPS Action Plan as explained in the paragraph 150 onwards. By taking the above context into consideration, it is dangerous to try to reach a conclusion on the Article 5 of the OECD Model Tax Convention or a new concept of PE by Action 1 that is related only to the digital economy. Action 1 should not go beyond analysing these issues and summing up main points.

JMC is against the creation of a withholding tax on digital transactions (option 3.4) because it is fundamentally difficult to make a distinction between digital transactions and the other transactions and thus it will not be feasible. If it were created, it would risk creating new economic distortions and double taxation.
Concerning 3.5 Consumption Tax Options, it is necessary to introduce a rule to require the non-resident supplier to register and account for the VAT on cross-border B2C service supplies in the jurisdiction of the consumer.

(8) **The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives**  
(Section VII)

Concerning the options 3.1 Modifications to the Exemptions from Permanent Establishment Status, 3.2 A New Nexus based on Significant Digital Presence, 3.3 Virtual Permanent Establishment, and 3.4 Creation of a Withholding Tax on Digital Transactions, because the recognition and valuation of attributable profits is complex and difficult, it will be extremely difficult and burdensome for many businesses to recognise such PEs and grasp attributable profits to them regularly and continuously.

(9) **Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented**

They are an appropriate framework. As the framework for analysing options to address the tax challenges, the tax principles in the Ottawa framework conditions centred on neutrality would be appropriate. Action 1 is more general and comprehensive than other Actions and contains various elements. Action 1 should, therefore, position itself as the general remarks on the entire BEPS project and focus on summing up issues. It may be mostly the case that concrete policy options could be delegated to other Actions of the BEPS Action Plan.

JMC submits the above comments to the OECD Public Consultation because the theme is of significant importance for many Japanese companies exporting machinery and investing. JMC appreciates the opportunity that has enabled JMC to provide these comments.

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Sony Corporation
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Nikon Corporation
NSK Ltd.
NEC Corporation
Pioneer Corporation
Panasonic Corporation
Fujitsu Limited
Fujitsu General Limited
Marubeni Corporation
Mitsubishi Heavy Industries, Ltd.
Mitsubishi Electric Corporation

1. As pointed out by the OECD, it is true that some aspects of the current international taxation system are lagging behind the economic reality amid the progress of globalization and development of digital technologies, and clarification of rules on taxation, particularly taxation in the digital economy that is the subject of the Action Plan 1, is highly hoped for, whether there is base erosion and profit shifting (BEPS) or not. The initiative of the OECD in summarizing the background for the information and communication technologies and digital economy in relation to the Action Plan 1 is thus highly appreciated.

2. It is difficult to segment the digital economy from the rest of the economy (paragraph 59), and we support the conclusion that applying tax rules on the digital economy that are separate from conventional tax rules would be neither appropriate nor feasible (paragraph 205).

3. In the Public Discussion Draft are mentioned the five principles of the taxation framework presented at the 1998 Ottawa Conference: namely, neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. We believe that these are useful for evaluating options on a wide range of tax issues presented in Section VII, and we support the idea that options should be evaluated based on these principles (paragraph 204).

4. In consideration of our descriptions in paragraphs 2 and 3 above, we believe that the issue to be studied immediately is value-added tax (VAT) among the various tax issues related to electronic transactions.

In particular, most of the options on tax issues presented in 3.1 through 3.4 in Section VII are not consistent with the ideas in paragraphs 2 and 3 above. Moreover, these options are questionable in terms of usefulness and could place excessive burdens on
corporations. They may also affect the treatment of other transactions.

A very cautious study should be required on the proposals for expansion of the concept of permanent establishment (PE) presented in 3.1 (Modifications to the Exemptions from Permanent Establishment Status), 3.2 (A New Nexus based on Significant Digital Presence), and 3.3 (Virtual Permanent Establishment), because we are concerned that it may cause the source country to strengthen the tax imposition and double taxation may arise between the residence country and the source country. Concerning the treatment of PEs in the digital economy, detailed studies were carried out actively from 1998 by the Business Profits Technical Advisory Group, and the Commentary on Article 5 of the OECD Model Tax Convention was revised as a result. In addition, PEs will be further studied in the BEPS Action Plan 7 (due September 2015). Under these circumstances, it is not appropriate to draw conclusions on the ideal Article 5 of the Model Tax Convention or new PE concepts within the framework of the Action Plan 1 on digital economy alone. Instead, the Action Plan 1 should focus on raising and clarifying issues.

Concerning 3.4 (Creation of a Withholding Tax on Digital Transactions), because it is not appropriate to segment digital transactions from other transactions in the first place, it is not necessary to introduce a withholding tax on digital transactions alone. If anything, it may create distortions, such as double taxation.

As seen above, we believe that the issue to be studied immediately is VAT among the various tax issues related to electronic transactions.

5. With regard VAT, it is necessary to introduce measures that fully take into consideration the compliance costs to be incurred by corporations. In addition, we request the following:

(1) Concerning the business-to-consumer transactions, we support the proposals that a non-resident supplier be registered in the jurisdiction of its consumer, and that a simple registration be devised in order to ease the burden on such suppliers. At the same time, it is necessary to promote the establishment of an international structure for realizing appropriate taxation such as an appropriate tax declaration by a non-resident supplier and an improvement on the capture rate of tax payments from the viewpoint of fairness.

(2) It is necessary to create internationally harmonized rules for the “place the service was supplied” and “simplified procedures and mechanisms.”

6. We believe that measures in other BEPS Action Plans are also applicable to the
digital economy. The issues of the consumption taxation (VAT) on cross-border service transactions are being discussed by Working Party 9, and the definition of a PE will be studied in the Action Plan 7 (due September 2015). We believe that Action Plans 2 (Neutralise the effects of hybrid mismatch arrangements), 3 (Strengthen controlled foreign company [CFC] rules), 8 (Assure that transfer pricing outcomes are in line with value creation: intangibles), and 12 (Require taxpayers to disclose their aggressive tax planning arrangements), in particular, are also applicable.

7. Changes to the international taxation rules involve complicated issues. Accordingly, it is not right to jump to hasty conclusions within the framework of the Action Plan 1 alone. Instead, it will be appropriate to see how studies in other fields are progressing, and to determine the direction that is consistent with the directions of these studies. Even in such a case, it is imperative to examine the issues carefully, taking into consideration the impacts and burden on corporations.

Sincerely,

Subcommittee on Taxation
KEIDANREN
Memorandum

To: OECD, Centre for Tax Policy and Administration, BEPS Project
From: Anne Quenedey
Date: 14 April 2014
Subject: Comments on the Public Discussion Draft entitled “BEPS Action 1: Address the Tax Challenges of the Digital Economy”

Dear Sir,

We are pleased to respond to the OECD request to send comments on the Public Discussion Draft entitled “BEPS Action 1: Address the Tax Challenges of the Digital Economy” dated 24 March 2014 (hereafter referred to as the “Draft”).

We are thankful to the OECD for initiating an international and public discussion on the broader tax challenges raised by the digital economy and on possible options to address BEPS and tax challenges of the digital economy.

The tax challenges of the digital economy are a complex and sensitive subject.

In that context, we welcome the work that has been done by the OECD to take into consideration the concerns from the business community and would like to make the following comments.

1 Information and communication technology and its impact on the economy

Comments are welcome on whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules.

We do not believe that it is possible to ring-fence the digital economy from the rest of the economy.

On the one hand, if tax authorities try to ring-fence the digital economy, the tax laws and criteria will be most of the time late and not adapted to the issues at stake. Digital economy is indeed fast changing. Business models have already changed a lot but they are going to change again in the future.

Tax laws in order to be efficient and arm’s length need to be more oriented on principles and on
rules that can be applied to the largest number of cases and situations rather than to try to identify and ring-fence specific situations.

For example, the Directive 2002/38/EC of 7 May 2002 amending Directive 77/388/EEC as regards the value added tax (VAT) arrangements applicable to radio and television broadcasting services and certain electronically supplied services tried to issue specific rules for internet services. However, discrepancies created by this Directive were identified soon after its signature, such as VAT regime applicable to the provision of financial services through internet, the provision of press services through internet or the sale of books through internet.

On the other hand, information and communication technologies have spread all over businesses, across all sectors. Therefore, we fully agree that segmenting the digital economy is increasingly difficult and that arbitrary lines to be drawn between what is digital and what is not would certainly not achieve a successful outcome.

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

The key features of the digital economy that are described in the Draft are comprehensive as of today.

However, it is impossible to ascertain that there will be no additional major changes in the future and even more than that, it is most probable that there will be such new changes. Therefore, the idea that "digital economy" is now mature and will not change cannot be considered as reasonable.

Broader tax challenges raised by the digital economy

In our opinion, the description of the tax challenges raised by the digital economy is sufficiently broad.

Potential options to address the broader tax challenges raised by the digital economy

The options that have been briefly described in the Draft are the following:

- Modifications to the Exemptions from Permanent Establishment Status,
- New Nexus based on Significant Digital Presence,
- Virtual Permanent Establishment,
- Creation of a Withholding Tax on Digital Transactions,
- Consumption Tax Options.

Business is taxed when doing transactions in another country, either through the existence of a permanent establishment in the other country or through withholding taxes in that other country. All the elements of the transactions are already taxed in the normal international taxation system.
Tax rules relating to digital economy should be general and should be able to adapt to existing situations and to the evolution and emergence of any new business models in the future. Therefore, in order to ensure stability and a maximum security for the taxpayers, potential options to address the broader tax challenges raised by the digital economy shall not lead to specific legislation but rather lead to general adjustments.

In addition, creating new concepts for taxation such as:

“an enterprise engaged in certain fully dematerialised digital activity would have a permanent establishment if it maintained a significant presence in the economy of another country. [...] a significant digital presence could be deemed to exist in a country when, for example: [...] Digital goods or services of the enterprise are widely used or consumed in the country;” could be a source of double taxation and discrepancies.

For example, if a company is implemented and carries out all its activity in a country A and sells digital goods that are widely used and consumed in the country B, why and on which basis would country A accept not to tax all the profits of the company?

For the reasons mentioned above, we therefore suggest:

- **to renew and adapt the Exemptions from Permanent Establishment Status.** The actual definition is probably old and would need to be modified to include any kind of transactions,

- **not to create new taxes** i.e. withholding taxes, consumptions taxes etc. Creating new taxes would add an excessive tax burden for businesses,

- **not to create new situations of taxation** i.e. New Nexus based on Significant Digital Presence of the creation of a Virtual Permanent Establishment. Creating new situations of taxation would appear to be rapidly obsolete and would trigger double taxation situations.

Comments are welcome on the potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives.

It is a sensitive subject for the business community. Efforts must be undertaken not to lead to burdensome formalities for companies in order to implement the possible options to address BEPS concerns of the digital economy.

5 **Annex 1. Prior work on the digital economy**

Comments are welcome on whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

We fully agree with the principles developed by the 1998 CFA Report “Electronic Commerce: Taxation Framework Conditions”.

In particular, compliance costs for taxpayers should be minimised as far as possible and the tax rules should be clear and simple to understand.

***

We are at the disposal of the OECD in order to contribute further.
Very truly yours,

Anne Quenedey,
Partner
Comments on the OECD Discussion Draft on the Tax Challenges of the Digital Economy

14 April 2014
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To: Committee on Fiscal Affairs’ Task Force on the Digital Economy

From: KPMG’s Global International Tax Services Group

KPMG’s Global International Tax Services Group professionals (KPMG) very much appreciate the opportunity to present our collective feedback to the OECD on the Public Discussion Draft BEPS Action 1: Address the Tax Challenges of the Digital Economy.

1 Background

The Public Discussion Draft on ‘BEPS Action 1: Address the Tax Challenges of the Digital Economy’ (Discussion Draft), published on March 24, 2014, responds to the OECD charge set out in Action 1 of the OECD’s Action Plan on Base Erosion and Profit Shifting (‘BEPS’). Specifically, to:

1. Identify the tax challenges presented by the digital economy; and
2. Develop detailed options to address these challenges.

Both direct and indirect taxes are to be considered. The Action Plan identifies specific issues to be addressed in the Action 1 Report, including:

1. The ability of companies to have a significant digital presence in the economy of another country without being liable to taxation because of a lack of nexus;
2. The attribution of value created from the generation of marketable location relevant data through the use of digital products and services;
3. The characterisation of income derived from new business models;
4. The application of related source rules; and
5. How to ensure the effective collection of VAT/GST with respect to the cross-border supply of digital goods and services.

The Task Force’s work should include a thorough analysis of digital economy business models.

2 Summary observations

2.1 Ring-fencing the Digital Economy

We commend the Task Force for concluding that it is “neither appropriate nor feasible” to ring fence the digital economy to create a separate set of rules for digital economy businesses. The task force appropriately observed that there is no separate digital economy, but that the overall global economy is increasingly digitized. Consistent with the Task Force’s conclusion that it is not feasible to ring-fence the digital economy, the only options addressing the tax challenges of the digital economy that should be pursued are those that apply to all taxpayers.

2.2 Other aspects of the BEPS Action Plan addressing the tax challenges of the Digital Economy

The principal BEPS concern is “… practices that artificially segregate taxable income from the activities that generate it,”¹ creating no, or low, taxation. The OECD’s work under the other aspects of the BEPS Action Plan is expected to address this concern generally and therefore can be expected to address BEPS across all sectors of the economy. As a result, no separate rules need be created for digital businesses.

¹ BEPS Action Plan, page 10
2.3 The Discussion draft’s options to address the tax challenges of the Digital Economy

Modifications to the Exemptions from Permanent Establishment Status
KPMG recommends further exploration of the option of modifying the exemptions under paragraph 4 of Article 5 of the OECD Model Treaty as a solution to the tax challenges of the digital economy as well as BEPS across all sectors. Specifically, the exceptions of paragraph 4 should be retained, but modifications could be considered that would provide that if an otherwise exempt activity is a ‘core activity’ for the taxpayer, the exception may not apply. Detailed guidance on what constitutes core activities will be necessary. KPMG believes that this action, coupled with the other aspects of the BEPS Action Plan, should fully address the tax challenges of the digital economy.

A new Nexus based on significant Digital Presence
This option should not be pursued as it is impractical and opens the door for significant risk of double taxation – impractical because of the difficulty in ring-fencing digital aspects of any enterprise; and gives rise to substantial risk of double taxation due to the difficulty of defining the fact patterns that would trigger a ‘digital presence’ and the attribution of profit or loss to the digital presence (particularly where the OECD transfer pricing guidelines emphasize important functions in terms of Significant People Functions).

Virtual Permanent Establishment
This option should not be pursued for the same reasons as mentioned above with regard to the proposal to create a new nexus for a significant digital presence. Further, these options would generally create a taxable nexus without regard to consideration of whether such presence is a significant element of the enterprise’s value creation activities.

Creation of a Withholding Tax on Digital Transactions
KPMG does not recommend that this option be further pursued because of the complexities in administration identified in the Discussion Draft as well as the fact that, from KPMG’s experience, many of the enterprises offering digital goods and services are either loss making or generating relatively low margins that would not support a final gross basis withholding tax (even a withholding rate as low as five percent). Digital goods and service are not equivalent to high-profit payments that typically draw withholding tax (e.g., dividends, interest and royalties) and should not be taxed similarly. Introduction of a specific withholding tax would have an immediate effect of restricting growth and development of the digital (global) economy itself. A gross basis tax imposed on ‘business profits’ payments from the source country should be a value added tax, not a final withholding tax.

Consumption Tax options
KPMG is supportive of the Task Force’s further pursuit of options to improve the efficiency of collecting and reporting VAT and agree that doing so is essential to reducing exemption thresholds. We are also supportive of efforts to develop workable solutions to VAT collection and remittance on cross-border B2C digital transactions. We expect that this issue will be dealt with by Working Party 9 as part of the VAT TAG.

Discussion draft summary and background
The Discussion Draft spends the initial 47 pages outlining the evolution of Information and Communication Technology (‘ICT’) and its impact on the economy; discusses the emergence of new business models and the key features of the digital economy; identifies opportunities for BEPS in the digital economy and reviews how the other action areas within the overall Action Plan could address concerns raised in the digital economy. The final 14 pages cover the broader challenges raised by the digital economy and actions so far presented for discussion to the Task Force.

Not surprisingly given the substantial work already performed within the EU on the VAT issues associated with the digital economy, in contrast to the other work-streams VAT/GST is given equal footing with direct tax matters. Indeed, there appears to be clear acceptance that in the context of VAT/GST as it relates to digital services, the place of taxation should be linked to the location where the service is consumed. Notwithstanding the clarity gained form such a decision, there is still plenty to determine, what factors are used to ascertain location of consumption, who is liable to account for the tax due, what simplified processes should be considered to reduce compliance burdens on business and make collection feasible.
Finally, due to the complexity of the issue, the Discussion Draft is seeking input on the best way to address the issues raised by the digital economy and a number of detailed questions on both direct and indirect tax are raised.

**The OECD context of what defines BEPS**

To address the overall question posed by the Discussion Draft (i.e., what should be done to address the tax challenges of the digital economy), we first step back to review the BEPS problem generally and then the specific tax challenges of the digital economy. With this background, we conclude that the other aspects of the BEPS Action Plan should address the tax challenges of the digital economy.

In the February 2013 OECD Report on Base Erosion and Profit Shifting, a number of strategies were identified as being responsible for BEPS in the context of direct taxation which can be summarised into four areas:

- Minimisation of taxation in the market country by avoiding a taxable presence, or in the case of a taxable presence, either by shifting gross profits via trading structures or by reducing net profit by maximising deductions at the level of the payer;
- Low or no withholding tax at source;
- Low or no taxation at the level of the recipient (which can be achieved via low-tax jurisdictions, preferential regimes, or hybrid mismatch arrangements) with entitlement to substantial non-routine profits often built-up via intra-group arrangements; and
- No current taxation of the low-tax profits at the level of the ultimate parent.

From the perspective of VAT, to the extent that Guidelines 2 and 4 of the OECD’s ‘Guidelines on place of taxation for B2B Supplies’ are not implemented, BEPS concerns may be summarised as:

- Remote digital supplies to exempt businesses; and
- Remote digital supplies acquired by multi-location enterprises that are engaged in exempt activities.

As well as the above two specific examples of how BEPS may occur in the context of VAT, the draft also notes that connectivity afforded by the global adoption of ICT, puts two additional pressures on the correct accounting for and collection of VAT, namely undeclared VAT on B2C supplies and the ability of businesses to deliberately structure their operations to take advantage of a country’s low value thresholds and sell goods to consumers without the payment of VAT.

**Tax challenges of the Digital Economy**

The Discussion Draft notes that many of the key features of the digital economy exacerbate the opportunities for BEPS.

Specific examples are drawn out such as:

- The importance of intangibles in the context of the digital economy, combined with the mobility of intangibles for tax purposes under existing tax rules;
- The mobility of users creates substantial challenges and risks in the context of the imposition of VAT; and
- The ability to centralise infrastructure at a distance from a market jurisdiction and conduct substantial sales into that market from a remote location.

However, many of these features are found throughout all industries and amongst most modern enterprises as a result of the digitization of business in the modern world. Indeed, para 2.2.8 of the UN ‘Practical Manual on Transfer Pricing for Developing Countries’ notes that:

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2 Many VAT jurisdictions apply an exemption from VAT for imports of low value goods as the administrative costs associated with collecting the VAT on the goods is likely to outweigh the VAT that would be on those goods.
“The key features of MNEs (multi-national enterprises) are that they are integrated (global) businesses. Globalisation has made it possible for an MNE to achieve high levels of integration and the ability to have control centralised in one location. Modern Information and communication systems also provide increased horizontal communications across geographic and functional business lines...”

Business will generally outsource activities in which they do not have a competitive advantage. Outsourcing has been driven by advances in computing power and the growth and development of the internet. These same factors allow for the realization of efficiencies from centralizing key functions within an enterprise. Indeed, not only is technology pervasive throughout business but throughout major consumer markets. In para 30 of the Discussion Draft, it is noted that within the OECD area, households alone have approximately 1.8 billion connected devices, with estimates that this could reach 14 billion by 2022. Rightfully, the Discussion Draft concludes that,

“As digital technology is adopted across the economy, segmenting the digital economy is increasingly difficult. In other words, 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. Attempting 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. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by MNEs together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns, and developing approaches to address those challenges or concerns.”

We strongly endorse the Task Force’s conclusion stated above and encourage the OECD to develop solutions through other aspects of the BEPS Action Plan to address the tax challenges of the digital economy—challenges manifest more clearly through innovative and modern business models adopted across all sectors.

2.4 Specific question answered:

The paper states that, “comments are welcome on any of the issues addressed in the Discussion Draft and in particular on specific issues highlighted in the draft”. We provide comment on several of these issues:

Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules

We commend the Task Force for concluding “that ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible.” We are in complete agreement. Indeed, para 208 of the draft, notes that if the issues noted above are fully addressed through the measures envisaged in the BEPS Action Plan, addressing the challenges posed by the digital economy may become less pressing. The danger will be pressing on with specific digital solutions before the full impact of other work streams can be assessed. We strongly endorse the Task Force’s recommendation to address the challenges of the digital economy through the other measures of the BEPS Action Plan. As the modern economy is a digitized economy, the other aspects of the BEPS Action Plan should address the concerns identified by Action 1 of the BEPS Action Plan.

The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account

We believe that one aspect of the digital economy that is over emphasised by the Discussion Draft is the reliance on intangible property. Along with many other industries that rely on intellectual property,

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4 Discussion Draft, Para 205
it is the combination of people, functions, finance, assets and risk that should determine the correct allocation of reward. A sale may be made by a remote server but there are a lot of people who have supported the creation and maintenance of a business that enables a remote server to make such sales. We suggest that the ongoing work concerning Transfer Pricing Guidelines and Attribution of Profits to a Permanent Establishment could address this concern.

Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones

We endorse the view of the Discussion Draft that other key work streams can address the BEPS concerns of the digital economy, given the breadth of the action plan addressing so many aspects of the BEPS concerns, and given the digital economy is inseparable from the general economy we are confident that the other actions should address the concerns within the digital economy. That said we would recommend that the digital economy Task Force addressing BEPS Action 1 is maintained and coordinates closely, going forward, with the groups responsible for other aspects of the BEPS Action Plan to ensure that the digital economy concerns are adequately considered.

3 Potential options to address the broader tax challenges raised by the Digital Economy

The Discussion Draft presents five options to address the broader tax challenges raised by the digital economy—covering (i) modifications of the permanent establishment threshold, (ii) the imposition of a withholding tax on certain types of digital transactions, and (iii) improvement of the indirect tax system relative to digital transactions.

3.1 Modifications to the Exemptions from Permanent Establishment Status

KPMG recommends further exploration of the option of modifying the exemptions under paragraph 4 of Article 5 of the OECD Model Treaty as a solution to the tax challenges of the digital economy as well as BEPS across all sectors. Specifically, the exceptions of paragraph 4 should be retained, but modifications could be considered that would provide that if an otherwise exempt activity is a ‘core activity’ for the taxpayer, the exception may not apply.

The Discussion Draft states that the ability of companies to maintain some level of business connection ‘within a country’ without being subject to tax on business profits from sources within that country is the result of particular policy choices reflected in domestic law and tax treaties, and is not in and of itself a BEPS issue. (Para. 124). The purpose of the concept of permanent establishment is to provide guidance to taxpayers and tax authorities on the allocation of taxing rights. These guidelines must also facilitate the resolution of disputes under the Mutual Agreement Procedure of treaties that embody these concepts and therefore require clear guidance rather than broad concepts. Article 5: Permanent Establishment has been one of the areas of international taxation where countries have often struggled to arrive at a common interpretation and KPMG has seen many challenges on permanent establishment issues due to differing interpretations of Article 5. As far as possible the OECD should seek to eliminate the use of subjective tests to determine permanent establishments.

Post-World War I, there was a rapid expansion in world trade driven through manufacturing and transport. The consideration of double taxation in earnest commenced in 1921, when the League of Nations appointed a committee of economists (Committee of Experts) to undertake a theoretical study of double taxation. From the first report issued by the Committee of Experts in 1923, through to the development of The London Model in 1945, the term permanent establishment was an enduring feature and concept. The London Model defined in Article V that a permanent establishment exists when there is a fixed place of business in the host country where the place of business contributed to the enterprises income. If a permanent establishment does not exist, then the activity is ‘trading with a country’ and no taxing rights arise on the sale.

The considerable body of work by the League of Nations over a period of 24 years laid the foundation for managing the competing taxing rights of source and residence countries and are reflected in the
current UN and OECD Model Tax Conventions. The current exemptions listed in Article 5 paragraph 4 of the OECD Model Tax Convention are the reiteration of the second condition for a permanent establishment detailed in the London Model—that the business located in the host country must contribute to the enterprise’s income; core activities where value is created for the enterprise.

The imposition of a net income tax on a foreign enterprise is an intrusive exercise that requires disclosure of significant and sensitive financial and other detailed information of the foreign enterprise. The possible imposition of a net income tax is a consideration for many enterprises in evaluating cross-border trade decisions. A source country net income tax imposed upon a foreign enterprise is not only intrusive, but also places the enterprise in a position of net basis taxation from both the residence and source countries and the associated issues related to avoiding double taxation (not to be taken lightly as residence countries often dispute the existence of a foreign permanent establishment and the amount of profit attributable to such establishment). These concerns have long driven the policy considerations behind the permanent establishment concept as well as the specified exceptions to permanent establishment status.

Although innovative business models making particular use of ICT may raise less familiar fact patterns relevant to where value is created and whether a foreign enterprise’s source-country presence is of a preparatory and auxiliary nature, these concerns should not warrant an abandonment of over 70 years of sound tax policy. We therefore recommend that the exemptions to permanent establishment contained in paragraph 4(a) through (d) be retained. We support the development of a qualitative standard that clarifies when these exceptions would be inapplicable based on the identified activity as ‘core’ to the foreign enterprise’s business. Potential modifications to the definition of permanent establishment are part of Action Item 7 which is due by September 2015. KPMG will provide detailed comments at the appropriate time on Action Item 7. However, we note that any modifications should include bright line guidance that provides certainty for business and tax administrators.

3.2 A New Nexus Based on Significant Digital Presence

This option should not be pursued as it is impractical and opens the door for significant risk of double taxation—impractical because of the difficulty in ring-fencing digital aspects of any enterprise; and gives rise to substantial risk of double taxation due to the difficulty of defining the fact patterns that would trigger a ‘digital presence’ and the attribution of profit or loss to the digital presence (particularly where there OECD Transfer Pricing Guidelines emphasize important functions in terms of Significant People Functions).

This option considers the need to establish an alternate concept of nexus in which businesses are conducted wholly digitally. A two part assessment is discussed, first ascertain whether an enterprise is engaged in “fully dematerialised digital activities” and then assess whether it maintained a significant digital presence in the economy of another country.

With regard to the first test the Discussion Draft identifies eight potential indicators that could be included in a test for when a fully dematerialised digital activity was conducted. Two variants are then proposed and examples given to ascertain whether a significant digital presence has been breached. In the first “significant digital presence test,” a permanent established would be deemed to exist if the foreign enterprise has a significant market presence for its digital goods or services. In the second “significant digital presence test” a permanent establishment would be deemed to exist if the foreign enterprise, engaged in a fully dematerialised digital activity, conducts a significant business in a country using personal data obtained by regular and systematic monitoring of internet users in that country through the use of multisided business models.

To begin with, this proposed nexus standard appears to contradict the Discussion Draft’s conclusion (see paragraph 205 referenced above) that ring-fencing the digital economy is neither appropriate nor feasible. This approach is impracticable not only because of the difficulty of identifying digital goods and services offered across multiple sectors, but because of the difficulty of defining terms such as “significant” and “substantial,” as well as the thorny issue of attributing profits to a Digital permanent establishment. This problem was acknowledged by the Task Force. (Para. 216).

Additionally, this approach would be a major shift from three fundamental long-standing tax policy concepts – (i) the ability to ‘trade with a country’ without creating a taxable presence, (ii) the acceptance of a force of attraction principle, and (iii) a presumption that value is created at the location of consumption. As a relevant example, the 2010 Report on the Attribution of Profit to
Permanent Establishments states, “... since a server-PE will not be carrying out any significant people functions relevant to the attribution of economic ownership of assets and/or the assumption of risks in the absence of personnel acting on behalf of the enterprise, no asset or risk could be attributed to it under the authorised OECD approach, supporting the conclusion that little or no profit would be attributed to such a PE’. We reiterate that the OECD should carefully consider the consequences of abandoning long-standing principles that establish jurisdiction to tax rights predicated on the existence of a core physical presence.

The proposals relating to the creation of a Digital permanent establishment as a result of gathering consumer data is particularly troubling. This proposal pre-supposes market data alone is sufficient to trigger a taxable nexus and that such raw data is a key value driver to the enterprise. We see no support for such a conclusion. It is difficult to get an estimate of how much data is created every day but an often quoted estimate puts it at 2.5 quintillion bytes per day, with 90% of the data generated in mankind’s existence having been created in the last two years. There is no doubt that modern computers can process massive amounts of data and through statistical analysis identify potential correlations between data, however the value lies in the identification of causation and that involves the development of highly complex algorithms, software tools, and expensive research and development. Raw data is being produced at a rate that is driving its unstructured value to a minimum; the value can only be attributed to the activities that turn that data into something meaningful, and profits should be attributed to the location where that occurs, not the raw production.

This leads us back to one of the more troubling aspects of this proposal as mentioned briefly above— attribution of profit to a Digital permanent establishment. It appears inconsistent to posture that income from intangibles should be allocable to Significant People Functions (e.g., where the research and development activities occur) and ignore the people functions that drive value for businesses offering digital goods and services (e.g., the people functions that create the digital content, perform the supporting research and architect the necessary IT infrastructure). The digital content and functionality of these offerings is ultimately created by people. If this analysis were to follow the current emphasis on people functions in the draft Chapter VI Transfer Pricing Guidelines, there is no basis to find significant value based on consumption activity.

3.3 Virtual Permanent Establishment

This option should not be pursued for the same reasons as mentioned above with regard to the proposal to create a new nexus for a significant digital presence.

The discussion draft notes that over recent years a number of alternative options for PE thresholds have been discussed. The most recent work being performed by the Business Profits TAG which considered three broad alternatives:

- A virtual fixed place of business PE – created through the maintenance of a website on a server of another enterprise located in a jurisdiction ad carries on business through that website.
- A virtual agency PE – extend the habitual conclusion concept when this is performed through technology and not a person
- On-site business presence PE – created through on-site services or other business interface at the customer’s location

The Discussion Draft states the above are only mentioned for completeness – which implies they are not proposing to pursue any of the options at this time. This is presumably on the basis that existing principles, such as selling into a market without presence or a dependent agent, are accepted as not creating a PE, and for the reasons outlined above are not changed by the adoption or expansion of technology into the economy.

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5 Part 1: General Considerations, para 66, (July 22, 2010)
3.4 Creation of a Withholding Tax on Digital Transactions

KPMG does not recommend that this option be further pursued because of the complexities in administration identified in the Discussion Draft as well as the fact that, from KMPG’s experience, many of the enterprises offering digital goods and services are either loss making or generating relatively low margins that would not support a final gross basis withholding tax (even a withholding rate as low as 5 percent). Digital goods and service are not equivalent to high-profit payments that typically draw withholding tax (e.g., dividends, interest and royalties) and should not be taxed similarly. Gross basis source country tax imposed on “business profits payments” (clearly a point made in the Discussion Draft’s lengthy discussion of business models), if imposed at all, should be value added taxes, not withholding taxes. This position is consistent with long standing tax policy.

It is interesting to note that the income payments currently subject to withholding tax relate to primarily passive forms of income associated with capital investment in the form of equity or debt (dividend and interest withholding) and income from rights that have been transferred be they protected under patent or copyright or process knowledge such as know-how. A common feature of such items is that they represent a return from an asset that subsists within the economic framework of the country making the payment and therefore can be considered to have a source within that country. Another common feature of such passive investments is that as a general rule nothing further is required of the investor, they have given up the right to enjoy the money or asset and have to do nothing more to enjoy the interest, dividend or royalty. As such, absent possible sundry expenditure the gross payment is an adequate estimate of the income generated from the underlying asset. This is in direct contrast to the sale of (digital) goods or services that give rise to business profits. There is all manner of expenditure incurred by the selling party to get the good or service to the point of consumption and it is impossible to ascertain what level of profit is associated with the good or service in question and the application of a withholding tax could push even an otherwise profitable transaction into economic loss. Assessing the rate of withholding to be applied would be a monumental task as well as an effective collection mechanism as the bulk of purchases will be B2C.

This proposal also raises serious complexities around income characterization. What would constitute a digital good or service? Further, would DVDs, CDs, and other digitally embedded media/hardware constitute a digital good? What about future goods and services we cannot envision today? This issue further illustrates the administration complexities of this proposal.

Further, B2C transactions present significant administrative concerns. It is unlikely that individual consumers will collect and pay over a withholding tax. Imposing a withholding tax on these transactions will create significant burdens for the financial system—a concern of the Ottawa principle of neutrality. Such administrative issues appear to be essentially the same as those applicable to the indirect tax system for cross-border digital transactions.

In our opinion, not only are there similarities in administration for this proposed gross basis withholding tax and VAT, both taxes appear to have the same end result—i.e., a tax levied on consumption, not value creation. This has historically been the role of indirect taxation. In other words, long standing tax policy holds that net income tax is imposed on the location of value creation whereas VAT is imposed on the location of consumption—notwithstanding that value may have been created elsewhere. Given the similarities of this proposal to a VAT and the difficulties of imposing a new digital withholding tax as discussed above, we discourage the OECD from pursuing this option.

3.5 Consumption Tax Options

A constant theme in the Discussion Draft is the impact of ICT in the economy and the observation that for goods and services that may be digitised business has embraced these technologies and in certain circumstances adopted a business model that enables them to market and sell goods and services from remote locations to consumers in foreign jurisdictions. Automatic credit checking and billing platforms have facilitated the growth in online shopping by consumers. These developments have presented challenges to VAT collection as these supplies often result in no or an inappropriately low amount of VAT collected and create potential competitive pressures on domestic suppliers.

Exemptions for Imports of Low Valued Goods

In an attempt to optimise the costs of collection and administration requirements, many countries have implemented a VAT exemption on the import of low value goods. The thresholds for these exemptions vary widely across jurisdictions. Many of the exemption systems were introduced before
the on-line sales and the year on year growth in digital sales may require a review of the exemption systems to ensure that they are still appropriate.

It is proposed that if improvements to the efficiency of processing low value imports were made by tax authorities, it would be more feasible to lower VAT exemption thresholds and increase the relative VAT revenue collected. The discussion draft concedes that a key element of the solution is for non-resident vendors of low value parcels to be able to efficiently charge, collect and remit the tax on the imports of these goods in the importing jurisdiction. This will likely only be achieved through simplified registration and compliance mechanisms, using the possibilities offered by new technologies (e.g. on-line registration and filing, electronic payment).

KPMG agrees that governments should take all necessary measures to protect their tax base and to ensure competitive distortions are avoided. However, this must be in the context of ensuring that the cost of collection and compliance is commensurate with the VAT collected.

Remote digital supplies to consumers
As noted above a key element to the solution is to require the non-resident supplier to register and account for the VAT on these supplies in the jurisdiction of the consumer. Many jurisdictions, most notably the EU have announced proposals that will set out to achieve this aim.

Whilst this remains the most viable option, it is recognised that requiring non-resident suppliers to register in countries to which they remotely deliver services may impose significant compliance burdens. It is recommended therefore that countries should consider the use of simplified registration regimes and registration thresholds to minimise the potential compliance burden on businesses. KPMG recommends that in order to minimize the administrative burden in this area that OECD develops recommendations on these points so that countries can adopt uniform rules that apply on a global basis.

To assist in managing the challenges in enforcing compliance from non-resident suppliers, improved international co-operation between jurisdictions is likely to be required and should consider enhanced exchange of information, assistance in recovery and simultaneous audits.

3.6 Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

We have some concerns about the explanation for “neutrality” in the Ottawa principles. The principles were put together in 1998, which predate by nine years the launch of the smart phone (around 2007) and the explosion in on-line businesses in the last ten to fifteen years. Digital businesses often do not have an analogous non on-line equivalent – for example social networking sites do not have an analogous non on-line equivalent. We are concerned about statements that taxation should be neutral between “conventional and electronic forms of commerce” may cause inappropriate comparisons of unique digital businesses and non-similar conventional businesses. Furthermore, is it really appropriate to say that a business selling computer game discs in a particular country through physical shops should be tax neutral with a business selling computer games on line, or providing the game for free and allowing users to pay for advantages within the game or particular features? We think not. We feel the concept of neutrality as outlined in the Ottawa principles is now outdated, and should be replaced by a concept of neutrality that provides for tax guidance that treat all business fairly through uniform broad based rules that do not single out a particular sector or business model for “special treatment”.

4 Conclusion

Para 59 of the Discussion Draft summarises the challenge faced by trying to address this particular issue in isolation:

“As digital technology is adopted across the economy, segmenting the digital economy is increasingly difficult. In other words, 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. Attempting 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. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by MNEs together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns, and developing approaches to address those challenges or concerns.”

We endorse the conclusion that there is no separable digital economy without reservation and encourage the Task Force to address the tax challenges of the digital economy through the other aspects of the BEPS Action Plan. The principles of international trade that started in the late 19th century, were tackled by the League of Nations over a 24 year period from 1921, and embodied in the OECD Model Tax Convention are as relevant today as they were when first considered by the League of Nations’ Panel of Experts.
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13 April 2014  
**Digital Economy Discussion Draft**

Dear Mr. Eggert:

Liberty Global appreciates the opportunity to submit these comments to the OECD on the Discussion Draft on the tax challenges of the digital economy dated 24 March 2014. We agree to have our comments posted on the OECD website.

Liberty Global is the largest international cable company with operations in 14 countries. We connect people to the digital world and enable them to discover and experience its endless possibilities. Our market-leading triple-play services are provided through next-generation networks and innovative technology platforms serving 25 million customers with 48 million television, broadband internet and telephony services. Liberty Global’s consumer brands include Virgin Media, UPC, Unitymedia, Kabel BW, Telenet and VTR. Our operations also include Liberty Global Business Services, and Liberty Global Ventures, our investment fund. We employ 36,000 people. Our headquarters are located in Denver, Amsterdam and London. For more information, go to www.libertyglobal.com.

**Taxation principles**

Our view is that potential tax challenges of the digital economy should be analyzed in a structured way. Therefore, it is important to deal with the challenges within a robust framework. We strongly support the 1998 Ottawa Taxation Framework Principles, referenced by the Discussion Draft, as it provides a good framework to perform the analysis. Further, we believe the right balance should be struck between the principles mentioned. In this complex world, it is very important that the rules are clear and simple to understand, and simple to apply for both taxpayers and tax
authorities. It is also very important that taxation is neutral and does not discriminate between
digital transactions and conventional commerce. Taxation should not disturb the development of
the digital economy. It is not possible to ring-fence the digital economy from the rest of the
economy and, because of the neutrality principle, we are also of the view that it should not be
ring-fenced.

Reliance on Data

The Discussion Draft lists a number of key features of the digital economy, including the reliance
on data. We agree with the importance of data in today’s economy. We also agree with the
statement made in the report that the use of data to improve products and services is not unique
to the digital economy. The Discussion Draft continues that the gathering of information is
creating challenges for tax policy makers. The data may be collected using technology developed
in a second country.

The BEPS action plan in general focuses on value creation as an important factor when allocating
profit. On the other hand, action point 1 of the plan and the Discussion Draft introduce the
generation of data or the use of data as a (new) value creating factor. The Discussion Draft
seems to imply that (part of the) profits should be allocated to the country where the customers
from which the data is collected are based, notwithstanding that the functions are being
performed in another country. These two factors – the mere use and the value creation through
functions - are inherently contradictory, and can and should not be used simultaneously.

The introduction of specific rules for the taxation of the use of data would potentially challenge the
neutrality principal referred to above. For example, a company selling physical goods into another
country without physical presence in that other country would be taxed for corporate income tax
in his home country, while a company selling digital goods might also be taxed in the country of
use of the data. In addition, the practical implications (compliance burden and profit allocation)
would be considerable.

Finally, it follows from the above that this would mean a significant shift towards source taxation
which will have broader consequences than the mere taxation of the use of data: certain
countries may broaden the concept of making use of their markets to increase the level of
corporate income tax. Therefore, we wonder whether the OECD should further explore this
direction.
Nexus and Permanent establishments

The Discussion Draft indicates it does not only deal with BEPS related topics, but also addresses other tax challenges of the digital economy. Some of these relate to fundamental discussions with respect to taxation rights. The suggested options to address the broader challenges include the introduction of a new nexus concept and the modification of the Permanent Establishment (PE) status. First, we would like to note that any reconsideration of the definition of PE and/or the introduction of a new nexus concept should go hand in hand with an analysis of the allocation of profits to a PE. Broadening the definition of taxable presence, or reduction of the exemptions in the PE definition, would in itself not result in attribution of (significant) profits to the PE. However, it would lead to an increase in situations where taxable nexus /PE would exist, and therefore to an increase in the administrative burden for international business.

In the current rule set for allocating profits, the role of (significant) people functions is preponderant. This is aligned with the focus on value creation in the rest of the BEPS action plan. Shifting to another methodology, like physical or even virtual presence without people functions would – similar to the use of data as commented above – imply a significant shift with broader consequences. The starting point should be that the digital economy is not treated differently from regular commerce. Therefore, we would recommend the OECD not to change the allocation of profits methodology, given the broader impact.

VAT, consumption tax and withholding tax

Liberty Global agrees with OECD’s statements in paragraph 171 that implementation of the OECD’s Guidelines on place of taxation for B2B supplies of services and intangibles seems the appropriate way to minimize any unwanted BEPS results as indicated in paragraph 170. Furthermore, for our business it is even more important to have as the main principle that B2B cross-border services are taxed in the country in which the customer is established and that these are taxed through the self-assessment mechanism (main rule). This mechanism is the least burdensome for business and at the same time it reflects the key principles of a consumption tax. Whilst Liberty Global recognizes the need for certain specific rules for determining the place of supply, we believe that these specific rules should be kept as minimal as possible. In order to avoid double or non-taxation, alignment of definitions of the main rule versus specific rules, as well as establishment criteria (between direct and indirect tax as well as countries) is a key requirement.

With regard to cross border B2C services by a non-resident supplier, Liberty Global agrees that the most viable option to ensure an appropriate VAT-collection is the vendor collection mechanism through the mini One Stop Shop as implemented in the European Union. We also
agree with the OECD that countries should consider the use of simplified registration schemes to minimize the potential compliance burden on businesses. At the same time, in our view it is important administrative requirements and audit procedures are aligned to avoid that differing positions of tax authorities would result in an uneven burden for business.

The Discussion Draft does not explicitly discuss the option of introducing new consumption taxes. However, it does make reference to the potential introduction of a withholding tax on digital transactions. Liberty Global is of the view that the existing taxation system provides a robust basis for countries to levy taxes. Simplified procedures may reduce the administrative burden for business and may enhance the enforcement of the existing rules. The introduction of consumption taxes or withholding taxes for digital transactions - if double tax treaties would not provide a credit for the tax withheld - would increase the tax burden, thereby harming the neutrality between digital transactions and conventional forms of commerce. It might also increase the compliance burden if new administrative requirements would be introduced, e.g. for filing tax returns for the new taxes or procedures to credit the withholding tax.

Features of the digital economy and its implications

The Discussion Draft contains an extensive description of the features of the digital economy. It addresses various important topics, like network effects, first mover advantages and market position. The Discussion Draft does not yet provide guidance on how to deal with these topics. Specifically from a transfer pricing perspective, Liberty Global would welcome concrete and practical guidance on how to deal with these features.

If you have any questions or would like further elaboration of any of these comments, please contact us.

Yours sincerely

On behalf of Liberty Global

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Dear Sirs

We write in response to the request for comments on the Public Discussion Draft on BEPS Action 1: Address The Tax Challenges Of The Digital Economy 24 March 2014. We are pleased to offer our comments as follows.

In respect of the specific issues on which you have requested comments:

• Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules;

It is fair to say that today’s economy has digital features which in some areas determine the way business is conducted. In other business activities digital features merely alter certain processes but do not change the business model fundamentally. As such there is no separate digital economy just as there is not a separate economy for other technological innovations. However the way that business is now carried out does render certain aspects of international tax law outmoded. This does not mean that long established and widely recognised concepts such as the residence principle and the arm’s length principle need be set aside. We therefore feel that solutions should be developed within the existing framework of international tax principles that underlie the OECD Model Tax Convention.

• The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account;

• The examples of new business models in the digital economy and whether (and if so which) other business models should be considered;

The discussion draft provides a useful summary of the key features of the digital economy and many new business models that have arisen as a result of changes in technology. One striking feature of current progress has been the acceleration of the speed of change in information technology and related fields. There is a need to find solutions which are sufficiently flexible so that they are not quickly outdated. While it is never easy to speculate on what the future holds it should be possible to introduce rules suitable for the medium rather than the short term.
A feature that should be recognized is the highly speculative nature of much development in this field. For every business initiative that has a successful outcome with commercial value, many initiatives fail. It should therefore be recognized in tax arrangements that not all ventures will be profitable and governments should not expect tax revenues to ensue from all activities. Tax incidence at an early point in the value chain, irrespective of commercial outcome, will stifle investment returns. This will discourage investors from taking the risks necessary to generate the economic benefits that flow from technological progress.

• The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy;

As the discussion draft recognises, many jurisdictions with a value added tax or other consumption taxes use a destination principle to determine whether VAT should be charged. In our view, business to business supplies create few BEPS concerns from a VAT perspective, with the exception that businesses that carry out exempt activities may achieve a VAT saving in some cases. For example, where the destination country does not operate a reverse charge, or if the supplier can charge VAT at a lower rate than applies in the destination state.

Within the European Union, specific rules governing the place of supply of electronically supplied services, coordinated at the EU level, have existed since 2002, with substantial changes in 2010, and again from January 2015. In the case of business to business supplies, VAT is usually accounted for by the customer in the jurisdiction where they are based, under the reverse charge mechanism. In the case of business to consumer supplies, from January 2015, all suppliers will be required to account for VAT based on the rates applicable where their non-business customers are based. They will either register for VAT in each EU jurisdiction where they have customers, or in one place under a special "one stop shop" scheme.

Compliance for consumption taxes on cross-border supplies is also a problem. The draft recognises that the excessive cost of collection can justify exemptions from VAT for the import of low value parcels, but heavy use of the exemptions by suppliers moving operations overseas can have a significant revenue cost and distort competition with domestic suppliers. Similarly, it is difficult to collect VAT on the remote delivery of services by non-established businesses (for example, software downloads, or streaming of music or films). Adopting a source principle would allow suppliers to establish in low-tax jurisdictions, and individual consumers cannot be expected to self-assess under a destination system. Vendor collection (as adopted in the EU) is perhaps the best route, but relies to an extent on enforcing compliance extraterritorially. Compliance can be encouraged by adopting simple online registration and accounting systems, backed by exchange of information and mutual assistance.

We believe that a solution based on consumption tax options will give rise to double taxation because consumption taxes, such as VAT, GST, sales and purchase taxes, are particularly poorly coordinated across jurisdictions compared to direct taxes.

• Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones;

We believe there needs to be a close connection between the allocation of taxing rights and the ability to measure the amount of profit, or other tax base. For example BEPS Action Point 8 (Assure that transfer pricing outcomes are in line with value creation: intangibles) will be of particular relevance. The discussion draft recognises that the digital economy is characterised by an unparalleled reliance on intangible assets. It also recognises that many areas of the digital economy rely heavily on the mobility of
intangibles. This mobility should not be limited by tax policies that infringe the neutrality principle and thereby create a disincentive for businesses to deploy them internationally. This would nullify much of the social gain that has arisen from technological progress. For example, a jurisdiction claims taxing rights based on cash flows in relation to an intangible and then deems the intangible to be subject to an exit charge, based on future cash flows. Those future cash flows will be taxed again in a second jurisdiction causing double taxation, both juridical and economic, likely to extinguish the commercial viability of such transactions in the future.

A consensus on whether a PE has arisen will be of little value unless it is accompanied by agreement on how to attribute taxable profit. The OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments was a helpful document in that it set out how the approved method could be applied to three specific businesses, banking, global trading of financial instruments and insurance. A similar approach would prove very helpful in this work too. Otherwise we are concerned that in the BEPS project a considered and detailed approach to the practical issues could be sacrificed in order to meet tight deadlines.

Similarly BEPS Action Point 9 covering risks and capital and BEPS Action Point 10 covering other high-risk transactions will also be important points of convergence.

- The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation;
- The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft;

A distinction between those business models that have evolved as a consequence of digital technology and those enterprises that have merely enhanced their existing business models will be useful in developing solutions. It would not make sense for a business that has digitally enhanced an existing business model to face significantly different tax outcomes.

As noted above, residence based taxation has been the approach underlying much of the work done to develop an international consensus in tax matters. While source based solutions “bridge the gaps” they should not predominate. We are therefore concerned lest the options outlined cause a move to taxing a business merely because it has customer cash flows arising in a jurisdiction but no actual part of its value chain.

We feel that eliminating paragraph 4 of Article 5 entirely would represent a large step backward in the history of the OECD Model Tax Convention. Similarly to remove paragraph 4 (a) through (d) only, would expose many enterprises to an unjustified change of tax outcome. If the feeling is that the “preparatory or auxiliary exemption” is being abused then this should be addressed by clarifying the guidance in the commentary. Interpretation of Article 5 has been problematic even though the guidance has been expanded. Since there is much uncertainty on to how to apply Article 5 in practice, this is often considered by recourse to cases in jurisdictions other than the country in question. Such cases are of interest because the point under consideration has been litigated there, but usually they cannot be relied on as determinative. There are, therefore, good grounds to develop the Article 5 commentary much further.

We have misgivings about the idea of a ‘virtual PE’. In any case, it would be important that a ‘virtual PE’ test should be interpreted in the same way across different countries. The factors in such a test would need to be applied consistently across jurisdictions. Questions such as whether all or only a number of factors would need to be present also require similar uniformity.
We also have concerns on the comments on the value of “Big Data”. Data itself has limited value as it is only when data can be converted into useful information that it provides commercial advantages. The focus should therefore be on information rather than data collection.

- The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives;

Some of the greatest advances in technology come from smaller and medium-sized international businesses. Often this is from the vision of one or more individuals who are prepared to take risks to test and develop ideas that may not appear reasonable to larger organisations at first sight. This is especially true of the information technology and communications sector. We propose that exemptions should be extended to SMEs, especially in growth markets, to encourage innovation and to avoid stifling the commercial application of advances in technology. This should particularly assist those economies that are yet to fully engage with the digital economy, where capital and specialist skills may be scarce.

Many of our concerns, in fact, relate to a question of balance. A business may have some degree of presence, whether digital or otherwise. However it is inefficient to tax this unless that presence is sufficiently significant to make it worthwhile to measure the attributable value and to incur the costs of making a local tax filing. To find the right balance will always involve a challenging compromise but to push too far in either direction is neither in the interest of international development nor in the long-term interests of governments.

- Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

We agree that the Ottawa framework principles serve as a good guide with which to approach possible solutions. We would add the ability to pay principle and the benefits principle insofar as they are not specifically covered by the principle of ‘fairness’.

More generally we would like to make the following comments on this discussion draft:

The reform of the definition of a permanent establishment, how and when one arises and how profit should be attributed for the special features of the digital economy should be part of a separate process. This is partly because the BEPS timetable is a tight one and partly because it involves issues beyond base erosion and profit shifting. Any work to produce a new Article 5 and/or commentary should involve specifying as much detail as possible. The same is true of Article 7.

There must be a connection between the definition of a PE and the amount of profit that will be attributed to the PE. These two issues should not be divorced. A number of model business cases should be examined in further work. These would trace though the process from how a PE would be defined to how a profit attribution would work.

It would be helpful to classify digital business transactions further, expanding some of the references in the discussion draft such as “cloud services”, “fully dematerialised transaction” etc. For each one, the model itself and the terms used to express it could be defined. Some examples could then set out the key digital facets of the model, how these give rise to the challenges seen, how each of these would fit a proposed solution and, for each solution, how the attributable profit would be determined under an ‘OECD approved model’.
The discussion draft acknowledges the complexity of the issues. There may be a danger that the extent of work needed to provide practical solutions that are clear and are widely accepted may be underestimated. Superficial guidance with widely differing interpretations between jurisdictions on digital commerce issues will only prove counterproductive. We believe there are many points at issue that need to be worked through beyond the immediate priorities of the BEPS project.

Please contact the undersigned with any questions or comments.

Yours faithfully

Martin Zetter
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on behalf of Macfarlanes LLP

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14th April 2014

Comments to:  
Public discussion draft,  
BEPS Action 1: Address The Tax Challenges Of The Digital Economy.

Dear Sir, Madam

Thank you for providing the opportunity for Meridian to contribute with comments on  
the BEPS Action 1 document “Address The Tax Challenges Of The Digital  
Economy”.

Meridian has over 25 years’ experience in working with some 15,000 international  
businesses (Multinational & SME) in providing assistance with international VAT  
issues and have a staff of some 400 people dealing solely with international VAT  
issues and declarations.

We are currently a member of HMRC’s group on the Standard VAT Return and a  
forum member of the OECD Technical Advisory Group on International VAT / GST  
Guidelines (TAG).

Meridian is currently responsible for filing over 30,000 VAT/GST declarations into  
multiple jurisdictions per annum for clients from predominantly Europe, North  
America & Asia. We also work closely with companies that facilitate access to the  
global digital economy such as eBay, ChannelAdvisor, Digital River and many others  
to raise awareness among their users of the need to be VAT / GST compliant in all  
jurisdictions.

After reviewing the public discussion draft document in detail, we would like to  
provide you with the following feedback based on our practical experience and day to  
day discussions with businesses regarding the indirect tax challenges they experience.

We hope this feedback will aid you in your process and if you have any further  
briefing or request for feedback we would appreciate the opportunity to attend and or  
comment.
Consumption Tax Challenges:

From a business perspective

- Lack of awareness of current requirements
- Lack of understanding of the vast array of requirements in each jurisdiction
- Complexity and variety of different methods required in each jurisdiction
- Filing requirements in addition to VAT / GST declarations
- Increased IT Costs
- Focus on running what are often relatively new businesses and the other challenges associated with managing geographically expanding enterprises

We have a lot of experience of clients who already find it difficult to provide the necessary information and correct filing, on time and remit the appropriate monies to the correct location. Indeed as the party representing these companies, we ourselves find it an extremely onerous and burdensome task to keep up to date with all of the minute details required to successfully file VAT / GST returns and associated documents with each authority.

While this is the area we have specialised in for over 25 years our clients and the vast majority of businesses we engage with on a daily basis around the world have not and are busy trying to run and manage their own enterprises.

We would suggest that as part of the options being considered to try and address the tax challenges of the digital economy, consideration should also be given to reducing the burden on third party service providers of international tax services for these digital economy businesses. For the following reasons;

- Lack of awareness of current requirements

In our daily experience the vast majority of businesses we engage with are completely unaware of the VAT / GST obligations they may have in any country outside of their own location. We find that we and other third party service providers are regularly the first source of this information for these businesses. Through our associations with other businesses in the e-commerce sector like eBay, ChannelAdvisor etc, and our own communications we are far more likely to have raised the issue of cross border VAT / GST compliance than any other source. The business themselves does not know to look for this information and is normally distracted with many other more obvious and prominent pressures like marketplace listings, translations, payment systems, fraud, logistics, product sourcing, customer service etc.
• Lack of understanding of the vast array of requirements in each jurisdiction

Indeed even those businesses we engage with who are aware of their obligations often find the intricacies of meeting all the requirements for making a VAT / GST filings in multiple jurisdictions to be overwhelming. Some of the most frustrating elements tend to be around the different country specifics they need to keep abreast of e.g. in one country you must make filing then pay, in another you must make payment then file, in some countries you must provide additional detailed invoice listings etc.

For a business engaged in the modern global digital economy they will not have grown over a long time period and hence, not have built up internal experienced finance and tax teams. In fact the digital economy has brought about the ability for small companies to grow big quick and expand without having to take on a lot of traditional activities which would have been the norm.

• Complexity and variety of different methods required in each jurisdiction

A medium sized e-commerce business is now very likely to be doing business with customers in several other countries and because of the innovative solutions available to them they are also likely to be moving goods closer to these markets in bulk (fulfilment solutions such as FBA from Amazon). Therefore it is very plausible for a mid-size business to have VAT / GST filing obligations in several different countries.

In our experience where this is the case the majority will look to have a third party provider or several third party providers manage their obligations on their behalf. The main reason being that the business themselves does not have and has no interest in maintaining internal resources to keep up to date with the requirements in all jurisdictions and complete the on time filings for each jurisdiction. In nearly all cases the business is looking for a cost efficient outsourced solution that they can trust.

• Filing requirements in addition to VAT / GST declarations

The challenges for business do not confine themselves to the filing of the VAT / GST return. In a number of jurisdictions there are several other non-VAT / GST return filings that must be submitted as a consequence of the VAT / GST filing. These additional filing requirements appear to be increasing.

• Increased IT Costs

There is a difficulty experienced among many e-commerce businesses in accessing the required data from their systems, especially where additional specific information on transactions is required. As these businesses expand globally they face not only the burden of making themselves aware of what additional information is required but adapting their systems to be able to capture and report. As many work off a single platform for all markets it is not always possible to make these changes without incurring large costs. Third party service providers are often required to extract and
work with raw data to produce the necessary information in the required format to submit. As the number of markets entered by businesses increases it is just not commercially viable to make the changes within their systems for every jurisdiction and manual intervention is the only option.

In our experience there is a large amount of non-compliance among e-commerce businesses. Some of which is conscious and mainly due to the fact that they believe that no one is policing the non-compliance (or can’t). But the vast majority is due to lack of awareness or just being unable to work out how to comply. From what we have observed in previous examples of simplification of processes by authorities for foreign businesses, the aim is not always achieved and in some cases the burden is inadvertently increased.

For the reasons above and specifically the fact that in our experience engaging with thousands of these digital economy businesses, addressing the tax challenges that they face directly themselves will only address part of the possible solution.

The fact remains that a large number of these businesses use third party service providers because they do not want to maintain this expertise in-house and want this as an option to help them grow and expand their businesses globally. The current situation for third party service providers who specialise in international VAT / GST services is that they are further burdened by many countries. This situation creates another barrier to providing the digital economy with commercially competitive solutions for businesses to choose from as a viable and attractive alternative to maintaining international VAT / GST expertise in-house.

We would therefore suggest that another option to be considered in addressing the tax challenges of the digital economy is the additional burden placed on third party service providers. This segment is a potential willing and experienced contributor through whom the necessity to be tax compliant can be communicated to the market and from whom the concerns and pressures of businesses can be acquired. By reducing the additional burden on third party providers as well as any burden reduction for business directly, the costs to business will be reduced, the choice of viable options will be increased and the overall compliance level will be increased.

Finally we would like to express our interest in attending any arranged discussion concerning this topic.

If in the meantime you require any further information please don’t hesitate to let me know.

Best regards
Mark O’Riordan
Chief Executive Officer
Meridian Global Services
Patrick Breslin Comments in Response to the

Public Discussion Draft
BEP Action 1: Address the Tax Challenges of the Digital Economy
(hereinafter, the “draft”)

Issued by the OECD Committee on Fiscal Affairs and Country Delegates
under the OECD Base Erosion and Profit Shifting (BEPS) Action Plan

(Comments submitted April 14, 2014)

Once again, I would like to thank the OECD Committee on Fiscal Affairs, country delegates and other participants in the OECD BEPS initiative for the opportunity to continue to provide comments on this important project. As noted in my prior comments relating to this project, my views are informed by my experience as an economic consultant, which has focused on transfer pricing, including intangibles-related transactions, as well as non-tax-related intellectual property (IP) matters.

I also relate my experiences as an entrepreneur and business executive for a digital technology company (Relatable) that participated in early stages of the market for digital distribution of music over the Internet. With Relatable, I also testified in related copyright infringement litigation matters and consulted for technology providers on such matters. In addition, I weigh my experience as a consulting expert in litigation involving intellectual property, as well as IP valuation and related issues. This consulting experience often directly relates to the digital economy, including Internet and mobile technology-related business models. I believe all of these experiences are contextually relevant to this BEPS initiative, as it focuses on international tax issues in the digital economy.

These direct experiences with developing business models in the digital economy spanned formative periods in the markets for digital music and media distribution and foreshadowed their continuing evolution. In these contexts, I have also negotiated multiple arm’s length technology license agreements and other transactions involving intangibles, such as rights to copyrighted works, and valued technology solutions and enterprises.

My comments focus on the prominent role that technology development plays in creating value in the digital economy. This discussion considers software intangibles development as a primary example.
Technology development in the digital economy: Software as an example

The draft provides a useful and comprehensive discussion on the key features and business models pertaining to the digital economy. This detailed description facilitates useful references to other issues handled later in the draft. Of note with respect to my comments to follow are these observations regarding the “Evolution of Information and Communication Technology” (ICT), paraphrasing from paragraphs 11-14:

- ICT has been characterized by rapid technology progress;
- Pressure for constant innovation results in constant cycles of price decreases and commoditisation as newer premium technologies supersede old ones—constantly expanding consumer access to technology;
- There is frequent movement of technology innovation to new areas in the value chain as older elements (e.g. PCs) become standardized and lower priced;
- There is growth in specialisation in hardware devices on the part of businesses formerly specialized in software or other parts of the value chain;
- Innovative integrated packages of hardware and software, such as smartphones and tablets are becoming commonplace.

As noted in my prior comments, it is my view that a focus on technology investment and innovation itself as a business activity (along with its corresponding risks) is essential to understanding value creation in these contexts. This is the case even as enterprises develop and pursue very different business models and supply chain structures. The contributions of parties that undertake, manage and control risky technology investments greatly impact value creation in the digital economy, notwithstanding other potential contributions that may also exist.

Software development (including software embedded in devices) plays a central role in the digital economy, in part by increasing the productivity of humans and machines alike. In examining Figure 4.A (“Layered View of ICT,” page 19), every layer is inoperable without software. Infrastructure is supported and controlled using software. On top of it are software resources—primarily software used to create more software. Accessibility tools operate similarly for software development, as software applications are created in this environment—moving directionally from development and infrastructure tools toward end user applications. Finally, the end users must use software to access a user interface.

Furthermore, in order to function, computer hardware relies upon the software applications relevant to its purpose. These two elements are interdependent; there is no meaningful purpose in having one without the other. The same may be said for data and their
interdependence with databases, database software and, naturally, hardware. These items operate collectively and do not have much use separately. In fact, it is increasingly the case that automation of any equipment, computer or otherwise, is performed by embedded software or its equivalent (i.e. on the device itself).

Software essentially represents a series of instructions, devised by the programmer, that are later performed (i.e. “executed”) by hardware devices compatible with the software application. Thus, software accounts for a significant shift toward increased automation, which gradually allows machines to perform functions formerly done by humans. The early stages of artificial intelligence are manifest in the software development process. As noted in paragraph 179,

Advances in computing power have also meant that certain functions, including decision-making capabilities, can now be carried out by increasingly sophisticated software programs and algorithms. For example, contracts can in some cases be automatically accepted by software programs, so that no intervention of local staff is necessary.

Such advances will only continue. As the draft presciently notes, “as robots embed more software and are connected to cloud-based resources, it will become both easier and cheaper to program them...” (Paragraph 36) It also foretells that “robots learn to do jobs that previously were solely done by humans.” (Paragraph 37)

These are not purely futuristic notions. In many cases, software has long performed functions that were once “solely done by humans” – such as automated calculations in spreadsheet and tax preparation software, for example. None of this discussion diminishes the value contributions of hardware and other programmable devices themselves, or the other essential layers in Figure 4.A. The intent here is simply to focus the comments on value creation in one key context that pervades ICT and the digital economy.

The mobility of software intangibles exceeds that of users and key business personnel

The question then arises, when and where does value creation occur when using software that functions through the ICT chain? Most often, the software’s value is generated at a different time and place than it ultimately functions. That is, the value is created when and where the investments in software technology development are made, managed and controlled.

As the draft effectively notes in paragraph 92,

Development and exploitation of intangibles is a key feature of the digital economy. This investment in and development of intangibles is a core contributor to value creation and economic growth for companies in the digital economy. For example, digital companies often

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1 Note paragraph 14 which states “A relatively recent development is the advent of innovative integrated packages of hardware and software, such as smartphones and tablets (and increasingly, connected wearable devices).”
rely heavily on software, and will expend substantial resources on research and development to upgrade existing software or to develop new software products.

This view contrasts with assertions that substantial value creation takes place when and where software functions are executed, such as when software interfaces (e.g. websites) are accessed by consumers in the market and user data is collected. By this point, the programmed functionality of the software and its ability to collect, manage and process data has already long-existed, regardless of any raw data elements it may later collect from a certain location. Thus, it is important to recognize that the mobility of intangibles does not speak directly to the locus of their value creation.

In fact, the mobility of intangibles such as software extends far beyond the mobility of software development managers and programmers, as well as software users. The mobility of software intangibles is magnified by the potential for widespread distribution of copies at very low cost (through the ICT), such as when a popular game app is downloaded by millions of end users. However, the mobility of the skilled personnel responsible for programming such software is quite limited. Meanwhile, the mobility of users has increased as well. But, like the skilled programmer, the single consumer cannot replicate her/himself and/or be present in multiple jurisdictions at the same time, though this is true for copies of executable software and other intangibles.

The mobility of business functions (other than those executed by software) also arises due to increasing use of ICT. Often, this is “as a consequence of the decreased need for local personnel to perform certain functions.” (Paragraph 91)

Implications for value chain analysis

At arm’s length, the role and the value of a particular activity is often diminished by technology advances, as it becomes integrated with the activities of upstream or downstream parties at other steps along the value chain (or becomes altogether unnecessary). As described in the draft, new business models in the digital economy tend reduce or eliminate steps along the supply chain through such disintermediation. For example, as noted in paragraph 64 regarding B2C models:

Through digitisation of information, including text, sound, and visual images, an increasing number of goods and services can be delivered digitally to customers increasingly remote from the location of the seller. B2C e-commerce can in many cases dramatically shorten supply chains by eliminating the need for many of the wholesalers, distributors, retailers, and other intermediaries that were traditionally used in businesses involving tangible goods.

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2 See paragraph 102, which notes, “First, skills and talent remain a critical resource in the digital economy. Although many functions can be performed with limited personnel, managers, developers, software architects, and designers, among other key functions, remain instrumental.” It also notes other limitations on the geographic location of intangible development.
Meanwhile, as ICT enables multinationals to reduce their reliance on personnel and physical presence in market jurisdictions they sell into (see paragraph 123), they often organise their supply chains by integrating activities within centralized and/or intermediary structures. However, the draft notes it is possible for such structures to “spread [activities] among multiple jurisdictions, away from the market jurisdiction.” (Paragraph 179) Such a response may contradict the observed ability to disintermediate, raising questions when structures introduce new intermediaries in digital economy-focused supply chains.
14 April 2014

Via email: CTP.BEPS@oecd.org

Dear Sirs,

Comments on the Discussion Draft on Addressing the Tax Challenges of the Digital Economy

We appreciate this opportunity to provide our input on The OECD's Public Discussion Draft on BEPS Action 1: Address the Tax Challenges of the Digital Economy. The response in the pages that follow reflects the views of the PwC network of firms, and we offer our observations on several key aspects of the Discussion Draft. As an initial matter, we welcome the growing consensus reflected in the Discussion Draft that the digital economy cannot be ring-fenced from the rest of the economy and that businesses should not be subject to a different set of rules of taxation simply by reason of the use of information and communications technology (ICT). We fully endorse this principle of neutrality. In that regard, the Ottawa Taxation Framework principles are still relevant today and should constitute the basis to evaluate options to address the tax challenges of the digital economy.

The Discussion Draft provides a good background summary concerning the development and widespread use of ICT, and shows that nearly all sectors of the economy rely on advances in ICT to deliver their products and services, digital or otherwise. It seems to us that where the Discussion Draft speaks of a “digital business”, it is referring to businesses which make more extensive use of ICT, i.e., any difference between a digital versus other business is a quantitative difference in the use of ICT, not qualitative. Therefore, because the rest of the economy cannot be separated from the digital economy, any option for addressing digital economy tax challenges should consider not only neutrality, but also should avoid creating unintended collateral consequences for the rest of the economy.

We recognise that the BEPS Action on the digital economy is driven by a concern as to whether existing international tax rules have kept pace with emerging new business models enabled by the rapid development of ICT. However, we caution that these concerns should not lead to the discarding of long-established principles of international taxation on which there is international consensus. OECD treaties are valuable to support and encourage trade in goods and services. Any perceived concerns with, and any potential changes resulting from, the work on the digital economy should neither endanger this nor stifle innovation and the continued use of ICT which increases both business efficiency and productivity.

The remainder of this comment letter sets forth (A) our general observations (B) our answers to the questions in Para. 10 of the Discussion Draft, and (C) our comments on potential options in Part VII of the Discussion Draft.
A. Our general observations

1. The BEPS efforts on the digital economy have been driven by a concern from some states that the current rules of international taxation do not give fair allocation of taxing rights. This is a question which individual states are clearly entitled to raise. However, we urge great caution in separating questions of base erosion and profit shifting from questions of allocation of taxing rights which are best dealt with as part of a much broader discussion.

2. As discussed above, the economy cannot be separated into digital versus non-digital because almost all sectors of the economy use ICT to deliver products and services. Consequently, any changes or options that are proposed will affect all businesses and must be evaluated accordingly.

3. A common theme among the digital economy tax issues raised in the Discussion Draft is the ability to sell into a territory without creating a taxable presence. The use of data, characterisation of payments for services and collection of VAT are also commented upon (para. 177).

4. Looking at the examples in the paper some disquiet seems to come from the “fragmentation of business activities” and the collection of data. “Fragmentation” is not clearly defined and insofar as it refers to the performance of business activities through different locations and entities, it seems to us that it does not necessarily implicate BEPS concerns. In addition, the conduct of activities through different locations and entities can occur across all sectors, not just internet or “digital” companies. Similarly, all businesses collect customer data and many will analyse data using the techniques allowed by modern computing. These are not new business phenomena. As the OECD have acknowledged, any attempt to “recharacterise” transactions is fraught with difficulty. Accordingly any “anti-fragmentation” policy would be likely to create considerable uncertainty and therefore we question its effectiveness as an approach. If however, such an approach were to be pursued, it would be essential that very clear principles were established to reduce that uncertainty as far as possible.

5. We believe the OECD should not move away from the long-standing concept within permanent establishment of carrying on business through a fixed place of business. We would not have thought that it is possible to redefine that basic nexus standard to apply just to companies that make more extensive use of ICT.

6. Over the last 15 years, the OECD has undertaken significant work in defining permanent establishment in the context of distance selling, including the work done by the Business Profits Technical Advisory Group. The conclusion drawn from that work has been that merely selling into a market without a physical presence or a dependent agent within the market is not sufficient to create a permanent establishment allowing that country to tax a share of the enterprise’s profits.

7. We support this long established consensus. It seems to us that an individual or business based in one territory which sells into another territory, whether by use of catalogue, telephone or internet, should not be taxable in that other territory if they have no physical presence or dependent agent in that other territory.
In summary, we believe that there is no digital economy that is separate from the rest of the economy. Nearly all businesses leverage advances in ICT and, in this sense, constitute a part of the digital economy. As a result, any changes to existing international tax rules ought to be considered as part of the other BEPS workstreams, and not separately, consistent with the suggestions made in the Discussion Draft.

B. Our answers to questions raised in Para. 10

1. **Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules.**

   We do not believe that it is possible to ring-fence the digital economy because the digital economy encompasses almost all sectors of the economy and to formulate different standards for the digital economy would not satisfy the Ottawa Taxation Framework principles, including the principle of neutrality.

2. **The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account.**

   The key feature of the digital economy is the use of ICT which nearly all businesses across all sectors of the economy rely on to improve their businesses, increase efficiency, and reduce costs.

3. **The examples of new business models in the digital economy and whether (and if so which) other business models should be considered.**

   We think that very few, if any, of the business models described in the report are new or novel. In the vast majority of cases there are parallels in business models that existed long before the advent of the internet and ICT. What is different about them is the ability to conduct business through the use of ICT to achieve greater flexibility, efficiency, and geographical reach. This can apply in any industry or sector.

4. **The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy.**

   There are, as identified in the OECD’s paper, specific issues which need to be addressed in this area – essentially to do with compliance and identification of the supplier and/or customer. Of the four models suggested (to determine the place of taxation and the location of the taxpayer - issues currently being examined within the TAG on VAT/GST Guidelines), we agree that the most appropriate model is likely to be the model where the supplier has the obligation to account for VAT/GST in the country of residence of the customer, whilst acknowledging the practical difficulties that this may create for business. However, the requirement for non-resident suppliers to register in the taxing jurisdiction is feasible only if facilitated through the use of de minimis thresholds, simplified registration/compliance procedures and easy access by business to information about the VAT-rules and obligations in the taxing jurisdiction.
There is, in addition, a clear need for precision as to what services are considered to be ‘digital services’ to which the general rules above would apply (and are not exceptions to the ‘general’ rule, e.g., land related services). Although the definitions used by both the EU and the OECD are very much aligned in this area, identical definitions must be applied globally to prevent double taxation. Non-digital services must be specifically excluded where the underlying service supplied is consumed at a physical location – e.g., transport. Within the EU, substantial progress has been made to provide a clear set of guidelines and rules for business. There may be some assistance the EU could give to other countries in respect of drafting effective rules. Enforcement, compliance and collection will remain issues and could be dealt with through greater global cooperation, in the way that they are dealt with within the EU.

5. Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones.

We believe that the digital economy is not separate from the rest of the economy and therefore the transformation of business from the increased use of ICT is more appropriately addressed within the framework of the other workstreams in view of the Ottawa Taxation Framework principles, taking into account both direct and indirect tax considerations.

6. The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation.

Please see our comments above in Part A. In addition, we refer to the four areas of challenge specified in Para. 177 as follows:

- Nexus: anything done in respect of nexus could affect all businesses, not just digital, and therefore needs to be effected through the PE Working Party.
- Data: All companies collect and use data and we are not seeing any new challenges arising that are specific to “digital” businesses.
- Characterisation: We see no new issues pertinent to “digital” businesses alone. The proper treaty characterisation of transactions in digital products and services, including cloud computing, has been subject to detailed and thoughtful analysis by existing OECD guidance.
- VAT collection and compliance: See our comments below.

7, 8 The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft. The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives.

Regarding our comments on questions 7-8, please see our discussion below concerning Part VII of the Discussion Draft.
9 Whether the Ottawa Taxation Framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

We strongly believe that the Ottawa taxation framework principles remain an appropriate basis for analysing options to address any perceived tax challenges. The application of the framework principles should be supplemented by a consideration of unintended collateral consequences. Because the digital economy is not separate from the economy as a whole, any attempt to provide rules that specifically target the digital economy will affect broad cross sections of the overall economy. Please see our comments in the introductory part of this letter for our overall comments, as well as our discussions of various potential options discussed elsewhere in this letter.

C. Our comments on potential options in Part VII of the Discussion Draft

Part VII of the Discussion Draft merely presents options that have been raised to the Task Force, and does not fully analyse or evaluate their pros and cons or whether they satisfy the criterion of the Ottawa Taxation Framework principles. We would suggest that, in further considering the options, the Task Force should evaluate them based on these framework principles and would recommend that any perceived issues that led to these suggested options be addressed as part of the ongoing work in other working groups, taking into account the significant body of work that the OECD has done in the past 15 years or so, including the work done by the Business Profits Technical Advisory Group.

1. Modifications to the Exemptions from Permanent Establishment status (Part VII, section 3.1)

We are in favour of retaining the “preparatory or auxiliary exclusion” and believe that withdrawing it would cause considerable uncertainty and potentially controversy. However, we acknowledge that governments may feel the need to reconsider the scope of this exemption and, in particular, whether each category mentioned in Article 5.4 of the Model Treaty needs to be of a preparatory or auxiliary nature. If any such change were to be pursued it would be essential that it was very clear in scope and introduced over a period of time to allow businesses to adjust their operations as necessary. In any event, this issue will potentially affect all businesses and is a question for Action 7 rather than a digital economy only question. In addition it should be made clear that the existence of a VAT number in a territory does not of itself create any form of PE.

2. A New Nexus based on Significant Digital Presence (Part VII, section 3.2)

This new nexus would be an alternative for businesses that are completely conducted digitally and will be based on a significant digital presence and engaged in “fully dematerialised activity”. We believe that this option seems to be largely a different version of similar questions that arose several years ago with respect to business models arising from the use of radio, television, and mail-order. The conclusion has long been that merely selling into a market without physical presence or a dependent agent within the market is not sufficient to create a permanent establishment allowing that country to claim a share of the enterprise’s profits. This would be a substantial departure from those principles. We do not believe that the increased use of ICT by businesses warrants a departure from these long established principles.
Another important shortcoming of the significant digital presence PE option is that it is highly subjective and will likely lead to double taxation and increased controversy. For example, an economic presence PE is triggered based on certain vague and subjective standards, e.g., “significant” number, “widely” used or consumed, “substantial” payments, etc. (para. 214). In addition to our concerns regarding neutrality, we believe that such a new PE standard would not satisfy the Ottawa Taxation Framework principles of efficiency (due to the potential increase in controversy), certainty and simplicity, and effectiveness and fairness. If, despite the concerns raised, such a change were to be pursued, it would need to be very carefully and, we would suggest, very narrowly defined.

3. Virtual permanent establishment (Part VII, section 3.3)

The Discussion Draft presents certain “virtual PE” options but indicates that they are included “for the sake of completeness”. It is unclear whether this means that the Digital Economy Task Force is not proposing to take forward these suggestions at this time. In any event, many of our comments above regarding economic presence PE are also relevant to virtual PEs, including concerns from a neutrality standpoint. In addition, as more and more businesses utilise advancements in ICT, these options will also raise the issue of unintended collateral consequences across the entire economy. Finally, creating a new form of PE in this fashion could widely increase PE assertions, controversy, significant compliance burdens, and incidences of double taxation. It would also create significantly increased compliance costs and burdens for business and tax authorities.

4. Withholding tax on “digital transactions” (Part VII, section 3.4)

We would suggest that the issue regarding whether withholding tax should be imposed on payments for digital products and services should be determined under existing OECD guidance on characterisation of income from e-commerce transactions, and we would also suggest that most “cloud computing” business models in fact are not “new” business models that should warrant a change to existing rules concerning the types of payments that are subject to withholding tax. The Discussion Draft itself acknowledges that such business models have existed for decades (para. 26). Also, hosted software business models and other online products and services are already addressed in the 2001 OECD report on tax treaty characterisation issues arising from e-commerce transactions.

The broad international consensus for many years has been to try to minimise or eliminate withholding taxes because taxes imposed on gross income do not take into account profitability and can act as a deterrent to international commerce by making expansion across borders unprofitable. In addition, this option would create important potential collateral consequences by imposing withholding tax on broad categories of “conventional” commerce that previously were not subject to withholding tax, for example, traditional software products, music discs and movies, which are all digital products.

We agree with the observation in the Discussion Draft that various considerations must be taken into account in relation to this proposal, such as trade obligations, and the practicalities of collecting such a tax, especially in the case of individual customers. Clarification would also be needed as to which payments would be subject to the tax, and whether the decision for this, and the rates of tax, would be at international or local territory levels.
5. **Comments on consumption tax options (para. 219-224)**

The Discussion Draft identified four main issues in applying indirect taxes to the digital economy – the two other issues involving exempt entities and distortions created by the use of multi-location entities (MLEs) are not specific to the digital economy and whilst they are referred to in the Discussion Draft are not specifically commented upon here – as the work being done on the OECD’s guidelines on the place of supply of B2B services (to be formally launched at the Global Indirect Tax Forum in Japan) and the VAT treatment of MLEs (as well as the institution of a GAAR) would, in our view, deal with the issues raised.

The specific issues identified (in relation to both digitally supplied services and low value goods and which relate solely to B2C transactions) are:

- Identification of the supplier.
  - Difficult to implement and enforce taxation at this level, for a number of practical reasons.

- Determining the extent of activities.
  - This will require consistent and effective global cooperation between tax authorities.

- Information collection and verification.
  - As above, with respect to global information sharing.

- Identification of customers.
  - Will be onerous to implement and monitor.

Our more detailed comments on these issues are provided in Appendix 1 to this letter.

The solution adopted within the EU for the application of VAT to B2C supplies of services which are supplied digitally and which do not lead to ‘physical’ consumption, such as transport (in other words non-tangible services), is a good model to pursue globally and is one with which the EU and the OECD and business through the Technical Advisory Group on VAT/GST Guidelines have been very much involved. In this work, business has very much insisted on the need for flexibility when it comes to developing the appropriate proxies regarding the place of taxation. (In particular the need on tax audit to be able to evidence these proxies to the tax authorities where it is practically impossible for business to identify the actual residence of its customers.)

Further work within the TAG is needed in this area in order to be able to develop a robust, yet flexible system which is satisfactory to both taxpayers and tax authorities.

**Additional Comment**

In Section V, para 169, the report suggests considering a CFC rule that specifically targets income earned from the sale of digital goods and services. This proposal is at odds with the principle of neutrality. Under such a rule, a CFC that sells electronic books would generate taxable income to its ultimate parent company, unless certain exceptions are met, while a competitor CFC that sells the same books printed on paper would be unaffected. A CFC that sells both the electronic and printed versions of the same books – even if both are sold to the same customer – could cause its parent to be subject to tax on one sale but not the other. Such change should be considered by the CFC Working Party.
If you would like to discuss any of the specific comments in our response please do not hesitate to contact me or Pam Olson (pam.olson@us.pwc.com, mailto: +1 (202) 414-1401) or Stephen Dale (stephen.dale@fr.landwellglobal.com, +33 156574161).

Yours faithfully

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APPENDIX 1: Consumption Tax Options

The specific challenges identified in the Discussion Draft, in relation to both digitally supplied services and low value goods and which relate solely to B2C transactions, are:

- Identification of the supplier.
- Determining the extent of activities.
- Information collection and verification.
- Identification of customers.

1. The identification of the supplier. This is complex, as by their very nature such digital services can be supplied from outside of the jurisdiction of the taxing authority (assuming that the ‘model’ of taxation in the country of residence of the customer is accepted – ie destination principle). Any destination based taxation system will have to rely heavily on self-disclosure and registration. In this regard any taxation system must be simple to comply with, documentation must be readily available in multiple languages, and the requirements must be communicated and updated regularly to ensure that non-established suppliers are made fully aware of their obligations and responsibilities. The need for a very precise definition of a digital service is clearly key for suppliers to be able to appreciate whether they need to register, file returns etc and in which location. The issue of the identification of the supplier and ensuring its compliance is even more problematic particularly where there are long supply chains of the services involved and where the systems for compliance in the country of the usual residence of the customer are complex, not available in English and non-automated.

2. Determining the extent of activities. A tax authority needs information to be able to determine the extent of the activities carried out by a non-established supplier within the tax authority’s jurisdiction. This issue is not specific to the digital economy as in the non-digital economy the same issues arise, but probably on a smaller scale, with goods being sold within a territory within which the supplier is not established. The solution here, as is foreseen in relation to the B2C changes within the EU from next year, being an automatic sharing of information between tax authorities at least on the levels of globalised information. This cooperation between countries is essential, as the EU system for non-EU suppliers of digital services has shown, as it has apparently recorded less than 1000 companies registered for VAT in the EU, for a system in place since July 2003.

3. Information collection and verification. This issue is directly related to the above issue, in the sense of being able to determine not only the extent of the activity carried out in the taxing state but also the nature of the transactions – and the applicable tax rates – how the notion of proxies is applied etc.

4. Identification of customers. As the OECD notes in the Discussion Draft “There are in principle a number of ways in which a business can identify the country of residence of its client and/or the country in which consumption occurs. These could include... tracking of IP and card billing addresses. However, this could be burdensome for the business and would not work where customers are able to disguise their location.” Any solution
proposed must achieve a balance between the amounts of VAT/GST at stake that have to be collected and the administrative costs for business and governments related to the collection of that VAT/GST. Getting this balance wrong discourages compliance and will lead to a distortion of competition for business engaged in cross-border B2C supplies.

The requirement which results from the application of the ‘destination’ system for non-resident suppliers to register in the taxing jurisdiction is feasible only if facilitated through the use of de minimis thresholds, simplified registration/compliance procedures and easy access by business to information about the VAT rules and obligations in that jurisdiction.

There is, in addition, a clear need for precision as to what services are considered to be digital services to which the general rules above would apply (and are not exceptions to the ‘general’ rule, e.g., land related services). Although the definitions used by both the EU and the OECD are very much aligned in this area, identical definitions must be applied globally to prevent double taxation. Non-digital services must be specifically excluded where the underlying service supplied is consumed at a physical location – e.g., transport or other tangible service. Another aspect of the work of the TAG on ‘rulings’, to ensure that there is consistency in the treatments applied, is vital in this area and this work must be urgently pursued to ensure that the VAT/GST system is neutral. Within the EU there is no problem with the VAT rules per se but enforcement can be an issue. There may be some assistance the EU could give to other countries in respect of drafting effective rules. It may be possible to address the enforcement issue through greater global cooperation, in the way that it will be dealt with within the EU.

**Low-value imports of goods**

1. The Discussion Draft also deals with the treatment of ‘low value’ importations of goods which create potential distortions of competition with businesses located within the same territory as the customer. Whether this issue is directly related to the digital economy or more generally to the globalisation of business and even C2C trading is debatable.

2. The issue here is again one of identification of the supplier and the person liable for the payment of the VAT due. The OECD has identified that if the tax due could be collected from the suppliers, as for digital services, with a simple compliance obligation (and with de minimis thresholds) this would allow the exemption thresholds to be reduced and hence remove some of the current distortions of competition. However, the proposal by the OECD will represent a significant burden on suppliers, the costs of which will be borne by the end consumers in higher charges, potentially creating adverse distortions of competition and limiting the growth in international trade. If the existing system is maintained, there are economic arguments which suggest that reducing the thresholds is potentially not justified as the burdens on tax/Customs authorities are disproportionately large compared to the tax revenues collected. Countries should be able to decide to keep (or remove) the thresholds on a case by case basis.

As for the further work required on B2C digital supplies, the TAG should pursue work in this area.
Centre for Tax Policy and Administration  
Organisation for Economic Co-Operation and Development  
Paris, France

Via Email: CTP.BEPS@oecd.org

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

We are writing in response to the OECD’s request for comments in relation to the Public Discussion Draft on the tax challenges of the Digital Economy.

Reed Elsevier is a world leading provider of professional information solutions. We operate across several professional market segments through five business divisions comprising of Elsevier, LexisNexis Legal and Professional, LexisNexis Risk Solutions, Reed Exhibitions and Reed Business Information. Reed Elsevier operates in more than 30 countries and employs approximately 28,500 people worldwide. Reed Elsevier is the world’s fourth largest provider of paid-for digital content.

We appreciate the serious efforts which have been made in the Public Discussion Draft to enquire into the underlying characteristics of the digital economy which cause difficulties in a tax context and to explore options for further consideration. We have focused our representations on the key practical issues for our businesses.

1. **Challenges for international taxation**

We agree, as noted in paragraph 2 of the Public Discussion Draft, that “the spread of the digital economy also poses challenges for international taxation.” Quite apart from concerns regarding BEPS, it is necessary and timely for the OECD to develop further guidance on the treatment of digital business models under double tax treaties and for transfer pricing.
purposes. There are difficult issues to be addressed but we believe that these can all be dealt with in the course of the on-going project on the chapter of the Transfer Pricing Guidelines on intangibles, as well as some revision of the chapter on cost contribution arrangements, and under the other BEPS action items. We feel that the key objectives, in addition to addressing the BEPS concerns, should be to provide clarity, to avoid uncertainty and to minimise the risk of double taxation.

2. **BEPS concerns**

Paragraph 122 of the Public Discussion Draft describes certain strategies associated with BEPS including minimization of taxation in the market country by avoiding a taxable presence, low or no withholding tax and low or no taxation at the level of the recipient. While these features may be associated with BEPS, there are clearly cases where there may be no local presence, no withholding tax or no taxation at the level of the recipient where BEPS is not a relevant consideration. It is essential to consider the full facts and circumstances.

Example: A digital information provider based in a European jurisdiction with a tax rate of 25% provides data to hospitals throughout the world. The company will have no presence in any country other than its home country, is providing a business service on which there should be no withholding tax (under OECD principles) and there is no taxation at the level of the recipient because these are mostly non-taxable publicly funded bodies.

The Public Discussion Draft identifies BEPS opportunities in relation to VAT in the case of remote digital supplies to exempt businesses. Importantly, however, this is only half of the issue. Where a business provides digital services to entities which are not subject to VAT it is very important that mechanisms exist whereby the recipient can claim appropriate treatment.

Example: In country X digital services are not currently subject to indirect taxation. A new indirect tax is introduced to ensure that the consumption of digital services is appropriately taxed and foreign suppliers are required to register. Hospitals have fixed budgets and are not able to recover all of their input tax because their outputs are partially exempt. They would now have to either pay the indirect tax to the foreign supplier, who registers and collects the tax, or have to apply the reverse charge and account for the tax. Either way, they will have a reduced budget available for the actual services which they require. The solution is to provide a mechanism whereby the hospitals (and other publicly funded bodies e.g. Universities, Charities) are relieved from
applying the reverse charge or the supplier is relieved from charging the indirect tax.

It is important to deal with this issue in a balanced manner so that as well as the BEPS concerns, the treatment of publicly funded bodies, where indirect tax on digital services is a real cost to their budgets, can be addressed. It is also important not to create distortion between the treatment for VAT purposes of physical goods and digital services e.g. print medical journal containing papers of the latest research into cancer treatment compared to an electronic equivalent.

3. **Tackling BEPS in the digital economy**

We agree that the other actions of the BEPS Action Plan will address BEPS in the context of the digital economy and we agree that this is a better approach than devising special measures for digital businesses. We comment in the following paragraphs on the options discussed in Section VII of the Public Discussion Draft. We consider that most of the options are likely to be unworkable in practice. However, recognising that solutions have to be found to the problem areas we then suggest an approach to applying existing international tax principles to complex digital business models.

We comment first on the option to recognise a permanent establishment where a digital business maintains a "significant digital presence" but conventional rules would indicate that it has no permanent establishment in the territory in question.

**Example:** A digital information provider, the taxpayer, based in a European jurisdiction with a tax rate of 25%, provides data to hospitals throughout the world. It meets the criteria set out in paragraph 213. A significant number of hospitals in a foreign jurisdiction subscribe for data services. The customers submit a signed contract to the European home office where they are signed by the taxpayer. As a matter of contract law the contracts are regarded as made in the European home jurisdiction. Substantial payments are made for use of the services.

If a digital permanent establishment is considered to exist two questions arise. How is revenue to be attributed to the permanent establishment and how are costs to be allocated? Revenue could be allocated according to the country of origin. In other words revenues received in the European home country from customers in the foreign jurisdiction would be the starting point for the tax base in the foreign jurisdiction. The foreign jurisdiction would also need to
be assured that revenues received by other legal entities within the multinational enterprise, but of a similar nature, were included in the calculation in order to avoid artificial splitting of revenue streams. This means that every taxing jurisdiction would need to have a full analysis of all revenues received by every entity in the enterprise. As a practical matter it would be quite challenging to agree on the segregation of revenues into relevant categories and then the allocation between jurisdictions.

In order to allocate costs it would be necessary to identify which categories of cost related to which categories of revenue, to identify appropriate allocation keys for each category of cost and to provide every tax authorities with a complete breakdown of costs so that they could satisfy themselves that the allocation was appropriate. The allocation key is likely to at least include the local proportion of global revenues. This would mean that the foreign jurisdiction would need to know the amount of revenues received from every country in the world, in this case there being nearly two hundred countries in which hospitals subscribe for data. Again, it seems extremely challenging to agree on the cost allocations without a great deal of difficulty. This presupposes that it has been possible as a practical matter to provide the potentially enormous quantity of information to every tax authority and that once received it has been possible for them to process the data.

Other difficulties arise. For example it may be possible for a hospital to purchase certain data directly from the supplier or, in the alternative, from intermediaries or agents in other countries. Would revenues earned from an independent agent in a third country be allocated to that country in taxing the digital enterprise or to the country in which the ultimate purchaser, the hospital, was based? If the answer is the country of the agent, the taxation of the revenue in that country rather than that of the hospital would clearly be a distortion. If the answer is the country in which the hospital is located, the compliance process would be even more tortuous.

This example is just one illustration of the extreme complexity, uncertainty and administrative difficulty which could arise from the recognition of a significant digital presence as a permanent establishment.

Other difficulties arise in relation to “virtual fixed place of business PEs" where, for example, a server is located. Leaving aside the difficulties of identifying which particular server carries out a particular function in the era of cloud computing, there would be scope for abuse or
distortion, for example where traffic might be directed to servers in particular jurisdictions for non-business reasons.

Withholding taxes would create a number of difficulties. Withholding taxes cannot be calibrated to the profitability of a particular line of business so low margin businesses are likely to suffer significant disadvantages while high margin businesses might be insufficiently taxed. One consequence may be that contracts typically include “gross-up” clauses whereby the withholding tax is, in effect, borne by the consumer so that these become merely additional taxes on consumption rather than taxes on the profits of business activities through which the services are provided.

4. **VAT and indirect taxation**

There are difficult theoretical questions as to the appropriate balance between direct and indirect taxation which need to be carefully considered. At this point, we would simply suggest that the solution to BEPS is not to substitute additional taxes on consumption in place of taxes on business profits which have not been collected. It would be a reasonable presumption that, in any particular jurisdiction, consumption is already being taxed at a level which is felt to be appropriate.

5. **Application of the existing international tax principles to the digital economy**

We believe that the sound application of existing principles will provide a framework for the digital economy once further guidance has been developed to deal with difficult cases. We agree that value chain analysis and profit methods can be effective as indicated in paragraph 166 of the Public Consultation Document. Techniques that may be helpful include:

- Developing a model of a digital business by analogy with traditional businesses
- Functional analysis which recognises the relative contribution of small numbers of individuals who are responsible for key IP creation
- Accepting that where there is no physical presence in a jurisdiction, profits are not earned there for tax purposes.

Example: A company collects data on widget manufacturing and distribution and sells this data to manufacturers, distributors and consumers of widgets throughout the world. A manufacturer in Norway provides data free of charge to the company in the UK where the head of global widget research is based. He incorporates the data in his global database which is held on a server in the
US. The software was designed by a team in the affiliated company in France and written by software engineers in the affiliated company in India. The data is sifted and tagged in the production centre in the affiliated company in the Philippines. The sales contracts are negotiated with global customers and entered into by the affiliated company in the Netherlands. There is a sales office in Tokyo which provides support to a customer in Australia which contracts directly with the Dutch subsidiary. The customer’s global head of widgets is on holiday in China when he downloads the latest data. Although he is on holiday he sees an immediate opportunity and telephones his head office and secures a valuable contract.

The tax treatment of the various activities can be ascertained by reference to the equivalent traditional business activities and a value chain analysis.

Norway: Although certain data originates in Norway the taxpayer has no activity in Norway and should not be taxed there. In the traditional environment the data might have been posted or faxed by what is clearly a third party. The collection of data in Norway is clearly valuable for the taxpayer but entirely outside his control.

UK: The head of global widget research is located here. This is where a large part of the value is created and should be taxed.

US: The servers are located here but this is a routine service for which a routine return is appropriate.

France: The software was designed here. A value chain analysis is required to determine how much value is attributed to the software and how much to the data.

India: Coding is a routine service and a routine return is appropriate. (If higher value functions take place here the transfer pricing analysis should reflect that).

Philippines: Tagging is a routine service and a routine return is appropriate.

Netherlands: The appropriate return will reflect the degree to which risk is assumed by the Dutch company and the functions carried on there.
Japan: The return will be appropriate to a sales support function.

Australia: The taxpayer has no activity in Australia and should not be taxed there.

China: Although the data was downloaded in China the taxpayer has no activity in China and should not be taxed there. It may not be apparent that the data was downloaded in China if the individual used his company’s VPN which would route the request for the data through the Australian customer’s servers.

The key principles that might be applied are:

- to identify in each jurisdiction the analogous non-digital business, taking into consideration the functions, assets and risks;
- to recognise, where relevant, that very small numbers of individuals might represent the heart of the value creation in a particular business (in this example, in the UK);
- not to apply a “force of attraction” principle to attribute additional value to routine or secondary activities where these are, in substance, routine or secondary in nature.

6. Specific comments

Is it possible to ring fence the digital economy?

No because every digital business is at least to some extent traditional and every traditional business is at least to some extent digital. It is not possible to identify a clear boundary.

Are there other key features?

In the digital economy, technology platforms are increasingly costly and are likely to be jointly developed by members of a multinational enterprise. Work is urgently needed to update the Transfer Pricing Guidelines for cost sharing arrangements involving the joint development of intangibles such as technology platforms. One area which requires particular attention is that of assets which are developed over a long period of time where the allocation of costs to a jurisdiction in which the asset is brought into use may take place long after the original costs were incurred. There may be no mechanism for adjusting the cost allocation once periods of assessment in the original jurisdiction are closed. Other areas of difficulty include the identification of appropriate allocation keys where the
reasonably anticipated benefit is highly uncertain and the treatment of changes in ownership interests or cost shares of cost-shared assets like technology platforms.

Are the Ottawa taxation framework principles still appropriate?
Yes.

Are there more compliance cost efficient alternatives?

Despite the difficulties in applying the arm’s length standard in the digital economy, we strongly agree with the OECD that the alternative of formulary apportionment would result in a much higher degree of uncertainty and a risk of multiple double taxation. While it is difficult to apply the conventional approaches to the digital economy it is even more difficult to devise a satisfactory basis on which to allocate revenue and costs to all relevant jurisdictions on the basis of formulary apportionment. This problem will be exacerbated by the way in which the digital economy facilitates trade with larger numbers of jurisdictions than was possible in the past. The traditional allocation keys of revenues, employees and physical assets are extremely hard to apply in businesses where the revenues cannot easily be allocated to jurisdictions, employees are highly mobile and there are no physical assets. Although it may be difficult for tax authorities to agree the allocation of profits according to conventional methodologies, it will be far more difficult for large numbers of jurisdictions to agree to the outcome of formulary apportionment.

Paul Morton
Head of Group Tax
Reed Elsevier Group plc
Revenue Department of Thailand

I am very impressed with the work of the OECD.

It is well known that profit shifting impacts not only on the work of tax jurisdictions and government budgeting but also on ordinary taxpayers, including SMEs, and ultimately on the macroeconomic stability and social cohesion of a country.

It is widely felt, across all sections of society, that the tax system should be fair and comprehensive, where economic activities create value in accordance with the principles of tax legislation.

On the topic of OECD BEPs, I would appreciate it if your organisation could comment on the following points:

1. Regarding the concept of permanent establishment (PE) which at present does not differentiate between businesses (one size fit all). Therefore, in numerous cases, the definition of PE as a place of management or people can easily be abused and create many loophole which does not match with real business economic activities.

   Thus, if it is possible for the OECD and member countries to refine its definition in accordance with the nature, business purpose, result from significant value chain analyst to distinguish which function is profit center or support (cost) center and also economic value creation of the taxpayer’s business, which may all differ from business to business.

   For instance, by refining the elements that are value chain analyzed in order to establish whether a taxpayer qualifies for PE status according to its online, data base, place where customer are, manufacturing and distribution activities. Value chain analyst for PE, it may be the case that the definition of PE for trading may consider manufacturing and distribution activities and physical flow (rather than documentation flow) as elements in arriving at a definition of PE (group PE for the business), which may differ from the concept of PE for construction or e-commerce businesses.

   At present, the definition and the mechanics for establishing PE are prone to abuse through loopholes which are exploited by MNEs, because a crucial element in the current definition centres on the location of management rather than the real business purpose which could include the location of manufacturing and distribution activities. Thus, adding business purpose as one of the criterias for PE recognition may also help to close loophole of avoiding tax law principle.

2. Regarding a tax standard, the OECD and developed countries may wish to set up an International Tax Board to develop best practice for each tax issue/area.
This Board would have responsibility for setting up international tax standards for each area, for example responsibility for defining PE or for setting up an international tax standard, similar to the International Tax Reporting Standards. This Board would also assume responsibility for developing tax audit methodologies, rule of CPA for tax auditing which may be applied to developing countries to comply within the same standard as developed economies.

Lastly, I wish to express my appreciation for all of the OECD work on BEPS and other topics.

Best Regards,

Mr. Chalermphong Tungboriboonrat
CPA-Thailand, Tax Economist
Revenue Department of Thailand
c.tungboriboonrat@gmail.com
Dear Mr. Russo,

We appreciate the opportunity to comment on the OECD Public Discussion Draft “BEPS Action 1: Address the Tax Challenges of the Digital Economy”. SAP is one of the leading international providers of enterprise applications and one of the largest independent software manufacturers. Headquartered in Germany, we have more than 253,500 customers in over 180 countries and more than 66,500 employees in more than 130 countries worldwide.

We welcome the discussion draft’s thorough look at the digitalization of the economy and related tax implications, given the globalization of the economy which implies an increasing “virtualisation” of the trade and business. Considering the proposals made in the draft for direct and indirect taxation, we would highlight the following:

Regarding direct taxation

- From a general perspective, we do not share the view, that the taxation of digital activities requires a separate set of tax rules. In our view, the other actions addressed in the BEPS Actions Plan are sufficient in this regard.

- Nevertheless, if the OECD wants to increase the taxation right for digital activities in a market country, from our perspective, option (1), i.e. the amendment of the exception catalogue in Article 5 par. 4 of OECD Model Tax Convention, seems to be the only feasible approach which can be effective, fair and simple, provided that an obligatory arbitration process is introduced in case of issues of double taxation. The other three options i.e. a new nexus based on significant digital presence, a virtual permanent establishment or the creation of a withholding tax on digital transactions, are, in our view, not appropriate to distinguish traditional activities from digital activities, lack legal certainty, would significantly increase the administrative burden and also lead to significant double taxation. Therefore, we strongly recommend to not introduce options (2), (3) and (4).

- Finally, the discussion draft is very focused on the pure definition of a permanent establishment, while the relating profit allocation is underrepresented. However, what all three
permanent establishment relevant options have in common is a missing alignment between the
definition of a permanent establishment and the significant people functions approach. If the
OECD intends to retain this standard as it is, the proposed permanent establishment definitions
would have no significant impact on the market countries’ tax revenue. However, if the OECD
intends to modify or even suspend the significant people functions approach in certain areas
like the digital economy, this would weaken the overall coherence. We would welcome further
insights from the OECD on this topic.

Regarding indirect taxation

- In our view, the two measures proposed, i.e. exemptions for imports of low valued goods and
remote digital supplies to consumers, are acceptable.

- However, when implementing the measures, it should be considered that compliance and
administrative burdens for the businesses will arise which will result in higher costs for the
suppliers. If such burdens will not be minimised, it is inevitable that such increased costs will
be passed on to the customers. If this is not possible, depending on the business model, some
businesses might be endangered by the cost of such measures.

Attached please find our detailed comments on the key aspects of our concern. We would be
pleased to discuss our considerations at your convenience.

Best regards
Ina Schlie
SVP Global Tax / SAP AG
Comments on the Public Discussion Draft – BEPS Action 1: Address the Tax Challenges of the Digital Economy

I. Introduction

We refer to the “Public Discussion Draft – BEPS Action 1: Address the Tax Challenges of the Digital Economy” and the opportunity to comment on such Discussion Draft. Given the globalization of economy which goes in line with increasing “virtualization” of trade and business, the taxation of the digital economy is rapidly gaining importance in practice. Accordingly, SAP as one of the leading international providers of enterprise applications and one of the largest independent software manufacturers is very interested in a sustainable international framework of definitions and regulations. We therefore very much appreciate your efforts in developing guidance in this highly relevant tax matter and, in particular, the release of the present interim discussion draft. We are pleased to provide our comments on the draft and, hopefully, to contribute useful thoughts from our practical view.

Our comments are not intended to be comprehensive but are focused on the key aspects of our concern. Our comment letter concentrates on the following options:

**Direct taxation:**
- Option (1): “Modifications to the Exemptions from Permanent Establishment Status”
- Option (2): “A New Nexus based on Significant Digital Presence”
- Option (3): “Virtual Permanent Establishment”
- Option (4): “Creation of a Withholding Tax on Digital Transactions”.

**Indirect taxation:**
- Option (2): “Remote Digital Supplies to Consumers”.
II. General remarks

Taxpayers are particularly interested in a stable regulatory framework. Changes to the existing tax systems require adjustments of existing processes and usually lead to a high administrative burden. Against this background, we appreciate that none of the proposals in Section VII. Subsection 3. of the discussion draft aims at introducing a completely new and separate tax regime for the digital economy, as has been proposed e.g. in the “Collin-Colin-Report”1. Instead of ring-fencing the digital economy, any options to reform the taxation of digital activities should take the existing tax rules as a starting point and changes should be kept to a reasonable minimum.

We would expect that any design of specific tax rules for the “digital economy” would start with a definition of the scope. In this regard, it is essential to reach an alignment on the term “digital economy”. However, the economy as a whole is digitized. Thus, we see it critical to determine rules for the so-called digital economy that are compatible with the overall economy.

From a methodological standpoint, we agree with the OECD’s approach to evaluate potential options to address the broader tax challenges raised by the digitized economy by referring to a set of pre-defined principles, namely neutrality, efficiency, certainty, simplicity, effectiveness, fairness and flexibility (par. 204-208; referred to as “Ottawa-principles”). Instead of a pure “best-practice approach”, we share the OECD’s view that a principle-based framework is an adequate starting point for deriving an internationally accepted and systematically sound consensus. However, as any principle is subjective by its nature and therefore discussable, we recommend a clear hierarchy, i.e. relative weighting of these principles, if two or more principles conflict. From the stated principles, we consider “fairness” as the most subjective one. In order to have an objective starting point, we would appreciate a definition this term.

III. Direct Taxes

1. Comments on Option (1): Modifications to the Exemptions from Permanent Establishment Status (par. 211)

While preparatory and auxiliary services are not being qualified as permanent establishments (PEs) according to the current version of Article 5 par. 4 of the OECD Model Tax Convention (so-called exemption clause), option (1) proposes to grant the market/source country a general right to tax also those kind of services. Technically, this would essentially require a significant amendment of Article 5 par. 4 lit. (a) – (d) or even of par. 4 in its entirety.

The general question whether such services should be taxed in the source country cannot be answered in pure economic terms. Instead, such a decision is normative and therefore also depends on the political will of the governments. Hence, only under the assumption that the granting of an additional taxation right to the respective market country is desirable from a normative (tax political) standpoint, option (1) may be regarded as effective as well as fair. Also, as compared to the other options proposed in the draft (please refer to the following sections of this comment letter), a modification of Article 5 of the OECD Model Tax Convention appears to be the least complex measure as regards the implementation. Furthermore, it seems to be relatively advantageous in terms of simplicity, albeit existing double tax treaties would need to be adjusted accordingly. In addition, neutrality across industries would be safeguarded, because no distinction between digital activities and “other activities” would be made under option (1).

However, there are also critical aspects associated with option (1). In essence, we note a fundamental dilemma between the definition of a permanent establishment (PE) and the allocation of profits (and losses) based upon the “significant people functions approach”. Since the significant people functions approach is increasingly gaining importance in other areas of transfer
pricing, most notably in the context of intangibles\(^2\), we assume that the OECD, in general, still regards this approach as appropriate and therefore intends to hold on to it.

However, we suspect that the introduction of the PE concepts newly proposed in the discussion draft is of limited use in light of the significant people functions approach. For instance, if the functional and risk profile of the local service providers remains limited to “routine functions”, as it is the case with auxiliary and preparatory services, the profit (or loss) portion allocable to such a PE should be insignificant due to a lack of significant people functions located in that PE.

For sure, this dilemma could be solved by developing alternative allocation keys which are fully decoupled from people functions. However, any deviation from this currently applied OECD standard would question the credibility of the significant people functions approach as such and therefore requires a convincing justification. Auxiliary activities that have been regarded for decades as “routine functions” should from now on be classified as “core functions” (par. 152), consequently requiring a compensation that exceeds a mere “routine compensation”. Such a justification appears arbitrary and therefore not convincing as a similar (arm’s length) transaction would not be found in practice. Also, there might be other areas where the appropriateness of a significant people functions approach is doubtful. If one exception to the significant people functions is being granted, it needs to be justified why others are rejected. The discussion draft does not address any such fundamental questions. Furthermore, in terms of its practical application, option (1) would increase the administrative burden.

Against this background, we are concerned that the establishment of a PE in case of auxiliary and preparatory services would lead to significant additional administrative burdens on the taxpayer’s side (filing of tax returns, calculation of tax attributable to the source country, calculation of

creditable taxes in case of credit method in the resident country etc.), but not necessarily go along with a significant gain of tax revenues from the perspective of the respective market jurisdiction. Overall, the introduction of a PE status due to preparatory and auxiliary functions in conjunction with the existing significant people functions approach is neither efficient nor simple in terms of its practical application.

Moreover, there is a high risk of double taxation, if the involved jurisdictions fail to align on the determination of a PE and the profit attributable to such a PE. Thus, an obligatory dispute resolution mechanism is essential according to which national tax administrators are required to cope with each other and obliged to find a solution in a time-efficient way. Otherwise, (legal) certainty would not be ensured under this approach.

2. Comments on Option (2): A New Nexus based on Significant Digital Presence (par. 213-216)

Unlike the first option, the second option does not aim at a general modification of existing Article 5 of the OECD Model Tax Convention, but proposes to introduce a specific PE status. According to the first alternative, a (“digital”) PE is deemed to exist, if an enterprise conducts a “fully dematerialised digital activity” in the market jurisdiction (first test), and if this activity additionally implies a “significant digital presence” (“nexus”) therein (second test).

In a first test, a digital activity is deemed “fully dematerialised” under the following conditions (criteria catalogue according to par. 213):

(1) “The core business of the enterprise relies completely or in a considerable part on digital goods or digital services.

(2) No physical elements or activities are involved in the value chain other than the existence, use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialisation of location-relevant data.
(3) Contracts are concluded exclusively remotely via the Internet or by telephone.

(4) Payments are made solely through credit cards or other electronic payments using on-line forms or platforms linked or integrated to the relative websites.

(5) Websites are the only means used to enter into a relationship with the enterprise; no physical stores or agencies exist for the performance of the core activities other than offices located in the parent company or operating company countries.

(6) All or the vast majority of profits are attributable to the provision of digital goods or services.

(7) The legal or tax residence and the physical location of the vendor are disregarded by the customer and do not influence its choices; or

(8) The actual use of the digital good or the performance of the digital service do not require physical presence or the involvement of a physical product other than the use of a computer, mobile devices or other IT tools.

In a second test, a “significant digital presence” is assumed to exist in the following cases, which are understood as “examples” (first alternative):

(1) “A significant number of contracts for the provision of fully dematerialised digital goods or services are remotely signed between the enterprise and a customer that is resident for tax purposes in the country.

(2) Digital goods or services of the enterprise are widely used or consumed in the country.

(3) Substantial payments are made from clients in the country to the enterprise in connection with contractual obligations arising from the provision of digital goods or services as part of the enterprise’s core business; or

(4) An existing branch of the enterprise in the country offers secondary functions such as marketing and consulting functions targeted at clients resident in the country that are strongly related to the core business of the enterprise” (par. 214).

According to the second alternative, “a significant digital presence could be found where an enterprise engaged in a fully dematerialised digital activity does a significant business in the country using personal data obtained by regular and systematic monitoring of Internet users in that
country through the use of multi-sided business models” (par. 215).

Option (2) would generally fulfil the requirement of *effectiveness* if the overall goal is to enable source countries to tax certain digital activities. In addition, due to the BEPS debate, MNEs engaged in the “digital economy” are expected to pay their “fair share of tax”. Hence, *fairness* might be achieved under option (2) (again, depending on the interpretation of “fairness”).

However, option (2) has specific disadvantages. One of its most critical aspects is the violation of the principle of *neutrality*. Obviously, option (2) is exclusively tailored to enterprises conducting digital activities. One might likewise argue that this limited scope of option (2) is not *fair* (this again shows the vagueness of the *fairness principle*). Moreover, a special tax treatment of digital activities is obviously not in line with the statement of par. 205, that “ring-fencing the digital economy as a separate sector and applying tax rules on that basis would be neither appropriate nor feasible”.

On a more technical level, assuming that the criteria listed in par. 213 need to be tested cumulatively, it appears that the “criteria catalogue” is overly broad and thus not in accordance with the principle of *simplicity*. As the criteria catalogue contains numerous undefined terms, such as “physical elements”, “considerable part” and many others, it also lacks legal *certainty*.

Moreover, from our perspective, its appropriateness (*efficiency*) to distinguish fully dematerialized digital activities from other activities is more than doubtful. For instance, “payments that are made solely through credit cards or other electronic payments using on-line forms or platforms linked or integrated to the relative websites” (criterion (4) of par. 213) have become the standard for the economy as a whole and thus are not specific to so-called fully dematerialized digital activities. Criterion (6) of par. 213 is somewhat circular. Whether “the vast majority of profits” should be allocated to local market activities (or not) is the overall question which needs to be solved, but not a prerequisite for the existence of a PE. The definition of a PE on the one side and the
allocation of profits (losses) on the other side should be kept separate. Furthermore, one could
argue that the “legal residence and the physical location of the vendor”, as referred to in
criterion (7) of par. 213, is generally not decisive from a potential buyer’s angle, apart from e.g.
any “buy-local” considerations. Similarly, the appropriateness of a reference to the “actual use of
the digital good or the performance of digital service” (criterion (8) of par. 213) is questionable,
considering that the “actual use” after a sale of a good or a provision of services is normally not
under the control of the seller or provider.

Not only the criteria for the identification of a fully dematerialised digital activity, but also the
relevant criteria for testing the existence of a “significant digital presence” (“nexus”) are vague.
This especially holds true for the second proposed alternative, according to which “a significant
digital presence could be found where an enterprise engaged in a fully dematerialised digital
activity does a significant business in the country using personal data obtained by regular and
systematic monitoring of Internet users in that country through the use of multi-sided business
models” (par. 215).

Against this background we are concerned that option (2) would trigger significant administrative
burdens for multinational entities (MNEs), which may be passed on to the customers, while the
positive effect on the market country’s tax revenue is uncertain. First of all, one has to keep in
mind, that e.g. start-ups in the digital economy are usually generating losses in the beginning of
their lifecycle. In this case, the question is more about an allocation of losses than of profits.

Even more problematic, however, is the systematic dilemma between the definition of a PE and
the allocation of profits and losses to the market/source country based upon the “significant people
functions approach”. This dilemma is most visible in the second criterion of par. 213. According
to this criterion, a fully dematerialised digital activity is assumed to exist only in cases where
“[n]o physical elements or activities are involved in the value chain other than the existence, use,
or maintenance of servers and websites or other IT tools and the collection, processing, and
commercialisation of location-relevant data” (criterion (2) of par. 213). Conversely, if any physical element is part of the value chain (apart from the routine functions mentioned in par. 213), the fully dematerialised digital activity test would be negative and hence no digital PE would exist.

We assume that (human) employees performing significant people functions would qualify as a “physical element” in the sense of par. 213. Hence, the definition of a fully dematerialised digital activity and the allocation of profits referring to employees with a significant function are exactly excluding each other. Although (or because) a digital PE is deemed to exist due to the lack of physical elements in the market country, the profit (loss) allocation to that PE would be insignificant as no significant economic activity takes place.

Apparently, the problem that the significant people functions approach fails to deal with PE concepts exclusively designed for digital activities is also recognized in the discussion draft. Par. 216 contains a brief indication that the digital PE concept proposed under option (2) would potentially require a “modification of the current rules for the attribution of profits to PEs”. Against this background, it would therefore be of particular interest to know how the OECD is intending to resolve this dilemma. No further indication is given in this regard. Again, it needs to be emphasized that any deviation from the significant people functions standard undermines the overall coherence and therefore needs a convincing justification.

In summary, option (2) is likely to end up in disputes with local tax administrations not only about the PE status of a digital activity, but also with regard to the profit portion that needs to be allocated to the market country. Due to the vagueness of the proposed criteria we see a high risk of double taxation. For start-ups in the digital business this might create severe trade barriers for entering new markets due to a significant administrative and compliance burden including long periods of litigation or mutual arbitration across multiple jurisdictions. Considering the mentioned issues, we oppose option (2).
3. Comments on Option (3): Virtual Permanent Establishment (par. 217)

From our perspective, the three models which are briefly discussed under the third option, namely a “virtual fixed place of business PE”, a “virtual agency PE” as well as an “on-site business presence PE”, are even more theoretical and therefore less feasible than the options (1) and (2). The models consolidated under option (3) would not only lead to a further erosion of the conventional PE notion, but would also be ineffective with regard to the profit (loss) allocation, as none of them would require a personal presence in the source country. Without any local performance of significant people functions, it can hardly be argued that the significant part of the profit should be allocated to such a PE in the market jurisdiction. Stated differently, there would be a considerable mismatch between the additional administrative burden on the taxpayer’s side and the real increase of tax revenue in the source countries.

Overall, we understand that the three models consolidated under option (3) are just mentioned “for the sake of completeness” (par. 217). We agree with the OECD that the three models should not be contemplated as an option. We therefore do not discuss these models in more detail in this comment letter.

4. Comments on Option (4): Creation of a Withholding Tax on Digital Transaction (par. 218)

The last option proposed (4) is the imposition of a final withholding tax (WHT) on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider (par. 218). Consequently, instead of directly taxing the provider of a digital good or service, the respective service recipients would be in the scope of such a tax. Under the premise that the country of the customers should receive a (greater) share of the profit base generated by digital activities, option (4) might be considered as fair. However, as explained in the
next paragraph this is not the case. Additionally, a WHT is often considered a simple solution, as it avoids e.g. lengthy discussions on the definition of a PE.

We, however, think that there are substantial arguments against such a WHT. First of all, a WHT on digital transactions would obviously violate the *neutrality principle*. From an economic perspective, it is not understandable why similar business models should be treated differently ("ring-fenced") for tax purposes (e.g. sale of e-books versus hardcopies). We are concerned that such a WHT would discourage investments in innovative business models (e.g. cross-border cloud services). Such a ring-fencing cannot be desirable from an economic perspective.

Furthermore, in the past, withholding taxes were steadily abolished, thus giving the taxing right to the country of residence instead of the country of source. For examples, the OECD Model Tax Convention does not grant a taxing right for royalties to the source country but only to the residence country (Article 12). This is justified insofar as the residence country had the burden of the costs for research and development and thus should also be entitled to tax the income from research and development.

Moreover, imposing a WHT very likely ends up in economic disadvantageous double taxation scenarios. The first reason for such a double taxation is the common mismatch on determining the WHT. While the WHT is generally determined on a gross basis in the source country, the residence country determines the WHT on a net basis. This creates an extra tax burden if the tax basis in the source country is higher than the tax basis in the residence country and creditable taxes are determined according to domestic rules. Another reason for a double taxation is the general fact that the residence country only accepts those foreign taxes to be credited, which are equivalent to the domestic taxes. In tax practice, it is often the case that not all foreign taxes can be credited in the residence country, resulting in excess tax credits. Further issues occur if the source country interprets its source taxation extensively.
In addition, the imposition of a final WHT on certain payments made by residents of a market is far away from being simple. In reality, a WHT would create a significant administrative burden. Especially from the perspective of start-ups, such administrative burdens would certainly be perceived as factual trade barriers for entering new markets. It also needs to be kept in mind that start-ups are usually suffering from losses in the first periods of their existence. However, generally, no tax credit would be available for them in such cases in their residence country. In conclusion, we strongly oppose option (4).

IV. Indirect Taxes


We appreciate that competitive distortions shall be eliminated. However, when reducing the (materiality) thresholds for VAT exemptions for imports of the “low valued goods”, the countries of importation should implement administrative simplifications for the import of such goods. Alternatively, these simplifications can also be established in the country of residence or country of export. When allowing the suppliers e.g. to declare such imports in their country of residence, the local fiscal authorities would forward the import declaration and the respective import duties to the country of destination.

2. Comments on Option (2): Remote digital supplies to consumers (par. 222-224)

Generally, the taxation at the place of consumption is appreciated. Nevertheless, it must be acknowledged that the obligation of the suppliers to register and account for VAT in as many foreign jurisdictions as they have consumers of remotely delivered services will definitely impose compliance burdens and increase administrative efforts on these suppliers (instead of “may impose compliance burdens” according to par. 223). Such burdens will lead to increased costs which may
be passed on to the consumers. Simplifications (e.g. registration regimes or registration thresholds) will neither compensate the fact that businesses will have to deal with increased compliance cost nor that the local VAT law of each jurisdiction is applicable to the taxable supply at the place of consumption.

The applicability of different VAT jurisdictions could result in several audits conducted at the same time. In total, this leads to increased administrative costs in comparison to the taxation at the place where the supplier is established and where he would only need to deal with the local tax authorities. Overall, depending on the business model, some businesses might be endangered by the cost of such measures.

V. Conclusion

1. Direct Taxes

From a general perspective, we do not share the view, that the taxation of digital activities requires a separate set of tax rules (Action 1 of the BEPS Action Plan). We think that the other actions addressed in the BEPS Actions Plan, which are also addressed in par. 143-171 of the draft, are sufficient in this regard.

If the OECD, however, wants to increase the taxation right for digital activities in a market country, from our perspective, option (1), i.e. the amendment of the exception catalogue in Article 5 par. 4 of OECD Model Tax Convention, seems to be the only feasible approach which can be effective, fair and simple, provided that an obligatory arbitration process is introduced in case of issues of double taxation. The other three options, i.e. a new nexus based on significant digital presence, a virtual permanent establishment or the creation of a withholding tax on digital transactions, are, in our view, not appropriate to distinguish traditional activities from digital
activities, lack legal certainty, would significantly increase the administrative burden and also lead to significant double taxation. Therefore, we strongly recommend to not introduce options (2), (3) and (4).

2. **Indirect Taxes**

We think that both measures are acceptable. However, when implementing the measures, it should be considered that compliance and administrative burdens for the businesses will arise which will result in higher costs for the suppliers. If such burdens will not be minimised, it is inevitable that such increased costs will be passed on to the consumers. If this is not possible, depending on the business model, some businesses might be endangered by the cost of such measures.

* * * * *
Dear Sir or Madam,

The Swiss Bankers Association, the leading professional organisation of the Swiss financial centre, would like to take the opportunity to comment on Action 1 of the BEPS action plan.

We recognize that the Task Force has received a difficult mandate and that it does its best to present solutions. We note that the draft does not offer any definition of the “digital economy”. This lack of definition creates some confusion and uncertainty. We are of the opinion that a distinction should be made between the two following trends: (i) the increased impact of information and communication technology (ICT) on traditional business models leading to a digitalized economy and (ii) the development of new business models not linked to the traditional economy. We suggest that the draft gives a definition of the “digital economy” that we would rather call “virtual economy”. As far as the digitalization of the existing real economy is concerned, we strongly advise to refer to the other actions of the BEPS action plan and not create new rules for the purpose of Action 1. Concerning the virtual economy, there might be a need for a deeper discussion and an evaluation on whether or not a new action point is necessary.

For the financial sector, cost could be reduced thanks to digitalization: for example outsourcing is possible typically in the fields of IT development, call centers and back-office. Outsourcing takes place mainly from high cost countries to emerging countries such as India, Poland and the Philippines, to the benefit of the customers and of these emerging economies. In order to comply with consumer protection policies, the financial sector has to perform data mining: this allows a better assessment of consumer needs, of consumer product knowledge and of consumer risk profiles. To comply with various regulatory initiatives (in particular in the field of money laundering), the financial sector must also invest in data mining to prevent and detect money laundering activity. In addition, recent developments towards automatic exchange of information, e.g. FATCA, require substantial new efforts in the collection of client/consumer data. Similar devel-
opments in the area of consumer protection are also observed in other economic sectors as well and not only in the highly regulated financial sector.

Taxation is traditionally levied on the proceeds of flows of goods and services, on labor and assets in a real economy. When and where the e-commerce interfaces with the real economy then there is taxable substance. The interface between the e-commerce and the exchange of goods or services is generally linked to a payment. For example when the result of e-commerce is the cross-border flow of goods, such a delivery is subject to VAT when entering the country of the customer and sale proceeds are subject to direct tax at the place of incorporation of the provider.

For payments on the Internet the consumer can choose between credit cards or debit cards. To a certain extent there is a combination between the use of debit cards and vouchers like units (like iTunes cards). All these cards have in common the fact that they are linked to a legal tender or a bank account. The account is credited and the debit card is charged with a reference to a legal tender.

Latest developments in the digital world have however created opportunities to develop business in a completely virtual environment. These developments are primarily supported by a payment system using “credit-units” that are independent from any legal tender. Conventional payment systems including credit and debit cards are always linked to a real “account”. Credit-units like “Bitcoin” are created or “mined” in a pure digital environment. Whereas a legal tender reflects to a certain extent the value of a “real” national economy, virtual credit units do not. The detachment of a virtual credit unit from any real national economy is to a certain degree manifested in the “hyper-volatility” of for example Bitcoin vs. a legal tender like the EURO. As an effect of these developments the question of the link to a tax residence might arise.

We therefore recognize that there might be an actual “virtual economy”, dematerialized and with basically no link or interface with the “real economy”. Such activities might have to be examined carefully and there might be a need in this respect for a new set of rules for taxation purposes. Action 1 should not address however traditional activities, which have been digitalized thanks to ICT; for those activities, BEPS concerns are better dealt with in the framework of other actions.

You will find in the annex a more detailed analysis of selected issues contained in the discussion draft.

We thank you for taking due consideration of our submission.

Yours sincerely,
Swiss Bankers Association

Urs Kapalle         Jean Brunisholz

Annex
Annex

Discussion draft on Action 1 (Tax Challenges of the Digital Economy) of the BEPS Action Plan

1. Comments on point 10., page 7

- Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules;

It seems to us that, basically it is not possible to ring-fence the digital economy from the rest of the economy according to the understanding of the digital economy that seems to be adopted in the discussion draft.

We did not find a clear definition of what one should understand under “digital economy”. Is it an “economy” that is purely digital (“virtual”) with no link to the physical world (i.e. no physical delivery of goods or services happen, but typically transactions would only take place over the Internet) no stream of payments, or is it a “classical economy” enhanced by technology, in particular information and communication technology (ICT)?

If we take the example of the delivery of goods: goods could be ordered by mail or by telephone, long before the Internet was widely spread. Does it mean that ordering goods over the Internet makes the whole process including the physical delivery of goods an activity of the digital economy? We recognize that the use of ICT greatly facilitates the ordering of goods, and enhanced this kind of transactions (volume increased dramatically), we however strongly put into question the fact that the very nature of the transactions themselves changes because a new technological means is available to perform them.

In the finance industry, financial orders where traditionally given in writing by mail, or by telephone. Nowadays financial orders can be given over the Internet. Like for the delivery of books, we do not see that the very nature of the financial orders has changed. Here again, the use of ICT has greatly influenced the way the transactions are performed, the nature of the transactions however is still the same: a bank needs to process the order received, regardless of the fact that this order was mailed, e-mailed or given over the phone.

We therefore call for a clear definition of the digital economy, which according to us is not an ICT enhanced classical economy.

- The key features of the digital economy identified by the Task Force and whether there are other key features that should be taken into account;

We prefer a clear definition of the digital economy (see above).
• The examples of new business models in the digital economy and whether (and if so which) other business models should be considered;

We need to know first what digital economy is precisely meant with.

• The ability of the measures developed in the course of the BEPS Project and the current work on VAT/GST to address BEPS concerns in the digital economy;

Issues to be addressed in the current work of VAT/GST should be addressed regardless of the work related to Action 1: measures to prevent VAT avoidance. For example, deliveries performed from abroad to avoid VAT/GST should be tackled properly; this is not only or specifically related to the use of ICT to perform the order of the delivery.

• Whether other measures should be developed during the course of the work on other aspects of the BEPS Action Plan to address BEPS concerns in the digital economy and if so which ones;

See above.

• The broader tax challenges raised by the digital economy which have been identified by the Task Force and how these challenges should be addressed, taking into account both direct and indirect taxation;

We recognize that ICT has generally contributed to increase the volume of business performed in a number of sectors. With increased volumes the need to address properly some issues may appear more clearly (VAT/GST collection/avoidance). The principles on which such issues have to be addressed should not be technology driven but based on principles also valid for the economy at large.

• The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft;

The basic question is to define what is exactly meant by digital economy. We think that the definition should be narrow. Once the concept is clearly defined, it should be examined whether special taxation rules are needed to tackle issues such as VAT/GST avoidance for example.

• The potential cost of compliance arising from the options proposed to address the tax challenges of the digital economy and suggestions for more cost efficient alternatives;

We cannot give any estimate on this.

• Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

We think that the Ottawa taxation framework principles are still valid and should not be supplemented each time a new technological step occurs. We in particular support the neutrality principle according to which “Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. […] Taxpayers in similar situations carrying out similar transac-
tions should be subject to similar levels of taxation." (see discussion draft, point 203., page 63).

2. **Comment on point 59., page 24**

“59. [...] Attempting 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. As a result, the tax challenges and BEPS concerns raised by the digital economy are better identified and addressed by analysing existing structures adopted by MNEs together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns, and developing approaches to address those challenges or concerns.”

We are of the opinion that it is necessary to be able to draw a line, which is not arbitrary, between what is digital and what is not. For that reason a clear definition of what is a digital economy is necessary. If no clear definition of what is a digital economy can be given, then arbitrary tax treatment might prevail.

3. **Comment on page 28, before (2.2. App Stores)**

We think that a definition of “digital economy” vs. “virtual economy” or “shadow economy” (including its implication for example in the field of black labor) should be inserted.

4. **Comment on point 128., page 44**

“128. Once a taxable presence in the market country has been established, another common technique to reduce taxable income is to maximise the use of deductions for payments made to other group companies in the form of interest, royalties, service fees, etc. [...] Many structures put in place by digital businesses appear to make use of these techniques, with the taxable income from the local operations being reduced to extremely low amounts.

Tackling tax avoidance is a concern of BEPS, which is not specific for a sector or a type of business, including what is referred here as digital business. These issues, which are relevant, should be handled in the appropriate BEPS actions.

5. **Comments on Part VII. Potential options to address the broader tax challenges raised by the digital economy**

To point 211., pages 64-65 (3.1. Modifications to the Exemptions from Permanent Establishment Status)

“211. One potential option discussed by the Task Force would modify the exceptions contained in paragraph 4 of Article 5 of the OECD Model Tax Convention. […]”

As long as the digital economy has not been clearly defined, it is unwise to modify the exceptions contained in paragraph 4 of Article 5 of the OECD Model Tax Convention.
To points 212-216, pages 65-66 (3.2. A New Nexus based on Significant Digital Presence)

We recognize the difficulty of trying to define a nexus based on a digital presence and its potential arbitrary nature. The criteria set out in the bullet points of point 213. might serve as a basis for a definition of the digital economy. According to us the issue of the payment is one of the key element to be able to state that one is confronted with a truly “digital economy”, that we have designated as “virtual economy”. When dematerialized goods and services are paid with a virtual currency, then we have an issue to be addressed, because there are no traceable flows that could be taxed. Such activities might have to be examined carefully and there might be a need in this respect for a new set of rules for taxation purposes.

To point 217, pages 65-66 (3.3. Virtual Permanent Establishment)

As long as the digital economy has not been clearly defined, it is premature to develop a concept of virtual permanent establishment in that context.

To point 218, pages 66-67 (3.4. Creation of a Withholding Tax on Digital Transactions)

We doubt that the introduction of a withholding tax would be appropriate to serve BEPS purposes. Such a tax would create an additional burden and might not lead to taxing the customers fairly: it would in particular not respect the neutrality and equitability criteria set out in Ottawa.
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Comments on the discussion draft on Action 1 of the BEPS Action Plan

Dear Sir or Madam,

I appreciate the opportunity to comment on the OECD Discussion Draft on Action 1 (Tax challenges of the Digital Economy) of the BEPS Action Plan published on the 24 March 2014.¹

I am connected to the Maastricht Centre of Taxation of Maastricht University as an external PhD researcher and my research is to a certain degree related to the issues raised in the draft. The comments below are meant to solely convey my personal opinion and do not reflect the opinions of the Maastricht Centre of Taxation.

The growing importance of the digital economy necessitates a coherent approach in applying the long-standing international tax laws that is also fit for the changes that are going to emerge within the near future. Merely a quick fix of the problems related to the digital economy should not be desired.

My comments are raised on a selection of issues pointed out in para. 10 of the draft.

1. Whether the Ottawa taxation framework principles identified above are an appropriate framework for analysing options to address the tax challenges, and whether and how they should be supplemented.

The Ottawa taxation framework principles are appropriate as guiding principles when seeking a solution to the taxation of the digital economy. The most prominent principle should in fact be the principle of neutrality since the digital economy more and more transcends into the non-digital economy. Trying to differentiate between the two would in that case only lead to patchy legislation and uncertainty. Furthermore, in line with the OECD Action Plan of 19 July 2013 the principle of effectiveness and fairness of the

¹ Hereinafter referred to as the draft.
Ottawa Taxation Framework should be extended to also include that taxation of profits should be in line with actual value creation.\(^2\)

Additionally, when applying these principles to the digital economy it should be kept in mind that the rise of the digital economy is based in the mere aim to gain efficiency and simplicity that the participants of this economy expect. Therefore, efficiency and simplicity also needs to be given when it comes to the taxation of it.

2. **Whether it is possible to ring-fence the digital economy from the rest of the economy, and if not, whether specific types of digital transactions could be identified and addressed through specific rules.**

When dealing with the digital economy some of the business models employed may appear to be new, yet it is not to be forgotten that most of them are merely an abstraction of existing real world business models. Furthermore, all of the transactions undertaken digitally still need to be fitted into the existing framework provided for by the different contract laws. So far this framework was capable of adapting to all the new ways of conducting business that came along. Similarly, the basic principles of taxing either corporations or transactions remain largely in tact also in the digital realm. Ultimately the digital economy is still only about the sale of either goods or services.

Considering that in the digital economy the basis for levying a tax is a transaction that is rooted in the regular contract/civil law, it is questionable whether it is necessary to ring-fence it from the rest of the economy. Indeed, the main challenge that needs to be dealt with is that the respective transactions taking place in the digital domain are no longer purely revolving about tangibles but intangibles instead. The difficulties in classifying, allocating and identifying the source of income stemming from an intangible may sound like a good reason for placing these transactions into a framework separate from the one applied in the non-digital world. Yet, considering that businesses in the digital economy still function within the frameworks provided for by contract laws conceived unaware of business being conducted digitally, ring-fencing the digital economy from the non-digital economy is to be refused. Trying to fix the current problems stemming from the digital economy with a different set of rules for the digital economy will most likely only lead to a set of patchy rules that are not fit to deal with new and upcoming developments in the digital economy. This will become particularly apparent, considering the proposed options to tackle the broader Tax challenges discussed by the Task Force.

3. **The options to address these broader tax challenges discussed by the Task Force and summarised in the discussion draft.**

From the proposals made I would like to comment in particular on the elements that are suggested for a establishing a nexus based on significant digital presence (para. 212 – 216) and on the options for a Virtual Permanent Establishment (para. 217). In doing so I focus on what is going to be the next network trend after cloud computing. This will be **fog** or also called **edge computing** and has been made possible with the introduction of IPv 6 and lies at the heart of the **Internet of things**.\(^3\)

Fog computing basically takes the internet back to its roots based on peers instead of what could be observed in the past decade with a main focus on the divide

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between server and network clients which is in particular relevant for cloud computing services. These two different network structures are pictured below:

![Cloud computing compared to fog computing](image)

More precisely fog computing can be defined in the following manner:

*Fog Computing is a paradigm that extends Cloud computing and services to the edge of the network. Similar to Cloud, Fog provides data, compute, storage, and application services to end-users. The distinguishing Fog characteristics are its proximity to end-users, its dense geographical distribution, and its support for mobility. Services are hosted at the network edge or even end devices such as set-top-boxes or access points. By doing so, Fog reduces service latency, and improves QoS, resulting in superior user-experience. Fog Computing supports emerging Internet of Everything (IoE) applications that demand real-time/predictable latency (industrial automation, transportation, networks of sensors and actuators). Thanks to its wide geographical distribution the Fog paradigm is well positioned for real time big data and real time analytics. Fog supports densely distributed data collection points, hence adding a fourth axis to the often mentioned Big Data dimensions (volume, variety, and velocity). Unlike traditional data centers, Fog devices are geographically distributed over heterogeneous platforms, spanning multiple management domains.*

The *Internet of Everything* and fog computing go hand in hand. One needs to consider the factors proposed for a significant digital presence in para. 214 and 215 in the light of exactly these developments.

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5 Definition provided for by Cisco Systems; can be retrieved from: [http://www.cisco.com/web/about/ac50/ac207/crc_new/university/RFP/rfp13078.html](http://www.cisco.com/web/about/ac50/ac207/crc_new/university/RFP/rfp13078.html) (last visit 13.04.2014).
3.1. Paragraph 214

Regarding the four options for establishing a significant digital presence the following, rather vaguely formulated one is problematic:

*Digital goods or services of the enterprise are widely used or consumed in the country.*

The mere usage or consumption of digital goods or services in one country is completely alien to any sort of value creation and should therefore not result in a significant digital presence that in the end leads to source taxation. Applying the principles included in the Ottawa Taxation Framework, this is also not in line with neutrality let alone certainty. This does not only constitute a burden to the establishment of networks that are not as centrally organized, like fog computing but also to the current digital economy.

3.2. Paragraph 215

As a consequence of the Internet of Everything about 50 billion devices will be connected to the Internet by 2020. Naturally this also results in the ability to collect vast amounts of user data, so called big data. Even though the data collected from these devices is of value it should not be used as a nexus for a significant digital presence in a certain country.

It might be tempting to consider the collection of data effectively forming big data as a nexus for a significant digital presence since the competitive advantage that can be gained from it is tremendous. Nevertheless, the raw data collected from users is of not much use, unless one is able to analyse said data. Such an analysis is done centrally and not on the end-user devices that originally provided the data. Therefore, the actual added value of the collected data is to be seen apart from the locations it has been collected in.

Limiting it to cases where a business makes use of the data collected in a multi-sided business model is comprehensible since the collection of data is put at a premium in order to make this business model work. However, the mere collection of data should not, regardless of the business model lead the establishment of a significant digital presence. Applying this would lead to the result that businesses would end up having a permanent establishment as a result of a “significant digital presence” virtually everywhere. Especially considering the spread of the Internet of Everything with potentially 50 billion devices linked together and collecting data. Even though not all of the data will be used in the framework of a multi-sided business model the value creation in a multi sided business model is also not derived from the mere collection of data itself but mainly from the ability to further process the data and thereby being able to make use of the network effects.

Therefore, using this proposed standard in order to establish a significant digital presence would contravene the just principles established in the Ottawa Taxation Framework. It would contravene neutrality since the collection of data in a multisided business model is also done in none-digital businesses such as customer loyalty

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programmes\textsuperscript{7} without resulting in a permanent establishment in the respective country. Furthermore, the principles of efficiency as well as certainty and simplicity would not be met when deriving from the systematic collection of data the presence of a permanent establishment. Consequently, this leads to business having a permanent establishment in virtually every country, taking into account current and future technological penetration. Especially considering the creation of a lack of certainty that results from the possibility of a business having to deal with a permanent establishment in every country hampers the development of new technologies. All in all, establishing an alternative nexus of a significant digital presence would be as artificial as the long discussed virtual permanent establishment.

\textit{3.3. Paragraph 217}

In para. 217 of the draft the virtual permanent establishment is put up for discussion in three different embodiments. The "virtual fixed place of business PE" and the "virtual agency PE" still suffer from the fact that the content provider has only a very limited influence on the Internet service provider on where the server providing the website or the platform through which the business is carried out is located. Even though these two proposed versions of a virtual PE try to differentiate between content and internet service provider, it is still contrary to the logic of the Permanent Establishment where websites and platforms only used as sales channels or as means to collect and feed back data for further processing.

The proposal of an "on-site business presence PE" is closer to what an actual permanent establishment is about since it considers at least economic presences in the respective jurisdiction and requires that on-site services are provided at the customers location. However, presuming that the provision of on site services or other business interface is meant to focus on the provision of said activities digitally, would mean that fog or edge computing would once again be included in this kind of PE and this would lead to uncertainty, loss of efficiency and lack of neutrality, thereby hindering further development of these technologies.

\textit{Conclusion}

Thus, in order to tax the digital economy, of today and tomorrow by way of a system of direct taxation, it is important to adhere to the most dominant and just nexus, which is value creation. Expanding source taxation to parts of the digital economy where there is actually no value created will only stall the further development of the digital economy to the detriment of all market participants.

I am pleased to answer any questions that may arise regarding these comments. For further clarification, please feel free to contact Thomas Kipka; by phone +31-643665494 or via e-mail: thomas.kipka@maastrichtuniversity.nl

Yours sincerely,

Thomas Kipka, LL.M.

\textsuperscript{7} A major part of the business model of customer loyalty programmes e.g. Payback (Germany, India), Airmiles (Netherlands, Canada) etc. is made up of the collection of data on consumer behaviour which are then sold to the participating businesses or even third parties.
We wish to contribute to the very dense work that has been made by the OECD on the BEPS n°1 project on the tax challenges of the digital economy. We have tried to summarise some issues or comments as followed:

Probably a **general definition of what e-commerce** is and whether it includes goods as well as services in the OECD jargon. Indeed, in the EU, rules on e-commerce only related to telecom, broadcasting and electronic services: they do not relate to sale of goods which are dealt for under the distance selling rules or low value import scheme since 1993 (single market).

- **1°) The report currently outlines opportunities for BEPS with respect to VAT (paragraph 136 to 142).**
- This mainly addresses issues for remote digital supplies to exempt businesses and the remote digital supplies to Multi-location entities (MLEs). We believe these are mostly issues resulting from various tax audits (with some probably still on-going) more than hard-core issues from Digital businesses.
- The paragraphs 136 and 170 address issues for the exempt sector: but this is a sectorial business activity. The scheme in the back of the mind there, is one with an EU supplier invoicing a Hong Kong branch of an EU bank: this scenario incurs no VAT all the way through, because of the adjunction of territorial rules and branch to branch (out of scope) transactions. In our view, this is NOT a the N°1 issue for the Digital economy in a BEPS environment: this is rather an “abuse of law” scheme on some B to B practices implemented by some banks. Moreover, the scheme is quite old, has circulated a lot in a non-digital business transactions: it is not specific to digital business although it can accelerate in a digital business context: this should be an argument in the last position for BEPS and certainly not to be addressed as the first opportunity for Digital BEPS in the VAT area.

In our view, the main opportunity for BEPS with respect to VAT lies with the location of a non-resident Vendor (or supplier) in a B to C transaction: particularly in the EU which has a declaring platform for B to C transactions for non EU vendors, it seems that very few of the non-EU suppliers have effectively registered and declared their VAT (less than 1000 companies in the world have spontaneously registered on the EU portal). This is “THE” major concern of BEPS in a VAT environment. Failure to register by the non-resident suppliers invalidates the VAT collection mechanism and creates harmful and unintended VAT competition.

Only the OECD can address that issue because of its eminence and its International role. Regional platforms can only provide technical rules but they have no impediment to force non-resident vendors to register otherwise than voluntarily. Therefore, we strongly believe that the political commitment is the one that only OECD can and should take on-board.

This issue should be the N°1 opportunity for Digital BEPS with respect to VAT.

- Most of the MLEs tend to be 100 % tax payers so that the VAT is not their major concern: rather, the transfer price is their concern. VAT is due along the recharged invoices: VAT cascades down the value chain of services. This issue, although important comes after the non-resident vendor issue.

**2) Collection of VAT in the digital economy (paragraphs 189 through 201):**

The collection of VAT in the digital economy includes both exemptions for imports of low value goods and remote digital supplies to consumers (services). Therefore, it is clear that the digital economy has **both goods and services** as a basis for VAT to apply particularly in a B to C type transaction.
However, this would show the digital economy as a simplistic area where only a supplier and a customer/consumer interfere. This is far from true.....

In practice, the digital economy entails complex structures with **many intermediaries** : very often, a content owner, a data provider, an integrator, and App-store, a mobile operator, a bank collecting the cash, a web-portal operator, just to name a few.

The **report currently addresses none of these scenarios where intermediaries are involved.** We believe it is of critical importance that the report addresses these intermediaries and determines to what extent they are deemed to intervene in the transaction. Because failing to do that, any third country supplier could easily "hide behind" one of those intermediaries which would hold any conclusion ineffective. The EU has set forth presumptions to help operators determine whether they are the entity deemed engaged in the digital transaction vis-à-vis the customer (B to C) or not. This is a matter of **legal security for the businesses** to understand what entity is liable to collection of VAT.

3°) **Consumption tax options (paragraphs 220 through 224)**

- **Distance selling should be included in the paragraphs 220 and 221** pretty much as the low value imports scheme (just like also in sub paragraph 189); indeed, it may happen that some countries have set a customs Union or have no customs due because of free trade agreements in place or basically goods are no longer subject to customs duties. Still the VAT/GST scenarios need be addressed as a result of the “on-line shopping” habits from consumers. Most of the import value scheme address the customers as being the importer of records, rather than the supplier. Thus, it is of critical importance that the distance selling is also mentioned together with the import of low value goods.

- Finally, on paragraph 224 the OECD should propose specific enforcement agreements **and dispute resolution mechanisms (bilateral or multilateral) to cover the VAT**. Those could be clauses to be included in existing tax treaties or in newly negotiated ones. Businesses often suffer from the double taxation on VAT, resulting from mismatches of qualification by the authorities or from diverging interpretations by the authorities. Indeed the likelihood that Virtual PE will end up a VAT collection reassessments is quite high.

Kind regards

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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.
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.

The Digital Economy Generally

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

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.

Specific Measures to Address Digital Economy Issues

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).” 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. 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.

Terilea J. Wielenga
*International President*
Dear Sir/Madam,

We refer to the Public Discussion Draft in relation to the tax challenges of the digital economy, published on 24 March 2014. We welcome the opportunity to comment on the draft report on behalf of our members. Given the relatively short comment period, we have confined our comments to high level observations on key points raised in the draft report.

At the outset, we wish to lend our full support to the conclusion that there is no requirement to ring fence the digital economy from the rest of the economy; the digital world touches practically all sectors of the global economy. Thus any recommendations by the OECD in respect of the digital economy will have widespread implications.

We note that some of the comments and proposals in the draft report challenge the fundamental principles of taxing companies that operate across borders in a digital manner. There appears to be an underlying assumption that the business model of a “digital company” is unique and hence existing tax rules are not fit for purpose in terms of establishing an appropriate profit attribution.

Advances in technology mean that many new products and services have been developed in recent years. Businesses are also using new technology to operate existing business models, often more efficiently than previously. In our view, neither of these developments has led to a change in the business model itself. Even companies operating exclusively in the digital space still require investment in labour, capital and innovation. There has been no change to the basic business model involving the production/provision of goods/services to customers in return for payment. This is a fundamental point.

We note that an underlying theme of the wider BEPS project is a focus on substance. We noted an inconsistency between the wider BEPS focus on substance and one of the conclusions in the digital
economy draft report that companies operating across borders should be taxed in a jurisdiction where they have no assets, functions or employees. We do not believe that it is appropriate to alter fundamental and long standing principles of direct tax in this manner. In our view, the line between direct tax and indirect tax principles has been blurred. The taxation of the customer, both in the digital economy and beyond, is an indirect tax matter.

On this latter point, we would specifically point out that customer data on its own generally has little value to a business; it is the analysis completed on this data that creates the value. The work involved in analysing the data involves real substance, with that substance often remote from where the customer resides. An attribution of profits to the customer jurisdiction thus raises the risk of a misalignment of taxable profits and the real value added activities. As well as adding unnecessary cost to businesses, an attempt to arbitrarily apply direct taxation on a business on the basis of where its customers reside is also likely to be bad for the customer and bad for the global economy.

Similarly, the use of data to determine a taxable nexus doesn't make sense. There is no clear connection between the value of data and its location. An attempt to force such a connection is likely to be particularly onerous for small businesses.

The conclusions in the draft report raise the possibility of linking a permanent establishment to a digital tax presence. We believe that such a link is contradictory to what we understood to be the OECD’s wider objective of aligning taxable profits to substance. Digital economy businesses have substance. The conclusion also violates the neutrality principle in terms of penalising digital activities, thus discouraging businesses from expanding digitally. This could affect more remote countries in particular and impact adversely on their economic growth.

We would also note that the proposed virtual permanent establishment is likely to raise potential conflicts with the existing definition of a permanent establishment and could create additional double taxation issues for digitalised companies.

We welcome and strongly support the view expressed in the draft report that other actions of the BEPS Action Plan will address Digital Economy challenges. We believe that work on these Actions will successfully address the tax challenges of the Digital Economy without seeking to artificially attribute taxable profits to jurisdictions where, in our view, little or no value may reside. As noted above, we believe that taxation based on the market for goods or services is best addressed through VAT measures.

In conclusion, we agree with the conclusion in the draft report that no separate taxation regime is required for the digital economy. We believe that while technology advances have clearly changed the nature of how companies do business, the fundamental business model has not changed. We agree with the comments in the draft report that the tax challenges of the digital economy will be addressed by other Actions in the BEPS Action Plan. We look forward to commenting further in the future on publication of these Action Plans.

Kind regards

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The digital economy cannot be ring-fenced

1.1 The Discussion draft gives a comprehensive overview of the digital economy, its evolution and its impact on the rest of the economy. In doing so, it raises the question whether the digital economy can be ring-fenced from the rest of the economy, also from a taxation perspective.

1.2 Unfortunately, the Discussion draft does not answer this question clearly but we welcome the fact that it raises serious doubt as to whether the digital economy can be ring-fenced. We welcome comments made in, for example, paragraphs 59 and 205 that ring-fencing the digital economy from the rest of the economy is difficult, if not impossible (par. 59) and neither appropriate, nor feasible (par. 205). In our view there is no possible way to ring-fence the digital economy from the rest of the economy, since the digital developments have been pervasive in all sectors and all sorts of business models. In other words it can be said that the digital economy is increasingly becoming the economy itself.

1.3 Based on the above, it would make no sense to treat the digital economy differently from the rest of the economy from a taxation perspective or to create a separate set of rules for the digital economy. This will only create uncertainty and disproportionate burden for the business and may create an adverse precedent for the rest of the economy. We will elaborate on both points below.
2. **BEPS is not inherent to the digital economy**

2.1 The Discussion draft points out (e.g. in par. 120) that BEPS concerns are not inherent to the digital economy. The BEPS strategies utilized in the digital economy are identical to the BEPS strategies utilized in the rest of the economy. Also, the Discussion draft concludes that provided these BEPS concerns are dealt with in other actions of the BEPS Action Plan, there may be no need for additional measures specifically for the digital economy (par. 208). In our view this raises the fundamental question whether Action 1 really belongs in the BEPS Action Plan.

2.2 We find it striking that the Discussion draft insinuates (for example, par.125-128 but in essence the entire Chapter IV) that digital businesses in particular do not follow the arm’s length principle and typically use BEPS strategies to create “stateless” income. In our view the report unduly sets apart companies active in the digital economy negatively while similar concerns exist in the rest of the economy. Moreover, if there is indeed merit to the insinuations it does not seem to stem from a shortcoming of the (arm’s length) rules, but rather in the enforcement of these rules. This would mean that governments in fact have the tools to achieve an arm’s length result in all sectors (including digital businesses), but do not or are not able to apply these correctly and effectively. Therefore the wording of the Discussion draft should in our view have been more objective in line with reality and should avoid a subjective tone which seems to be aimed at a few companies that are engaged in the digital economy. In addition, in reality a majority of digital start-ups are not successful and not all digital businesses are profitable and cash-rich on an overall basis while paying tax in source countries. This begs the question whether a perceived problem with a limited number of larger companies would warrant measures that would affect a much larger number (and ultimately potentially) all businesses and may have precedents outside the digital economy..

2.3 The Discussion draft (par. 146) mentions that its main aim, in combination with the other action points mentioned in the BEPS Action Plan, is to restore taxing rights at the level of both the source / market jurisdiction and the jurisdiction of the ultimate parent. According to the Discussion draft, elements that are inherent to the digital economy, such as its mobility, its dependency on (mobile) intangibles (data) and the ability to operate far away from its customers without considerable physical presence, raise considerable opportunities for the digital economy to implement BEPS strategies. The Discussion draft goes even further and insinuates that the digital economy broadly uses these strategies to shift profits to low taxed jurisdictions. Digital businesses are subject to the same profit allocation rules, more specifically the arm’s length principle, as any other business. Shifting more effective taxing rights to the source/market jurisdictions in the context of the digital economy would require, however, different nexus rights and probably a fundamental change to the TP framework (deviating from the current trend towards attaching much value to “People functions”). Under the current TP framework, the value drivers and their related functions of the digital economy companies are typically located outside the source / market jurisdictions, for an important part in the parent jurisdiction, and this is recognized by the Discussion draft (see par. 161). If the parent jurisdiction does not take sufficient action to levy
sufficient/immediate tax on the “stateless” profits (e.g. inadequate CFC rules), this does not justify in our view granting more effective taxing rights (in terms of nexus and materially different profit allocation principles) to the source / market jurisdictions.

2.4 The aforementioned shows that in our view that there is not so much a need for a separate set of rules for the digital economy (widening the taxing rights of the source / market jurisdiction) but a need for a uniform and consequent application of the arm’s length principle in combination with actions to be taken by the parent jurisdiction. With respect to the latter in our view any country should be able to continue to develop its own (competitive) tax policy. The other BEPS actions in combination with the current international framework for allocation of taxing rights and profits should be capable to deal with the peculiarities of the digital economy supplemented by potential clarifications and/or amendments to the commentary to article 5 and 7 of the OECD model tax treaty. This should be acceptable to business as long as the risk of double taxation, which will only increase in the post-BEPS era, is similarly eliminated.

2.5 Furthermore, although the Discussion draft focused on direct taxation it acknowledges that a more serious BEPS concern lies in the area of indirect taxation (see par. 120). In view of the above, and the fact that the Discussion draft believes indirect tax strategies pose a greater challenge, it may be best to focus on a solution in the area of indirect tax, as done by European Union in the form of new EU VAT rules regarding electronically supplied services that will enter into force in 2015 and will be further developed to simplify collection and compliance within the EU and in relation to third-countries. We will discuss this point below in more detail.

3. **No need for new concepts/rules**

3.1 As concluded above, we believe that the current international framework should be capable to deal with the peculiarities of the digital economy. Of course there may be a need to clarify certain points and concepts that are specifically relevant for the digital economy. The OECD model commentary on article 5 and 7 is a suitable platform to make recommendations to countries as to how to deal with the digital economy in terms of taxable nexus and profit attribution, provided there is broad consensus among the member states so that the rules are clear and predictable for the business.

3.2 Introducing new rules and vague concepts, such as the concept of a “virtual PE”, limiting the PE exceptions and the introduction of new withholding taxes, will have negative consequences to the digital business community, which in our view will not outweigh the aim of the Discussion draft. More specifically:

- Considering that the Discussion draft concludes that the digital economy cannot be ring-fenced, introducing some form of virtual nexus or modifying the PE threshold would create a significant risk that the same concepts will spread out to the non-digital economy, at least source countries (e.g. BRICS countries which already take aggressive positions in unilaterally assuming taxing rights outside the current OECD permanent establishment concepts) will have a justification to widen their taxing rights and this would create a precedent potentially fundamentally changing the rules
for taxing cross-border business in general. In many cases, the current PE threshold is not the issue. The Discussion draft acknowledges (see par. 182) that even in the absence of a PE threshold imposed by an applicable tax treaty, many jurisdictions do not tax income derived by non-residents from sales to consumers located in those jurisdictions.

- Such developments may also open discussions relating to fundamental changes in current transfer pricing and profit allocation principles. In this respect, it is emblematic that the Discussion draft does not mention the fact that if a digital nexus would be created how profit then should be attributed to this nexus. It is very unlikely that there is a way to attribute profits to a digital nexus that is *simple, effective and fair* in the sense of the Ottawa Taxation Framework Principles. By definition a merely virtual presence would mean that no “significant people functions” would be present in the country where e-sales are made. Substantial profit allocation would be incompatible with the current OECD’s principles on profit allocation to permanent establishments. As this is a much more fundamental discussion than the BEPS discussion, careful thoughts and extensive discussion should take place before the OECD even considers embarking on this route. In addition, moving to fundamentally different profit allocation rules, such as formulary apportionment, is not feasible as it would lead to an unbalanced outcome if one consider the overall value chain.

- Uncertainty about - or different methods of - profit allocation would potentially seriously hamper digital enterprises doing business abroad and would open the door to potential double taxation, which does not seem compatible with the aims of the BEPS Action Plan.

- Moreover, introduction of some form of virtual nexus would increase compliance costs significantly, which will be a barrier for companies to conduct cross border activities, especially for SME companies. Companies will likely feel compelled to refuse to make sales in jurisdictions where the compliance costs would exceed the potential profits of doing business there. This would go against the key principle of the OECD of encouraging international trade.

3.3 Given these concerns, it may be considered to specifically clarify in the commentary to article 5 of the OECD model tax treaty in which cases within the context of the digital economy a company does *not* have a permanent establishment in the source / market jurisdiction.

4. **Indirect taxation may be the best solution**

4.1 Rather than introducing new digital nexus rules in the profit tax domain, which could have far reaching consequences, it should be considered adopting the principles introduced as per January 1, 2015 in the European Union regarding the new place of supply rules for electronically supplied services together with the mini One Stop Shop, including proposals to expand the One Stop Shop concept to third countries (reference
is made to the Working Paper on VAT issues of the EU’s Expert Group on Taxation of the Digital Economy dated 31 January 2014). This would ensure that jurisdictions in which foreign traders realize substantial e-sales would pay VAT/sales taxes, taking away competitive advantages they currently have over locally operating enterprises, while minimizing compliance burdens for such out-of-country entrepreneurs.

4.2 Compliance controls should be organized through co-operation between tax authorities in the jurisdictions concerned, rather than exposing enterprises (particularly SMEs) to differing positions taken by tax authorities in potentially many jurisdictions where a digital enterprise does business.

4.3 The cross border compliance area (particularly with respect to non-EU member states) appears to be typically an area where the OECD can have an important role, compatible with the principles of the BEPS Action Plan.

With kind regards,
The Dutch Association of Tax Advisers

mr. B.R. Zoetmulder
Chairman of Commission International Tax Affairs
April 11, 2014

VIA EMAIL

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Re: USCIB Response to the OECD’s Discussion Draft on the Tax Challenges of the Digital Economy (the Discussion Draft)

Dear Mr. Saint-Amans,

USCIB appreciates the opportunity to have input at this stage of the process. We understand that this is a report on the digital economy that identifies options for further discussion rather than makes recommendations. Keeping this in mind, we have the following general comments.

General Comments

First, we endorse wholeheartedly the conclusion that there should not be a separate taxation regime for the "digital economy", however defined.

Second, parts of the Discussion Draft range far beyond the Digital Economy, with some aspects affecting other BEPS Actions and others touching on issues explicitly excluded from the BEPS project. We believe that fundamental issues such as the division of income between the place where functions, assets and risks generating income are located and the market jurisdiction, should be addressed, if at all, directly and separately, rather than tangentially in this Discussion Draft. We believe that it is only by squarely facing the issues and doing the difficult analytical and political work that these issues can be properly resolved.

In particular, the Discussion Draft raises the issue of whether a market jurisdiction should have the jurisdictional basis to impose an income tax based solely on the demand created by the market place, regardless of the fact that an enterprise may have no physical presence in the market place. We believe that a combination of an origin-based income tax and a destination based VAT appropriately divides the jurisdiction to tax between the countries where income producing activities occur and the countries where consumption of goods and services occur. USCIB believes that the further work on this Action would be clarified by expressing the analysis as whether current business models or practices (digital or otherwise) warrant a deviation from
the principle that the right to impose an income tax should be based on the presence of actual business operations in a state. This work should include an analysis of the purpose and economic burden of the corporate income tax versus the VAT.

We note an important inconsistency between certain of the proposals in this Discussion Draft and other recent OECD/G20 work on the role of business substance to determine the right to tax and the measure of taxable income. The draft revisions to Chapter VI of the Transfer Pricing Guidelines (“TPG”) specify that the returns to intangibles should be allocated by reference to the location of personnel who perform or control the development, enhancement, maintenance, and protection of the intangible, and not by reference solely to ownership, funding and bearing risk. In contrast, this digital economy Discussion Draft expresses concern that taxpayers control the location of functions and assets, and thereby suggests that the location of the actual business activities giving rise to the development, delivery and support of digital products and services may not be the determinants of the jurisdiction to tax income arising from those activities. This inconsistency needs to be resolved, either the place of performance of profit producing activities is important or it is not. It cannot be important to determine the entitlement to intangible related returns, but not important to determine tax nexus for enterprises delivering digital goods or services.

We note with approval the many recent statements by OECD representatives that the OECD continues to endorse the arm’s length principles (“ALP”). We also strongly support the conclusion in this Discussion Draft that the proposals to be developed under the other Actions of the BEPS Action Plan will address the challenges posed by the digital economy. Chapter V of the Discussion Draft notes how some of the ideas now being developed under those other Actions would address the tax challenges of the digital economy. We are concerned, however, that a number of proposals described in Chapter V (discussed in more detail below) if adopted would move the OECD’s application of the ALP substantially in the direction of formulary apportionment. USCIB believes that the OECD should assess all capital allocation, interest expense allowance, and similar proposals by the criterion of whether the proposal is consistent with the purpose of the ALP. A hybrid tax system would allow countries to assert the ALP selectively (and almost certainly, inconsistently with the practices of other countries) or to adopt elements of formulary when it gives the better tax result. Businesses would be caught in the middle and subjected to a high risk of double taxation. This would have a negative impact on trade and investment. Further, a hybrid system will substantially increase the administrative burden associated with an either/or approach. Taxpayers will still be producing transfer pricing studies, but will also be required to produce information that will support apportionment in some cases. The current proposals for Transfer Pricing Documentation and the Country-by-Country Reporting template illustrate this tension.
USCIB sympathizes with OECD executives and staff for the extreme time pressure under which the OECD has been required to develop these proposals. We appreciate the opportunity to comment, and hope that our comments will be useful to allow the OECD to complete the next steps of this project with efficiency. We also understand the political imperatives under which the OECD believes it is operating. Nevertheless, the proposals raised in this and other discussion drafts are complex issues which require time and care to work through the analysis and study the expected repercussions. We believe that decisions on significant changes to the international tax law should not be made in haste. The OECD/G20 should not use the political exigencies of the moment as an excuse for not endeavouring to develop proposals which enjoy consensus support. Otherwise, proposals prepared and delivered in haste could undermine the OECD’s reputation for careful, analytical work that supports the foundation of sound tax policy. We look forward to contributing to a productive dialogue with the OECD as it continues this important work.

Specific Comments

INTRODUCTION AND BACKGROUND

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

INFORMATION AND COMMUNICATION TECHNOLOGY AND ITS IMPACT ON THE ECONOMY

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

THE DIGITAL ECONOMY, ITS KEY FEATURES AND THE EMERGENCE OF NEW BUSINESS MODELS²

USCIB strongly agrees with the Task Force that, “because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital

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

² As the OECD proceeds with this topic, it might want to include a definitional section. One of the issues with the Discussion Draft is that the definition of important terms is frequently unclear.
economy from the rest of the economy.”” (Para. 59) As a corollary to this statement, USCIB
notes that it is equally difficult to distinguish the digital economy from the larger economy.
Moreover, with the ever increasing digitalization of commercial activity, USCIB notes that it is
difficult to distinguish “pure play” digital / internet companies - i.e., companies that use the
internet as their principal method to deliver goods and services, including communicating with
users and suppliers through hosted web pages - from other companies. The Discussion Draft
implicitly acknowledges this point in its treatment in Chapter II of the Discussion Draft of the
internet of things, virtual currencies, and 3D printing, all of which create a business
convergence between digital / internet service providers and providers of manufacturing,
design, development, and financial services.

USCIB nevertheless acknowledges that digital / internet companies distinguish themselves from
low-technology enterprises through the positive contributions that digital / internet companies
make to the economies in which they are based. USCIB reaches this conclusion because
academic studies demonstrate that an economy in which a high-technology enterprise, such as
a digital / internet company, is based enjoys positive externalities in the form of increased
employment in the local service sector that exceed those associated with the presence of a
low-technology enterprise.

The Digital Economy Is Indistinguishable from the Economy

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

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

The Discussion Draft states that “[t]he digital economy has given rise to a number of new
business models” (Para. 60) and notes that examples of such “new “business models include
auction solutions, logistics services, online sales, the development and sale of applications,
online advertising, cloud computing, and payment services.” USCIB respectfully submits that
the activities that the Discussion Draft identifies are not examples of “new” business models.
Rather, these activities are examples of the use of ICT to operate existing business models more
efficiently and to extend these business models through opportunities for new products and
services. This conclusion follows because, as the Discussion Draft acknowledges, these “new”
business models have offline analogues, through which marketplace, payment, logistics,
auction, and other services have been provided since the 19th century. For example, in more
traditional companies digital activity generally flows from existing sale and supply chains and
the digital component is used to enhance capabilities within those flows.

The Discussion Draft observes correctly that ICT enables enterprises to conduct “many types of
business at substantially greater scale and over longer distances than was previously possible.”
(Para. 60) USCIB considers this feature of ICT to be one of its key virtues. With ICT, small- to
medium-size enterprises are able to reach discrete and specialized markets at earlier stages in
their development than was previously possible. This creates considerable economic
efficiencies, and goods and services can reach even these specialized markets with much greater efficiency than before. As a result, businesses and consumers around the world have access to a greater variety of goods and services, and more opportunities for economic advancement, than ever before. We would also note that the ability to monitor and apply standards remotely has actually led to the localization of production in some cases. Communications enhancements have reduced the need to keep development and production in close proximity.

ICT does not change the fundamentals of business models, however. A retailer of LPs once shipped LPs to consumers using the postal service. An online provider of song downloads now uses ICT to deliver songs to consumers over the internet. The fundamental business model of finding and developing artistic talent, marketing, and delivering musical content to consumers remains the same. Similarly, a software developer and manufacturer once shipped software on disk or CD directly to consumers or retailers. This same developer and manufacturer may now provide access to this software online. The fundamental business model of developing, delivering and supporting software for use by consumers remains the same.

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

The Discussion Draft suggests that e-commerce companies enjoy a competitive advantage over their offline counterparts because e-commerce companies are able to “eliminate[e] the need for many of the wholesalers, distributors, retailers, and other intermediaries that were traditionally used in businesses involving tangible goods.” (Para. 64) USCIB notes that the digitalization of certain forms of commerce has not resulted in a net reduction of costs. Instead, digitalization has shifted these costs to new operational areas. In place of costs associated with renting and operating retail space and transacting with intermediaries, e-commerce companies bear significant costs associated with developing, hosting, and operating websites that are accessible to consumers around the world every day of the year. These websites require ongoing R&D to ensure that they retain the right level of functionality to provide consumers with the interactive experience that consumers expect from a virtual marketplace. In some cases functions are shifted to third parties. For example, a digital economy enterprise which sells tangible goods still needs to develop logistics systems to deliver the goods to its customers, just as a department store needs to handle its inventory. In many cases for enterprises operating in the digital economy, these non-core functions are outsourced to third parties. The statement in the Discussion Draft also fails to sufficiently acknowledge how more traditional companies operate. Digital distribution functions may be an adjunct to rather than a replacement for traditional distribution networks.

Moreover, costs associated with activities such as product development, marketing, and customer support persist in the businesses of digital / internet companies, just as they do in other businesses. In many cases, these costs may be higher for digital / internet companies that must contend with short product cycles, the rapid obsolescence of technology, and low barriers to entry into markets. As the Discussion Draft acknowledges, this competitive pressure drives some digital / internet companies to give away hardware, and to treat this hardware as an operational cost, in an effort to expand the market of customers for their goods and
services. (Para. 15) In addition, the use of technology and data in business brings with it specific legal costs, such as costs of complying with local country export controls and data privacy rules. More traditional companies that are expanding their capabilities in the digital sphere are expending significant amounts of capital in the development of new products and have applied an impressive amount of resources in educating their customers as to the benefits of these capabilities. The Discussion Draft underestimates the financial commitment that companies must make and the significant risks they incur in order to become successful within the digital economy.

The Discussion Draft states that technological advances make it possible for businesses to carry on economic activity with minimal need for personnel to be present. The Discussion Draft notes that businesses can increase in size and reach with minimal increases in the number of personnel required, so-called scale-without-mass. (Para. 98) While some start up companies certainly have succeeded in developing valuable businesses at an early stage in their development, we believe this point is greatly exaggerated as a description of the industry as a whole. Well-known “digital economy” companies have tens of thousands of employees. Business cannot effectively scale without human and asset resources. This misimpression of the amount of business substance actually required to operate a significant “digital economy” enterprise distorts discussions on the appropriate nexus rule for such companies through the false implication that such enterprises lack substance outside the market jurisdiction.

**Key Features of the Digital Economy Are Key Features of the Economy**

The Discussion Draft identifies what the Task Force considers to be six “[k]ey features” of the digital economy. (Para. 91) USCIB agrees that certain of these features are present in the digital economy but observes that these same features are present in the larger economy. For example, the Discussion Draft characterizes “[r]eliance on data” as a key feature of the digital economy. USCIB notes that all enterprises, including digital / internet companies, “collect data about their customers, suppliers, and operations.” (Para. 103) Moreover, this practice is not new. By way of illustration, customer-facing enterprises used mailers, loyalty cards, and contests to collect and analyze data about customer behaviour long before the internet came into being. What digital has provided is the ability to collect such data in a faster and more accurate manner. For example, data regarding engine performance was historically collected by airline mechanics, pilots and flight reports. Much more accurate data is now collected from the engines themselves. The collection of data is not a new development and does not require sweeping changes to the rules regarding nexus and tax base.

USCIB respectfully questions whether the digital economy can properly be characterized as having a tendency toward monopoly / oligopoly if volatility is also a key feature of the digital economy. (Paras 117 – 118) With low barriers to entry, the digital economy is consistently witness to rapid ascents and declines. The now-defunct Friendster was considered “the hottest

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3 One major digital economy company, for example, has 99,000 employees worldwide with 41,000 outside the U.S. Many of its foreign marketing subsidiaries have over 1000 employees. Another digital economy company has around 30,000 people of which around half are in the US. There is “mass” behind this scale.
thing in social networking in 2003, one year before the founding of Facebook. Although Facebook arguably dominates the English-language social networking space today, its successor could be founded tomorrow. The trajectory of digital/internet companies thus stands in contrast to historic monopolies, like that enjoyed by the United Fruit Company, which dominated the banana trade virtually unchallenged for much of the 20th century.

USCIB respectfully submits that the Discussion Draft overstates concerns about the mobility of intangible assets, users, and business functions in the digital economy. Enterprises in all areas of the economy, including pharmaceutical, biotechnology, semiconductor, and natural resources enterprises, develop, acquire, and exploit intangible assets. These enterprises transfer intangible assets just as they transfer other, tangible assets, such as equipment. Transfers of both tangible and intangible assets may constitute gain recognition events and result in direct tax at the level of the transferor. In addition, in many cases, the physical ease with which an enterprise may transfer an intangible asset as opposed to a tangible asset is offset by IP protection and other compliance burdens associated with intangible asset transfers. Most OECD/G20 countries have developed rules that create significant tax costs upon the cross-border transfer of intangibles. These rules should generally provide a proper framework for addressing the issue of intangible transfers.

USCIB also observes that users are generally not mobile because users live and work in one place. Situations in which users reside in one country and purchase and/or access applications while located in a second country are less common. Similarly, business functions are generally not mobile. Personnel who perform R&D, IT, logistics, marketing, management, and other functions remain situated in a particular location. These personnel have always been able to move among different locations and are no less rooted to a single location now than before. USCIB nevertheless acknowledges that ICT enables enterprises to centralize certain functions, such as finance, legal, management, and customer support functions, in a single location to reduce costs and improve efficiency. This location might (or might not) be remote from market jurisdictions. By definition, centralizing such functions means that the centralized activity will be remote from the majority of market jurisdictions. Centralizing functions does not entail the mobility of functions, however. Instead, centralizing functions requires that these functions remain fixed at a single location. Current transfer pricing rules can be used to address the issue of mobility with respect to services that are used internally.

In its treatment of the mobility of business functions, the Discussion Draft suggests that digital/internet companies are able to “carry on economic activity with minimal need for personnel to be present.” (Para. 98) USCIB respectfully disagrees with this contention. USCIB observes that all enterprises, including digital/internet companies, require human resources to scale, as evidenced by the tens of thousands of employees of the leading digital/internet companies. Although digital/internet companies may retain fewer salespeople as compared to their offline counterparts, these same companies employ significant numbers of development, marketing, operations, IT, and other personnel. Put differently, digital/internet companies have reallocated the responsibilities of their employees but have not eliminated the need for

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employees. This statement also reflects a potential misunderstanding by the OECD of how companies operate in the digital sphere. Technology is developed by engineers, scientists and other sophisticated professionals that have the ability to innovate. The technology development may be both labour and capital intensive. Most of these people are located in countries which are hardly thought of as tax havens and there is not a tremendous amount of mobility within this population.

USCIB also respectfully questions the utility of Figure 8, which appears below paragraph 98 of the Discussion Draft and which depicts the “average revenue per employee of the top 250 ICT Firms.” As a threshold matter, USCIB notes that revenue generally does not translate into profits for digital / internet companies and thus represents a false metric for the productive capacity of employees of these companies. In addition, neither Figure 8 nor the source in which Figure 8 originally appears - i.e., the OECD Internet Economy Outlook 2012 - sets forth the names of the “top 250 ICT Firms.” As a result, USCIB is unable to assess the relationship between the average revenue per employee in Figure 8 and the profitability of the firms in question. Moreover, USCIB respectfully submits that an objective assessment of the relative profitability of ICT employees must take place in the context of other high margin industries, such as financial services, consulting services, and oil and gas.

Significance of Investment Decisions

Paragraph 101 notes that businesses are increasingly able to choose the optimal location for productive activities and assets, even if that location may be distant from the location of customers or the location of other stages of production. The ability of businesses to choose the optimal location for assets and activities is not limited to the “digital economy” and thus cannot be used to justify separate rules for digital enterprises. USCIB believes that this statement reflects concern on the part of some delegates that this ability to choose the optimal location for productive activities and assets will permit taxpayers to locate productive activities and assets where they are subject to little or no tax. USCIB believes that there are four true statements about tax and investment decisions, unrelated to the digital economy:

1. Taxpayers take into account the level of tax they will incur on their productive investment when they make decisions about where to locate these activities.
2. Low taxes or tax incentives will not make up for an unfavourable investment climate.
3. Tax incentives can tip the scales towards a location that has an otherwise favourable investment climate.
4. A difficult tax environment including high rates, lack of clarity and the difficulty of resolving disputes can discourage investment in an otherwise favourable environment.

In an open global market place, if countries seek to encourage business to make productive investments in their jurisdictions, then consequences of these factors are clear. Countries need
to focus on making the investment climate favourable. Tax regimes are a part of this, including tax regimes that are clear, predictable, and generally impose lower rates of tax on a broader base.

This paragraph also raises concerns that countries wish to have it both ways. The BEPS project generally has a theme of requiring more substance in order to support taxpayers’ allocating income to a particular jurisdiction. This focus on increased substance is inconsistent with the suggestion that income of a MNE can be taxable in a jurisdiction where that MNE has no assets, functions, or employees. That is, if a country wishes to focus on the “people functions” leading to the development of intangible property and assert that the people functions are the principal source of profit creation (in distinction to the contributions of risk and capital), then that country should not at the same time assert that another country where the “people functions” are carried on, which lead to the creation of products that are marketed in the first country, must yield to the first country insofar as the right to tax the full return from those functions is concerned. This point will be discussed in more detail in comments on section VII, but USCIB believes that the Task Force underestimates the need for people and assets in the production of digital economy products.

The Discussion Draft does recognize the volatility of the market and notes that the few companies that have managed long-term success typically have done so by investing substantial resources in research and development and in acquiring start-ups with innovative ideas, launching new features and new products and continually evaluating and modifying business models. (Para. 118) USCIB is concerned that although volatility and the resulting need to continuously innovate is acknowledged, it is not taken properly into account for purposes of profit attribution. Particularly in the context of the Discussion Drafts on intangibles, USCIB has been making the point that the OECD is undervaluing the contributions attributable to managing business risk. These fundamental business decisions are generally centralized in one or a few designated MNE group members, and are not decentralized into the market jurisdictions. For example, risk management policies are generally determined at headquarters, but their daily implementation and control are generally decentralized into a few regional management companies.

IV IDENTIFYING OPPORTUNITIES FOR BEPS IN THE DIGITAL ECONOMY

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

6 That is, if two men and a dog cannot support the attribution of income to a low-tax jurisdiction, then no men and no dog cannot support the attribution of income to the market jurisdiction.
The draft acknowledges that the nature of the strategies used to achieve BEPS in digital businesses is similar to the nature of strategies used to achieve BEPS in more traditional businesses. (Para. 120) Some of the characteristics of the digital economy may exacerbate the risk of BEPS, particularly in the context of indirect taxation. USCIB would like to point out that MNEs are much more likely to be VAT compliant with respect to digital economy transactions than smaller enterprises. Obviously, all businesses should comply with their tax obligations, but in the case of VAT, MNEs function as an uncompensated tax collector. The trade distortive effects that the OECD has pointed out in other contexts therefore operate in the opposite direction. That is, consumers may be discouraged from acquiring digital goods and services from MNEs because they do comply with their VAT obligations while smaller companies may not. Tax authorities may find that digital economy-based technology solutions may improve overall compliance with VAT by SMEs.

BEPS in the Context of Direct Taxation

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

Eliminating or reducing tax in the market country

Avoiding a taxable presence

The domestic laws of most countries require some degree of physical presence before business profits are subject to tax. Articles 5 and 7 require a permanent establishment before a non-resident may be subject to tax. Accordingly, a non-resident company may not be subject to tax in the country solely by reference to the fact that it has customers there. (Para. 123)

The Discussion Draft also states that the ability of companies to maintain some level of business connection "within a country" without being subject to tax on business profits from sources within that country is the result of particular policy choices reflected in domestic law and tax treaties, and is not in and of itself a BEPS issue. (Para. 124) However, digital companies may be able to take greater advantage of these opportunities. This combined with the elimination of taxation in the residence state, creates double non-taxation, and does raise BEPS concerns. (Para. 124)

First, USCIB believes a distinction needs to be drawn between actual presence “within a country” and sales “to a country”. Activities “within a country” include sales affiliates, customer support operations, and other personnel and assets that actually are established in market jurisdictions by many digital economy companies. This is distinct from making sales to
customers located in a country, which should not be considered a business connection “within a country”.

USCIB believes that these choices relate to the fundamental jurisdictional issue\(^7\) concerning when it is appropriate to impose income tax on participants in the economic life of a country. A legitimate substantive basis for imposing a tax may arise from different contacts between the country and the person or thing taxed. The location of a person, the situs of property, the performance of an activity, the entry of a person or property into a jurisdiction all can support the jurisdiction to impose a tax. Different contacts support different types of assertions of taxing authority. For example, importation of non-income producing property into a jurisdiction would support the imposition of a customs duty, but not an income tax on the person importing the property. Although all taxes are designed to raise revenue, they legitimately reach different aspects of the economic life of a country. Thus countries use a variety of tax instruments to reach each of these aspects and a country may have a legitimate jurisdictional basis for imposing one tax but not a different tax based on the type of connection between the country and the thing that they wish to tax.

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

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

\(^8\) See the FATCA rules.
The single fact that may differ in the case of the digital economy is that the scale of remote sales has increased. The policy choice, therefore, is whether this fact justifies a modification to the traditional nexus standards. USCIB believes that this increase in scale does not justify a general change, or a special rule for the digital economy, since over time trade in these goods and services will become more reciprocal among jurisdictions.

Traditionally, gross basis withholding taxes may be imposed on certain types of income even in the absence of an actual business presence. For a gross basis withholding tax to be considered appropriate, the income should be of a type the production of which does not require significant expenses. As previously discussed, the Discussion Draft asserts that internet businesses have significantly more revenues per employee. USCIB would like a further explanation of how those figures were derived. We believe that in most cases internet businesses are like any other. That is, it is difficult to move from a good idea to a business profit. Most businesses fail. Even successful businesses may have long periods of start-up losses before becoming profitable such that a model that imposes tax on a gross basis is likely to impose tax in many cases on amounts that do not reflect net profits. Gross revenue per employee, even if high, does not mean that those businesses do not incur significant costs. People may be replaced by technology, but technology costs may be expensive. For example, search revenue per employee may be high but traffic acquisition costs (TAC) may significantly reduce the profit opportunity on that revenue.

Historically, there have been two primary bases for imposing income tax: source and residence. Tax treaties generally recognize that a jurisdiction where the source of income is located (the jurisdiction in which the income “arises”) has the primary right to impose an income tax on that income, and the jurisdiction of residence has a secondary right to impose tax. A person’s income is generated by that person’s activity and/or property. Source rules generally are intended to reflect the location of the person’s activity, or the location of the person’s property, that generates the income or the origin of that income. Neither concept focuses on the location of the customer.

Source rules are not universal or immutable, but there are some basic principles that are generally used to determine source. Some of those principles are: place of activity (performance of services, profits attributable to a PE), place of use (rents and royalties\textsuperscript{10} from

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

\textsuperscript{10} The market jurisdictions may believe that returns attributable to accessing a market are royalties. The OECD’s Discussion Draft on intangibles rejects that view because the market cannot be owned or controlled by any person.
property), residence of the payor (interest and dividends), and residence of the recipient
(capital gains, and business profits, not otherwise dealt with, and not attributable to a PE
outside the residence country).

The income tax, at its most basic level, is an origin based tax on income created by activities
conducted in a particular place. That is, jurisdictional nexus is created by the location of
activities\textsuperscript{11} and assets of the person earning the income. The country or countries that have a
substantial nexus to those activities and assets should have the jurisdiction to tax that income.

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

The Discussion Draft asserts “[i]n the context of the digital economy, an enterprise may
typically establish a local subsidiary or a PE, with the local activities structured in a way that
generates little taxable profit.” (Para. 125) The Discussion Draft acknowledges that this is not a
BEPS issue in and of itself, even if the enterprise takes taxes into account in deciding where to
locate personnel and functions. (Para. 125) The Discussion Draft asserts, however, that this
creates "incentives to purport an allocation of functions for tax purposes in ways that may not
correspond to actual business functions performed, and that would not be chosen in the
absence of tax considerations.” (Para. 125) How much profit a local entity generates depends
on the functions, assets and risks of that entity. There has been a lot of public comment on this
issue, but the public comment does not necessarily reflect the actual operations taking place in
particular countries. In many cases, “digital economy” companies only locate a small portion of
their worldwide labour force in a jurisdiction and those personnel are not responsible for
intellectual property. Thus, minimal presence and low value functions are what leads to the
low profit attribution.

The Discussion Draft states that authority to conclude contracts is one of the functions that may
"purportedly" be in a nonresident entity, while the "effective authority" to conclude contracts is
in fact in the local entity.\textsuperscript{12} (Para. 127) The draft continues as follows: "assets, in particular
intangibles, and risks related to the activities carried out at the local level may be allocated via
contractual arrangements to other group members operating in a low tax environment in a way
that does not correspond to actual risks assumed or to functions performed, assets used, or
risks assumed related to the intangibles.” (Para. 125) The draft also identifies "undervaluing"
intangibles at the time of transfer as a risk. (Para. 126)

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\textsuperscript{11} The word “activities” is used broadly here. Activities would include investing, bearing risk, holding title and
managing property.

\textsuperscript{12} Contract approval parameters are generally set at the headquarters company or regional management
company, not at the local market level. Difficult contract negotiations are generally escalated to the headquarters
or regional management company.
The Discussion Draft also states “[o]perations in higher tax jurisdictions often are “allegedly” stripped of risk, do not “claim” ownership of intangibles or other valuable assets, and do not hold the capital that funds the core profit making activities of the group.” (Para. 126 internal quotations added.) USCIB has addressed some of these concerns in our comments in our responses to the Discussion Drafts on intangibles. USCIB is very concerned with the tone of this Discussion Draft, that it reflects an assumption that MNCs systematically misrepresent to tax authorities the actual functions, assets and risks located in a jurisdiction.

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

Maximizing deductions in market jurisdictions

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

Avoiding withholding tax

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

Opportunities for BEPS with respect to VAT

This topic is discussed at the end of this letter.

V. TACKLING BEPS IN THE DIGITAL ECONOMY

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

**Restoring Taxation on Stateless Income**

“Structures aimed at artificially shifting profits to locations where they are taxed at more favourable rates, or not taxed at all, will be rendered ineffective by ongoing work in the context of the BEPS Project.” (Para. 146) Presumably this includes all the transfer pricing action items (Actions 8, 9, and 10). The Discussion Draft also recognizes greater transparency and mandatory disclosure of aggressive tax planning arrangements, uniform transfer pricing documentation requirements, and country-by-country reporting as contributing to this. USCIB has previously submitted comments on these issues. We would like to highlight that the OECD needs to be mindful of the burden created by additional reporting requirements and ensure that burden is appropriate and proportionate.

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

These measures include the prevention of treaty abuse (Action 6). A Discussion Draft on this was published recently. USCIB has submitted separate comments on this topic.

On preventing the artificial avoidance of PE status (Action 7 – which is due by September 2015), the Discussion Draft mentions possible changes to the rules concerning the conclusion of contracts and dependent agents (Para. 150) and possible changes to the Article 5(4) preparatory and auxiliary activities. (Para. 151)

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

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

*Neutralize the effects of hybrid mismatch arrangements*

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13 The timing on this Action Item may be premature. Action Item 1 should probably have been Action Item 15. That is the impact of all the other changes should have been considered before taking action of the “digital economy.”
The OECD recently published two Discussion Drafts on these topics. USCIB will be developing comments on these Discussion Drafts.

Limit base erosion via interest deductions and other financial payments

The Discussion Draft points out that “many large and well-established digital economy players are cash rich and they often finance new ventures, the acquisition of start-ups, or other assets with intra-group debt.” (Para. 155) Intra-group financing entities are often established in low tax jurisdictions. The existing rules permit companies to fund profit-generating activities of the group with intercompany debt even though the group as a whole may be much less heavily leveraged. (Para. 156) This issue is not unique to digital economy companies and may be less prevalent in the “digital economy” than in other sectors of the economy.

The Discussion Draft identifies this as an area where mechanisms within or beyond the arm’s length principle may be necessary and suggests a formulary approach which ties deductible interest payments to external debt payments which may lead to results that better reflect the business reality of MNE groups. (Para. 157) This would obviously be a significant change from current law and a significant move towards formulary apportionment. USCIB has serious doubts concerning the feasibility of such an approach. In order for this to work, countries would not only deny deductions for intra-party debt, they would also have to permit a deduction for a portion of the external interest expense incurred by an entity located outside of their jurisdiction. Since, these countries are now allowing that deduction presumably they would also want the option to impose a withholding tax on the portion of external interest paid. Instead of actual intra-company debt would there now be deemed intra-company debt that would be subject to withholding tax? That does not seem appropriate since there would be no income in that jurisdiction since the only income is held by unrelated parties who are not necessarily located in the jurisdiction of the entity that incurs the third party debt. Would each company have a share of the external debt? If so, how would each company determine a share of that in a timely manner such that withholding tax could be imposed without burdening capital markets? Perhaps withholding agents have to determine which treaty applied to some portion of each payment. Perhaps withholding agents would withhold at the highest possible applicable rate and investors would be required to apply for refunds in every jurisdiction to which interest was allocated.

Counter harmful tax practices more effectively

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

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

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

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

The BEPS work on intangibles will address the below value transfer of intangibles by taking several steps. (Para. 160) These include:

1. A broad definition of intangibles -- this is intended to ensure that any intangible for which unrelated parties would pay compensation must be compensated in a related party transfer;
2. Entities that contribute value by performing or managing development functions or by bearing or controlling risks are appropriately rewarded;
3. Valuation techniques may be used when appropriate comparables cannot be found;
4. In the case of partly developed or hard to value intangibles, post-transfer profitability (commensurate with income) should be taken into account.

USCIB has submitted comprehensive comments on the topic of intangibles and stands by those comments.

**Business risks**

The Discussion Draft states that the BEPS work will require the control of risk, the financial capacity to bear the risk, and the management of risk to be more closely aligned. (Para. 163) Even more importantly, the Discussion Draft states “the guidance will also identify risks that, by their nature, are borne by the MNE group as a whole and therefore which cannot readily be assigned to a single group entity.” (Para. 163) The Discussion Draft does not say what would be done with these risks. Ignoring commercial risk is one of the principal tenets of formulary apportionment (those advocating for formulary approaches basically consider the return from intangibles and risk to be spread over all the activities of the group). So, ignoring risk would be
a significant move in the direction of formulary apportionment. As mentioned earlier in this comment letter, the managing of global risk is one of the principal functions of senior management. Management is responsible for identifying the direction of the business, deciding which ventures to pursue and which to abandon, and developing or acquiring new products or businesses which they believe will be successful. These basic decisions determine whether a company will become and remain successful. Even successful businesses must continuously evaluate and manage these risks. These risks are not managed in the contract manufacturing entity or the contract research and development facility, but they are key to the continuing vitality of any business \(^{14}\) and an approach that either ignored these risks or allocated them on the basis of a formula would fundamentally misallocate business risk. This approach would divorce taxation from business and economic realities; a result that appears contrary to the goals of the OECD. Additionally, formulaic apportionments carry significant risks of creating their own base erosion problems.

**Base eroding payments**

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

**Global value chains and profit methods**

The Discussion Draft provides that:

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

The output is to be delivered by September 2015.

USCIB is very concerned that all of these elements taken together represent a significant erosion of the ALP. As we stated at the beginning of this letter, this hybrid approach will

\(^{14}\) Even companies that have been successful over a long period can fail because they fail to manage business risk and change. Kodak is a prime example of the sort of failure.
potentially lead to a high risk of double taxation and will potentially create a significant drag on trade and investment.

Measures that will restore taxation in the jurisdiction of ultimate parent

The Discussion Draft provides that to address BEPS in the digital economy, CFC rules must effectively address the taxation of mobile income created by the digital economy. (Para. 168) To address this situation, consideration should be given to CFC rules that target income typically earned in the digital economy, such as income earned from the remote sale of digital goods and services. (Para. 169) Remote selling is neither new nor unique to the digital economy. Internet/cloud technology has made remote selling pervasive in the economy. So it would be difficult and unfair to limit rules on remote selling to digital economy transactions. The draft also says that the work will need to take into account the need for anti-inversion rules. (Para. 169)

USCIB believes that the purpose of the corporate income tax and the economic burden of that tax are relevant to whether a CFC approach or another approach is appropriate to reducing the incidence of low or non-taxation. That is, if other BEPS concerns are addressed and yet there is still low-taxed income: does any country have jurisdiction to tax that income? If so what is the basis of that jurisdiction? The corporate income tax ensures a comprehensive income tax; without a corporate income tax, corporate earnings would not be taxed until paid out to individual shareholders. It is also widely acknowledged that corporations do not bear the economic burden of the corporate tax, although it is less clear where that burden falls. Traditionally, the impact of corporate taxation has been believed to borne by the shareholders of the corporation since it reduces the value of their shares. More recently some have argued that the burden of the corporate tax falls on labour or the consumer. The U.S. Congressional Research Service believes the traditional analysis is generally correct. This is relevant to the policy analysis because if the corporate tax functions as a pre-payment of the personal income tax and the economic burden of the tax in fact usually falls on the shareholders of the corporation, then the jurisdiction which ought to be determining whether residual tax should be imposed on a corporation that is earning income subject to a low rate of tax ought to be the jurisdiction in which the shareholders reside. Taxing the ultimate individual shareholders is probably impractical. However, taxing the ultimate parent in the jurisdiction in which it resides is probably a reasonable proxy for taxing the individual shareholders. If that conclusion is correct, is the jurisdiction of the ultimate parent obliged to tax low taxed income or can it make a sovereign choice to tax that income only on repatriation to the ultimate parent or not at all?

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15 See the recent US Treasury proposal on CFC rules for the digital economy.
16 The Corporate Income Tax System: Options for Reform, the Congressional Research Service, p. 15.
17 Ibid at 16.
USCIB believes that countries do have the sovereign right to make these choices and that after appropriate returns are paid based on a FAR analysis, the right to impose an additional tax on corporate profits ought to be reserved to the jurisdiction of the ultimate parent.

This issue goes to the origin theory of income taxation vs. the supply/demand theory. Under the supply/origin theory: "profits originate where the factors that produce the profits operate and the source of the “normal” return of equity capital should therefore be identified “to the location in which the actual operation of the capital occurs”,18 ... the mere consumer market does not represent a factor contributing to the added value of the company.19 “[A]ctivity somewhere, as reflected by the entrepreneur’s risk assumption, labour deployment, and property investments, remains a necessary component to an enterprise’s creation of products and services. Nothing in the "new" economy changes the proper justification for a state to impose an income tax on an enterprise.”20

The Final Report also says: "No member of the TAG argued that tax rules should be modified to shield countries from the effect of technological developments on their tax base. Countries do not have a right to a particular level of tax revenues regardless of where business profits originate.”21 So, if activities have shifted to outside the jurisdiction, countries will lose tax revenue and that is appropriate. BEPS is intended to address artificial profit shifting. If the income is attributable to actual activities that have moved out of the jurisdiction, then the profit shifting is not artificial. We are concerned that the digital economy proposals are inconsistent with the other BEPS action items that strive to attribute more profit to the location where activities take place. We believe that countries cannot have it both ways. If they want to look to the location of people functions in the context of the attribution of income to development of intangibles, they should also look to the location of people functions in the context of the digital economy.

USCIB also believes that this does not deny a market jurisdiction an appropriate share of taxing jurisdiction because proper application of a destination based VAT will permit the market jurisdiction to collect an appropriate amount of tax.22

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18 Anne Schafer and Christoph Spengel, *ICT and International Taxation: Tax Attributes and Scope of Taxation*,
19 Business Profits TAG, final report, paragraph 40.
20 Business Profits TAG final report paragraph 50.
21 Ibid para. 118.
22 There are political reasons that some jurisdictions do not want to rely on a VAT to tax the value attributable to the market. These vary but include the fact that, as discussed, the economic burden of a VAT is supposed to fall on the final consumer. That is, jurisdictions may wish to tax corporate income precisely because the economic burden does not fall on their residents. In some jurisdictions VAT rates are already very high and there is not a lot of scope to raise rates further. Sub-national governments may impose VATs, so revenue from a VAT would have to be shared between national and sub-national governments. Some jurisdictions may have constitutional or other restrictions that limit their ability to impose a VAT. These political concerns of course need to be properly taken
In contrast to an income tax, a VAT is intended to impose a broad-based tax on final consumption by households. The central design feature of a VAT is that the tax is collected through a staged process. Each business in the supply chain takes part in the process of controlling and collecting the tax, remitting the portion of the tax corresponding to its margin. That is the VAT of a business is the difference between the VAT on its taxed inputs and the VAT on its taxed outputs. The tax is collected in principle on the “value added” at each stage of the collection process.

The economic burden of a VAT is supposed to be borne by the ultimate consumer (in contrast to the corporate income tax). We believe that the OECD should take a careful look at the economic burden of both of these taxes in the context of the digital economy. If companies are competing on price then VAT compliant MNEs may be bearing the burden of the VAT because SME competitors may be less likely to be VAT compliant and will undercut more compliant companies on price. Thus, VAT compliant businesses may be bearing at least a portion of the VAT. Also, companies may want to use a uniform pricing model across jurisdictions and in order to avoid pricing differentials caused by different VAT rates, some VAT may be borne by MNEs (which may mean that it is ultimately borne by shareholders). Business also believes that in determining the economic burden of the VAT compliance costs should be taken into account. These costs are higher than they need to be because governments have not coordinated their rules; compliance is more burdensome than it needs to be; penalties are significant; and there is no process for resolving double taxation disputes. Precisely because the economic burden is supposed to be borne by the customer, the compliance costs business incurs are an economic burden on the company.\footnote{Some have argued that making use of the infrastructure of a country ought to be a sufficient basis for finding a PE and imposing an income tax. We disagree with that view, but note that MNEs not only make use of the infrastructure of a country, but also contribute to it. Serving as the government’s VAT collector is a prime example of such a contribution.}

The fundamental policy issue in relation to the international application of the VAT is whether a VAT should be imposed by the jurisdiction of origin or the jurisdiction of destination. Under the destination principle, tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction. If countries adopt a destination based VAT, in the case of a cross-border transaction, the country of origin is ceding its taxing jurisdiction to the country of destination. This may be the right policy, but the economic result is that the country of destination is taxing value added in other jurisdictions.

Under the destination principle, exports are not subject to tax (and are entitled to a refund of input tax) and imports are taxed on the same basis as domestic supplies. Thus, the value that
was added outside of the jurisdiction of consumption is subject to full VAT in the jurisdiction of final consumption. In other words, the jurisdiction of consumption is able to impose a tax on the value created by activities taking place outside the jurisdiction and assets whose use and value is outside the jurisdiction.

Under the origin principle, each jurisdiction would levy VAT on the value created within its own borders. Thus, jurisdictions would tax exports on the same basis and at the same rate as domestic supplies and would tax imports as domestic supplies with a credit for the hypothetical value of its VAT (not the actual VAT paid in the country of export). By imposing tax at the various rates applicable in the jurisdictions where value is added, the origin principle could influence the economic or geographical structure of the value chain and undermine neutrality in international trade.

Obviously this is true and could also be true for origin-based income taxes. That is, imposing income tax on the place where value is created can and does influence the economic and geographical structure of the value chain, as discussed above companies take taxes into account in deciding where to locate productive activities. The OECD has recognized that consumption taxes are preferable to income taxes, precisely because consumption is less mobile and does not create distortions. This does not mean that all taxes – income taxes in this case -- should be imposed on the basis of place of consumption. A distinction between origin based income taxes and destination based consumption taxes allows both the jurisdiction of origin and the jurisdiction of destination to tax value creation in an appropriate way.

Although VAT is a tax on final consumption, VAT is not imposed on actual consumption but on proxies that are intended to predict the likely place of consumption. In the context of developing VAT guidelines, the OECD is identifying which proxies work best in certain circumstances. Once proxies are identified, actual consumption is irrelevant to determining the place of taxation. That is, the proxy trumps the place of consumption if they differ. In the context of digital transactions there are four possible proxies being considered. Those proxies are: consumer residence; actual location of the consumer; residence or location of the supplier; and place of performance. It is likely that the only really feasible proxy in the majority of cases will be consumer residence. The residence of the consumer is the proxy (and therefore the deemed place of consumption) for digital transactions. In other words, the place of actual consumption would be irrelevant and the place of consumer residence would generally be the place of consumption.

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

VI. BROADER TAX CHALLENGES RAISED BY THE DIGITAL ECONOMY

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

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

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

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

Data and the attribution of value created from the generation of marketable location-relevant data through the use of digital products and services
The Discussion Draft provides that data gathered from various sources is a primary input into
the process of value creation in the digital economy. (Para. 183) A key challenge is the
attribution of value to this data and the extent of value relative to other sources of value –
systems, software and people. It may be challenging to assign an objective value to raw data
(Para. 183) and determine the ownership of that data. Personal data is generally considered to
be owned by the individual to whom it relates, rather than by a company. (Para. 183)

USCIB believes that raw data has little or no intrinsic value, especially generally available raw
materials such as usage data. Value is created by the aggregation of data and the application of
analytics, which is achieved through investment in people and technological resources.

Characterization of income derived from new business models

This section of the Discussion Draft raises the question of whether monetization models
utilizing new delivery methods of goods and services challenges the rationale behind existing
categorisations of income and consistency of treatment of similar types of transactions. These
issues are raised, in particular, with respect to "cloud computing" transactions, including
infrastructure as a service, software as service, or platform as a service. (Para. 187)

The Discussion Draft includes a lengthy factual description of the nature of cloud computing
transactions. (Paras 79 - 84). USCIB generally agrees with that description and the broader
factual statements contained in Chapters II and III of the Discussion Draft relating to cloud
computing models. To consider the appropriate characterisation for such transactions, the
Discussion Draft notes that it: “will, therefore, be necessary to examine the rationale behind
existing rules in order to determine whether those rules produce appropriate results in the
digital economy and whether differences in treatment of substantially similar transactions are
justified in policy terms.” (Para. 188)

With respect to the characterisation of cloud computing transactions, we note the prior OECD
work in this area, which produced guidance that remains useful today. In 2001, the OECD
published the final report of the Technical Advisory Group on Treaty Characterisation of
Electronic Commerce Payments.\(^\text{24}\) That TAG addressed the characterisation analysis for a
variety of e-commerce transactions for purposes of the OECD Model Convention. The TAG
discussed general principles which should be applied to the characterisation analysis, then
applied those principles to 24 specified transactions. Those 24 transactions included several
remote access transactions, including “application hosting”, “web site hosting”, “data
warehousing”, and “streamed (real time) web based broadcasting”, which would be described
as "cloud computing" transactions today.

\(^{24}\) Taxation and Electronic Commerce - Implementing the Ottawa Taxation Framework Conditions (2001),
hereinafter the “Business Profits TAG Final Report” or “Final Report”.
The TAG evaluated the available precedents for characterising such payments as business profits or royalties, and concluded that the most useful guidance existed under U.S. tax law. Accordingly, the TAG adopted the principles of U.S. Internal Revenue Code section 7701(e) to guide its characterisation analysis. The TAG report states as follows:

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

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

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

29. This is a non-exclusive list of factors, and some of these factors may not be relevant in particular cases. All relevant facts bearing on the substance of the transaction should be taken into account when determining whether the agreement is a service contract or a lease.
The TAG then applied these principles to application service provider and data warehousing examples, concluding in both cases that the payment would be for the provision of services, and not for the lease of industrial, commercial or scientific equipment, as follows:

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

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

The guidance provided in the TAG continues to be useful today in characterising payments for cloud computing transactions. While the TAG language discussed above has not been formally incorporated into the OECD Commentary, guidance on certain analogous transactions recently has been incorporated in the Commentary. In particular, the Commentary discusses how satellite operators and their customers frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilize the capacity of a satellite transponder to transmit over large geographical areas. The Commentary concludes that in most cases, payments for these transactions should be characterised as business profits rather than royalties. This is true even in the context of treaties that include the leasing of industrial, commercial or scientific (ICS) equipment. In reaching its conclusion, the Commentary points to the fact that customers typically obtain access to the transponder's transmission capacity, rather than physical possession of the transponder itself. We believe this analytical approach should apply to cloud computing transactions, and that the current Commentary guidance is consistent with the TAG report and the principles of section 7701(e).

In most cases, an application of the factors accepted by the TAG to XaaS transactions would characterize payments for cloud computing transactions as business profits (based on the

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25 See e.g., OECD Commentary on Article 12, para. 9.1.
provision of a service), rather than royalties. As with transponder leasing agreements, we believe this is true even in treaties that include the leasing of ICS equipment in the definition of royalties because the user generally does not acquire physical possession of the server in most cloud computing transactions.

We would be pleased to work with the OECD to develop language for the Commentary that provides guidance for payments from cloud computing transactions.

**Collection of VAT in the digital economy**

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

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

**Framework for evaluating options**

The Discussion Draft states that the Ottawa framework of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility continues to be a good starting point. (Para. 204) USCIB strongly endorses the use of the Ottawa framework. The framework will also need to take into account the key features of the digital economy as outlined in section III.

The principle of neutrality means that “ring fencing” the digital economy and applying separate tax rules is neither appropriate nor feasible. (Para. 205) USCIB agrees completely with this conclusion.

Another key point is that the OECD expects that action on the other action items will raise the effective tax rates of digital economy companies. If that is not the case and effective rates in the digital economy remain extremely low, then “addressing the broader tax challenge of the digital economy becomes a more pressing concern.” (Para. 208) While not surprising, this statement seems somewhat inconsistent with the notion that countries are free to choose to impose low (or no) tax on income properly attributable to that jurisdiction because it implies that a certain level of income tax ought to be paid at the corporate level in all cases. If income is subject to tax in the appropriate jurisdiction, then whether that jurisdiction chooses to impose a low tax or any tax at all, is a sovereign choice for that jurisdiction. If that jurisdiction does not choose to impose tax, then (apart from appropriate CFC rules) other countries should not be able to assert a claim to tax that income.

**Options proposed to the Task Force**

*Modifications to the exemptions from permanent establishment status*
The Discussion Draft raises the question whether the activities described in Article 5 (4) of the OECD Model Convention could constitute core functions of a business. (Para. 210) At least in the case of maintaining a warehouse, that activity normally could be considered a "core" activity only of an enterprise whose principal business function is to provide warehousing services. Warehousing is an activity within almost every industrial supply chain. But it is seldom if ever a core function – indeed it is an area that many companies outsource in full or part and it is a function that is generally acknowledged as being easy to benchmark, given the multitude of third party comparables. It would also be unfair and distortive if companies that outsource their warehousing function are potentially treated differently from those companies who primarily insource. USCIB believes that if Article 5(4) is to be changed, then any such changes should modify the preparatory or auxiliary exception only for those enterprises whose primary source of revenue is an Article 5(4) activity. USCIB supports a policy that all businesses are subject to tax in the jurisdictions in which revenue-generating functions relating to their core competencies take place.

Changes to the definition of PE are part of Action Item 7 which is due by September 2015. USCIB will provide comments at the appropriate time on OECD/G20 proposals modifying these rules. Business prefers bright line rules that provide certainty, so to the extent the changes the OECD/G20 is considering move in that direction, that would be a plus. However, as we discuss at length in other parts of this comment letter, PE rules that minimize exposure to local country tax have a sound basis in policy. The OECD/G20 should not make broad changes without careful consideration of the consequences.

A new nexus based on significant digital presence

The Discussion Draft includes an option of an alternative nexus test when a business is “fully dematerialized.” (Para. 212) This seems to directly contradict the statement in paragraph 205 that ring-fencing the digital economy is neither appropriate nor feasible. Paragraph 213 provides a potential test for determining whether “fully dematerialized digital activities” are conducted, including the following elements:

- The core business relies completely or in considerable part on digital goods or services;
- No physical elements or activities are involved in the value chain other than the existence use, or maintenance of servers and websites or other IT tools and the collection, processing, and commercialization of location-relevant data.\(^\text{26}\)

\(^{26}\) This condition is the most difficult to understand how it could apply to any significant enterprise. Assuming that the object of this option is to define a category of digital enterprises that provide valuable services cross-border, it is hard to conceive of such a business that does not include as part of its value chain development, operations,
• Contracts are concluded exclusively remotely via the Internet or by telephone;
• Payments are made solely through credit cards or other electronic means;
• Websites are the only means used to enter into a relationship with the enterprise;
  no physical stores exist for the performance of core activities other than offices
  located in the parent company or operating company countries (emphasis added –
  USCIB questions why these operations seem to be ignored);
• All or the vast majority of profits are attributable to the provision of digital goods
  or services;
• The legal or tax residence and physical location of the vendor are disregarded by
  the customer;
• The actual use of the digital good or the performance of the digital service does
  not require physical presence.

If a fully dematerialized business is considered to exist, then a significant digital presence could
be considered to exist in a country, under the following circumstances:

• A significant number of contracts for the provision of fully dematerialized digital
  goods or services are remotely signed between the enterprise and a customer that is
  resident for tax purposes in the country;
• Digital goods or services of the enterprise are widely used or consumed in the
  country;
• Substantial payments are made from clients in the country to the enterprise; or
• An existing branch of the enterprise in the country offers secondary functions.

As a general comment before analyzing this under the Ottawa principles, it is interesting to
note that the tests do not look to whether the payment by the recipient of the good or service
is deductible. USCIB believes that this is because many of the transactions intended to be
covered by this option are B2C so a deduction would not be available. It would seem that in
order for this to be a base erosion problem, a deductible payment would be necessary. To
reiterate, as to profit shifting, the BEPS project should be targeting artificial profit shifting, if
profit producing activities shift, profits should move. Countries do not have a right to a
particular level of tax revenues regardless of where business profits originate. It seems
fundamentally inconsistent for market jurisdictions to argue that income from intangibles
should be allocable to people functions (e.g., where the research and development takes place)
and ignore the people functions when the transaction is digital (where the digital content is
created). The digital content ultimately is created by people, so if people functions should
trump then there is no basis for a nexus that looks solely at consumption activity. Otherwise,
this option is inconsistent with the emphasis on people functions in the draft Chapter VI TPG revisions.

Ottawa Principles:

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

Efficiency: USCIB believes that the efficiency criterion is also violated. USCIB believes that the nexus based on significant digital presence must be based on taxation of net, not gross, income.\(^{27}\) Net basis taxation will require some sort of return and depending on how the many subjective terms – significant number, substantial payments, widely used – are defined this could result in tax returns in many additional countries where the company has no physical presence at all. Establishing the intercompany transaction infrastructure and accounting systems necessary to file returns in many additional countries is a significant burden and one of the principal reasons for the historical PE standard.

Certainty and Simplicity: The nexus test contains many subjective criteria such that the criterion of certainty will be violated. The test uses terms such as “considerable part”, “significant number”, “widely used or consumed”, “substantial payments”, which are all subjective and probably intended to be subjective. The determination of a "significant number" will vary widely between jurisdictions depending upon factors such as market size.

At the same time, however, one of the core elements of the definition would seem to apply only in exceedingly rare cases. One element of the proposed definition of a fully dematerialized digital business is that “no physical elements or activities are involved” in the value chain other than servers, websites and the collection of location-relevant data. Any enterprise of sufficient size to have its goods or services "widely used" in a country will have many employees who perform critical business activities other than “the collection, processing, and commercialization of location-relevant data.” As written, it is hard to conceive of an enterprise to which this element of the definition could apply. This would lead companies to be concerned that the test does not really mean what it says.

Effectiveness and Fairness: This criterion is more difficult to judge given that the standard is “that taxes imposed are designed to produce the right amount of tax at the right time, and

\(^{27}\) In part, because one of the other alternatives is a gross basis tax.
avoid creating new opportunities to artificially avoid taxation.” The Discussion Draft does not provide details of how profits would be attributed to a taxable presence imposed under this new nexus standard. Accordingly, it is difficult to judge whether the right amount of tax would be imposed at the right time. The nexus rules fail the fairness test depending on whether what appear to be absolute tests are in fact absolute tests.

Flexibility: This criterion is difficult to apply; since it is difficult to anticipate which direction technology will take. However, the number of absolute tests proposed likely will make the test less flexible. For example, new technology may make the criterion of “contracts are concluded exclusively remotely via the internet or by telephone” irrelevant.

USCIB believes that the proposed option of a new nexus based on a significant digital presence clearly fails the Ottawa principles.

Looking at the new nexus test more generally, we believe that the only argument in favour of adoption would be a political one. That is, it would permit market jurisdictions to impose an income tax on “fully dematerialized digital activities” in certain limited cases. This option would result in significant controversy and double taxation. This option also would discourage the expansion of digital goods and services into remote economies, which will adversely affect economic growth.

Accordingly, USCIB recommends that countries reject this approach. The Discussion Draft also proposes the option that a fully dematerialized business could be considered to have a significant digital presence if it uses personal data obtained by the regular and systemic monitoring of Internet users in that country through the use of multi-sided business models. (Para. 215) USCIB believes that this is narrower than the above proposals, but it is not clear who is doing the regular and systemic monitoring of the Internet users: the enterprise itself? If the data is obtained and analyzed by another entity, then it would seem the profits from those activities should be attributable to the other entity and therefore should not give rise to a nexus for the business purchasing the data.

The Discussion Draft acknowledges that development of these options would “require evaluation of the above elements to determine which combination of factors would result in an appropriate nexus to address the tax challenges of the digital economy effectively, while providing enough clarity to minimize dispute. It would also require consideration of how profits would appropriately be attributed, and whether doing so would require modification of the current rules for the attribution of profits to PEs. The work would also need to consider whether such a change would require a change in the attribution rules for all enterprises or whether the changes could be limited to “fully dematerialized digital business.” (Para. 215)
This seems inconsistent with the statement in the Discussion Draft that ring-fencing the digital economy and applying separate rules is neither appropriate nor feasible.

**Virtual permanent establishment**

The Discussion Draft includes "for the sake of completeness" virtual permanent establishment options considered by the Business Profits TAG. (Para 217) It does not seem that these options are being actively considered by the Task Force since the options are merely stated with no assessment of pros and cons as were expressed by the Business Profits TAG. USCIB opposes the adoption of any of these virtual PE options because adoption would violate the Ottawa Principles.

Neutrality: A virtual PE establishment is not real; there is, in fact, no place of business in the cases in which the virtual PE options seek to deem a PE to exist. The neutrality principle would be violated to the extent that the options would result in different tax outcomes for conventional and digital forms of commerce. \(^{28}\)

Efficiency: Extending the PE concept to cover situations where websites are being hosted in a country would create serious compliance difficulties. A business may not even know where a website is hosted. Tax administrations would have to attempt to enforce their tax rules in the absence of physical assets and employees. \(^{29}\)

Certainty and Simplicity: The virtual PE proposals would add uncertainty to the determination of whether a PE exists. For example, businesses may not know where the servers hosting its operations are located. Businesses may have difficulty identifying where contracts are concluded and to the extent there are thresholds, it may be difficult to have reliable information on whether the thresholds are exceeded and it will be difficult to know at the outset whether the thresholds will be exceeded. \(^{30}\)

Effectiveness and Fairness: The virtual PE options attempt to tax business activities that are not carried on within a country. Thus, creating a PE is “unfair”. It is also likely to be ineffective both because it will be difficult to administer and unless profit attribution rules are fundamentally changed, little or no profit will be attributable to the virtual PE.

Flexibility: It is unclear whether these models would be flexible enough to deal with emerging technologies.

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


\(^{29}\) Ibid at para. 333.

\(^{30}\) Ibid at para. 338.
A further proposed option is a final withholding tax on certain payments made by residents of a country for digital goods or services provided by a foreign e-commerce provider. (Para. 218) Presumably, the justification for such a tax is that the provider delivers a substantial amount of goods or services into a jurisdiction but does not maintain a taxable nexus in that jurisdiction. Consistency with trade obligations would need to be considered, as would the difficulties of imposing a withholding tax in the context of B2C transactions. The burden of complying with a withholding tax may be imposed on financial institutions. (Para. 218)

A withholding tax would allow the market jurisdiction to collect some revenue without the burden of imposing net income filing requirements and determining the profits attributable to the market jurisdiction. It would likely therefore be simpler in some respects. However, this option raises difficult characterization issues and those issues have caused significant controversy and double taxation in the software and service industries. Revenue is a poor proxy for net income. As discussed above, developing digital products and services may require significant investment in time and money. Many products and services never make any money on a net basis. Because of these concerns any withholding tax should be at a very low rate. India’s High Powered Commission recommended a 3% rate for these reasons.

Neutrality: “It would be difficult to justify applying withholding tax only on cross-border e-commerce and not on traditional cross-border trade. Such a tax would violate the neutrality principle as presented in the Ottawa framework principles. The alternative of applying the tax to all forms of cross-border trade would mean, however, the introduction of tariff-like taxation, which might well be against WTO rules and principles.”

Efficiency: There are also administrative concerns. Many of these transactions will be B2C and very low value. It is unlikely that individual consumers will collect and pay over a withholding tax. Imposing a withholding tax on these transactions will create significant burdens for the financial system.

Certainty and Simplicity: A withholding tax applicable only to digital transactions would require a definition of the transactions to which it applied. This would likely be a difficult task.

Effectiveness and Fairness: Given the difficulty of imposing a withholding tax on B2C transactions, this option may not be effective. It also appears to fail the fairness test since the withholding tax would be levied regardless of profitability. A tax on gross revenues is a very poor proxy for a tax on net income.

31 Ibid at para. 260.
32 We reiterate that in the case of B2C transactions there should not be a base erosion concern.
It seems to us that the administrative issues will be essentially the same as those which would be created by imposing VAT on cross-border digital transactions. Since the VAT is the conceptually more appropriate tax in this context, the consideration argues for preferring a VAT over a withholding tax.

**Consumption Tax Issues**

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

**Exempt Sector and Multi-Location Entities**

The Discussion Draft identifies remote digital supplies to exempt business (Para. 137) and to a multi-location enterprise (MLE) (Para. 140) as aspects which, under certain conditions, create opportunities for tax planning by businesses and corresponding BEPS concerns for governments in relation to VAT. Concerns particularly relate to the extent that Guidelines 2 and 4 of the OECD’s “Guidelines on place of taxation for B2B supplies of services and intangibles” are not implemented.

Before commenting on this aspect in further detail, we would like to first highlight some more conceptual aspects that are not specific to the digital economy.

All stakeholders, including governments, business or academia, agree that conceptually, a broad based VAT system, with ideally no or very few exemptions, and one standard VAT rate, would represent the most efficient and effective structure for all relevant parties. It would take
substantial complexity out of the VAT system, would ensure neutrality for business, and would ease both compliance for business and administration for governments.

The issues relating to the exempt sector and MLEs in the exempt sector are not specific to the digital economy. Instead, they are conceptual issues related to the design and the application of the VAT system. As the Discussion Draft points out these issues arise to the extent that Guidelines are not implemented. (Para. 136) Thus, implementation of the Guidelines would alleviate these BEPS concerns. (Para. 171) Business supports the implementation of the Guidelines and urges governments to implement the principles of the Guidelines in a consistent fashion.

USCIB would also like to point out that the imposition of VAT on exempt purchasers of digital products is a significant issue. Universities, hospitals, governments, local government bodies and many others buy vast quantities of digital services and do not have the budget to pay VAT. As the OECD examines the application of VAT to the exempt sector, these issues should be taken into account.

Finally, we would like to clarify two editorial aspects of the Discussion Draft to ensure a common understanding:

In paragraph 140, an MLE is referred to as a multinational business that has establishments in different jurisdictions. This could be misunderstood as including subsidiaries of multinationals. However, putting this statement into the context of the relevant example described in the Discussion Draft, and considering the work already done on the VAT Guidelines, it should be clear that it can only mean a multinational business established as a single legal entity with branches of that same entity in different jurisdictions.

Paragraph 171 states that “Guideline 2 recommends that the taxing rights on cross-border supplies of services and intangibles between businesses be allocated to the jurisdiction where the customer has located its main business establishment and that business customers be required to self-assess VAT on remotely delivered services acquired from offshore suppliers according to the rules of the jurisdiction in which they are located”. We agree with the allocation of the taxing rights to the jurisdiction where the customer is located, and with the required self-assessment of VAT by the business customer, but we would like to point out that in context of Guideline 2 of the International VAT Guidelines, which deals with legal entities that are established in one location (Single Location Entity, SLE), the taxing rights will always be allocated to the jurisdiction where this legal entity is located. Therefore, there is no “main” business establishment in this context, as the business is only established in one location.

**Consumption tax options**
The Discussion Draft states that the main VAT challenges created by the digital economy relate to exemptions for importation of low value parcels (Para. 219) and the increase in direct sales of services to consumers (Para. 222) (not the tax treatment of the exempt sector). Paragraph 189 states that the challenge posed by the digital economy may result “in no VAT being levied at all on these flows, with adverse effects on countries VAT revenues and on the level playing field between resident and non-resident vendors. (Para. 189)

With respect to low value imports, there is a need to find a balance between the need for appropriate revenue protection, avoidance of the distortion of competition and the need to keep the cost of collection proportionate to the small level of VAT collected. (Para. 193)

With respect to remote digital supplies to consumers, the Discussion Draft notes that compliance by non-resident suppliers is essentially voluntary. (Para. 195) Experience suggests that MNEs do comply, in part because of reputational reasons. (Para. 195) We expect that this issue will be returned to Working Party 9 to be dealt with be the VAT/TAG.

USCIB agrees that the most effective and efficient option to ensure appropriate VAT collection on cross-border B2C services is to require the non-resident supplier to register and account for these supplies in the jurisdiction of the consumer. (Para. 221) Countries should consider simplified registration regimes to minimize the compliance burden. (Para. 222)

To safeguard VAT revenues and to be able to accurately, timely, and efficiently comply with the VAT obligations, clear, consistent and easy to apply rules are of utmost importance for business. This is even more important in the B2C context, both for imports of low-valued goods and for remote digital supplies to consumers, where businesses have to deal with high volume and low value cross-border transactions.

Striking the right balance between the VAT at stake and the administrative costs for business and governments related to that collection is crucial. The wrong balance discourages compliance and can lead to a distortion of competition for business. This is a significant concern for the international business community related to cross-border B2C supplies, particularly in the context of e-commerce related supplies. It is important to recognize that VAT revenues are best safeguarded and collected when the administrative costs of collection and compliance are reduced. Nevertheless, thresholds and exemptions will still be necessary. Business should not be forced to deal with compliance burdens in relation to a de minimis level of transactions, especially where the business may have no control over whether the obligation is incurred because customer’s ability to purchase goods and services without regard to borders.

The question that therefore arises is how can collection be made as easy and as efficient as possible for business while ensuring enforceability for governments?
Two aspects play a vital role here:

a) Internationally consistent ‘place of taxation’ rules are required that allow business to determine, in an easy and efficient manner, where a transaction should be taxed for VAT purposes.

b) Internationally consistent simplified procedures/mechanisms are required, particularly for foreign businesses selling digital supplies cross-border, to allow business to collect and pay the VAT in an easy and efficient manner, while at the same time, improving enforceability for governments.

In a B2B scenario, the two aspects identified above are covered by the International VAT Guidelines based on the destination principle and the recommendation to apply the reverse charge regime as the collection mechanism. Adoption of the Guidelines by governments would ease the burden of the collection of the VAT for business while ensuring full enforceability for governments.

Consistent application of the destination principle by governments around the world, together with the application of a reverse charge regime is vital. It was suggested in the ‘E-commerce Guidelines and the Consumption Tax Guidance’ papers issued in 2003 and has been further explored and reconfirmed again by the VAT Guidelines. In a B2C scenario, it will be more difficult but not impossible to implement consistent place of taxation rules and simplified procedures. Flexibility on the use and evidence of place of taxation proxies, easy access to information, easily accessible, simplified, and standardized and technology friendly administrative procedures and an effective administrative cooperation between governments are crucial to make this happen.

A tax is not worth anything if it cannot be collected. Particularly when it comes to high volume low value transactions, the OECD should aim for place of taxation rules that allow VAT to be collected in an easy and efficient manner.

Business needs flexibility both on appropriate proxies for place of consumption and appropriate indicia to determine the application of those proxies. It may, in some cases, be impossible not just burdensome, for business to identify the residence of their customers and they therefore may need to rely on appropriate indicia of residence such as the address associated with a credit card. Only if flexibility is ensured will business be able to effectively collect the VAT at stake. Substantial work has already been done on this aspect in some jurisdictions, for example in the EU, which should be considered, learned from and further explored.

Procedures/mechanisms need to be as simple as possible. This will enable foreign businesses to collect and pay the VAT in efficient manner, while improving enforcement for governments. Business agrees that vendor collection is the most viable option. (Para. 222) Business also
agrees that simplified registration systems and registration thresholds are necessary to minimise the compliance burden on business. (Para. 223) The simplified registrations system should allow business the choice and maximum flexibility (i.e. direct registration, simplified registration, collection by a 3rd party intermediaries on behalf of the supplier, etc.).

Such a system will only work if business has easy access to information in order to know how to comply and if governments provide easily accessible, simplified, standardized and technology friendly administrative procedures. Technological solutions should be web-based, secure, and should cover remote selling of goods and remote supplies of services. In addition, governments must establish effective administrative cooperation. Without such cooperation, it will be impossible to simplify and standardize the compliance requirements, leading to inefficiencies for business and less compliance with VAT overall. Thus, business supports the notion expressed in paragraph 224 that improved international cooperation between jurisdictions is likely to be required. We would note, however, that this paragraph focuses on cooperation in enforcement actions. While such cooperation is both necessary and appropriate, cooperation needs to begin with designing simple, consistent VAT systems and extend through the cycle to dispute resolution. The issue of double VAT taxation is difficult for two reasons. First, unlike an income tax dispute, it is essentially impossible to split the tax because the issue is always in which jurisdiction did consumption occur? Therefore to reach resolution one jurisdiction has to concede that its VAT will not apply. Second, although VAT is covered by the Mutual Agreement Procedures of income treaties and the MLAT, we believe it is unlikely the Competent Authorities would be willing to deal with VAT issues. If the Competent Authorities were to accept a VAT case, it is unlikely they would have a basis to reach agreement because of the jurisdictional nature of these disputes.

Remote B2C digital supplies may involve multiple parties in the supply chain which can make it difficult to determine who the supplier of the service is to the final consumer. Knowing the supplier is key, particularly when aiming at supplier registration as the mechanism to collect the VAT at stake. The OECD must develop clear rules on this. These rules should be informed by EU rules in this area.

In some cases business may wish to use third party intermediaries in the collection process. This should be an option for foreign business, not a requirement. Financial intermediaries may not have the relevant information to determine VAT properly. So financial intermediaries can only be a part of the solution if both the supplier and the intermediary agree.

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

Coordination with other Digital Economy Options

In section VII, various options unrelated to VAT are proposed to address the broader tax challenges raised by the digital economy. Some of these options could have an impact on VAT. For example, any changes to the current permanent establishment concept may have an effect on the application of the simplified VAT registration procedure. Such changes might also influence the application of the reverse charge mechanism.

Therefore when considering these options from a direct tax perspective, adequate time must be dedicated to fully understanding the potential VAT consequences.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business (USCIB)
Dear Mr. Saint-Amans,

The Confederation of Netherlands Industry and Employers VNO-NCW is happy to provide comments on the Discussion Draft regarding BEPS Action Point 1: Address the Tax Challenges of the Digital Economy.

The comments are included in the annex. The main points we would like to make, are:

1. It is essential that underlying principles are set out to which a taxation framework should be held. It should be promoted that both domestic and international rules hold to these principles.

2. VNO-NCW is of the opinion that ring-fencing the digital economy from the rest of the economy is not possible, feasible or appropriate.

3. It seems unlikely that there are (digital) enterprises that have no physical presence worldwide whatsoever and consequently the corporate income tax base is not attributable to any jurisdiction. VNO-NCW questions if the Discussion Draft does not overstate this occurrence.

4. Since ring-fencing the digital economy is not possible, introducing some form of virtual nexus would risk spreading out taxation of enterprises not physically present to non-digital businesses. This would entail a very serious risk of creating double taxation on the shorter term and potentially changing the rules for taxing cross-
border business fundamentally.

5. Creating a digital nexus as suggested in the Discussion Draft would not meet with the taxation principles as set out in the start of the Discussion Draft. Creating a digital nexus might even result in discouraging businesses – and especially small and medium sized businesses – from engaging in international trade and investments.

6. Uncertainty about – or different methods of – profit allocation to a digital nexus would potentially seriously hamper digital enterprises doing business abroad and would open the door to potential double (non) taxation.

7. VNO-NCW opposes introducing a withholding tax on digital transactions that would essentially discourage instead of promote cross border trade and investments.

8. Regarding indirect tax and the growth of cross-border B2C electronic services VNO-NCW advocates a broad adoption of the principles of taxation on the place of supply for electronically supplied services which will be introduced in the EU on 1 January 2015.

We hope you will take our comments into consideration in further developing this action point. Of course, we are available to elaborate on these comments should this be helpful and we look forward to the public consultation on this important issue.

Yours sincerely,

Jeroen Lammers
manager Fiscal Affairs

VNO-NCW welcomes the opportunity to provide comments on the Discussion Draft regarding BEPS Action Point 1 on addressing the tax challenges of the digital economy (hereinafter: Discussion Draft).

Underlying principles for taxation are crucial
VNO-NCW feels it is essential that in this Discussion Draft underlying principles are set out to which a taxation framework should be held. In fact, such a principle-based approach has been lacking in the previous Discussion Drafts on other Action Points. In our view the Ottawa Taxation Framework Conditions, as they are described in the Discussion Draft, are appropriate principles to not only apply to electronic commerce or digital economy, but to taxation of all sectors.

It should therefore be globally promoted that both domestic and international rules on taxation should;

- seek to be (technologically) neutral, as to allow for economic and technological advancement;
- be efficient so compliance costs are kept at a minimum;
- ensure certainty be simple to understand, as to provide sufficient comfort for domestic and cross border trade and investments to occur;
- be effective and fair so that taxation can be effected by authorities and there are no ‘blind spots’ and also no double taxation;
- be flexible enough to be able to keep up with commercial and technological developments.

There is no separate digital economy
The Discussion Draft very comprehensively describes recent digital developments. In doing so, the Discussion Drafts shows conclusively that there is no possible way to ring-fence the digital economy from the rest of the economy, since the digital developments have been pervasive in all sectors and all sorts of business models. This also proves that separate rules for the digital economy are not necessary. VNO-NCW therefore supports the comments made in paragraphs 59 and 205 that ring-fencing the digital economy from the rest of the economy is difficult, if not impossible (paragraph 59) and neither appropriate, nor feasible (paragraph 205).

The Discussion Draft convincingly shows, in our opinion, that digital economy business models do not lead to different BEPS questions than exist in other areas of the economy. Insofar as there are BEPS concerns raised by situations that taxable income can be artificially segregated from the activities that generate it, or in the case of VAT, situations in which no or an inappropriately low amount of VAT is collected, these concerns should therefore be addressed through the other Action Points. VNO-NCW determines that in section V of the Discussion Draft the OECD reaches the same conclusion. We would, however, like to point out that the timing of Action Point 1 does
not align with the timing of the action points. As we recommend relying on the other action points to address any BEPS concerns related to the so-called digital economy, we would strongly urge the OECD to ensure there is coordination with the action points and not pursue individual proposals under Action Point 1. In fact, pursuing individual proposals under this Action Point would contradict the conclusion that no separate rules are needed for the digital economy and that ring-fencing is not possible.

Although VNO-NCW does agree with some of the general conclusion reached in the Discussion Draft, as mentioned above, there are particular areas and wording in the Discussion Draft that we do object to. For instance in, but not limited to, paragraphs 125, 126, and 128 of the Discussion Draft the wording seems to insinuate that digital businesses in particular do not follow the arm’s length principle. It strikes VNO-NCW that this unduly sets digital businesses apart negatively. Moreover, if there is indeed merit to these intimations, it does not seem to stem from a shortcoming of the (arm’s length) rules, but rather from the enforcement of these rules. This would mean that governments in fact have the tools to achieve an arm’s length result in all sectors, including digital businesses, but do not or are not able to apply these correctly and effectively. Therefore, the wording of the Discussion Draft should be more objective.

Dealing with non-resident income
The Discussion Draft suggests that the evolution of business models in general, and the growth of the digital economy in particular, have resulted in non-resident companies operation in a market jurisdiction in a fundamentally different manner today than at the time international tax rules were designed.

The fact is that less physical presence is required in market economies in typical business structures. This means that companies can sell more easily than before into a jurisdiction without any physical presence there. It therefore is possible to be heavily involved in the economic life of another country without having a fixed place of business or a dependent agent therein. Under the current international tax rules no direct tax base can be attributed to that jurisdiction. Of course, indirect taxes can be levied on these activities.

This is congruent with the actual domestic and international tax rules in place at this time. Most jurisdictions are under their domestic tax rules not able – and under income tax principles should not be able – to tax the profits of non-resident enterprises deriving from sales to customers in that jurisdiction.

The fact, however, that no tax base for the purposes of corporate income tax can be attributed without a physical presence in the jurisdiction that sales take place, should in and of itself not lead to any BEPS concern. In fact, it seems more than unlikely that there are enterprises that have no physical presence worldwide whatsoever. VNO-NCW questions if the Discussion Draft does not overstate this possibility. Therefore, insofar as the corporate income tax base is not attributable to the jurisdiction in which there is no physical presence, it should be attributable to the jurisdiction where it has physical
presence. This means that there should be no question of a ‘blind spot’, outside unlikely situations where there are businesses that have no physical presence anywhere in the world.

The Discussion Draft does not explicitly go into the jurisdiction where there is a physical presence that would be able to tax the profits. Only in paragraph 180 it is stated that there often are compelling reasons that core [physical] resources are placed close to possible markets. This would therefore mean that there should not be any real BEPS concerns. By mainly focusing on the jurisdiction where there is no physical presence, this Discussion Draft seems to address not so much a question of BEPS activities by (digital) businesses, but rather a debate between states about splitting the tax cake in a different way.

Given the Task Force’s position that ring-fencing of the digital economy is not possible, introducing some form of virtual nexus, therefore, would risk spreading out taxation of enterprises not physically present to non-digital businesses and this would create a precedent potentially fundamentally changing the rules for taxing cross-border business. This is a discussion that is, and should be, far outside the scope of the BEPS project.

**Proposed actions by the Task Force**

The Task Force propose to further investigate three options to deal with the question on how the tax cake should be split in paragraphs 211 through 217. Notwithstanding the foregoing, we would like to make a few observations regarding these options.

First, all three of the options regarding direct taxation have in common that digital nexus will provide states with a way to tax profits derived in their jurisdiction. The options, however, also share a significant risk that they will result in double taxation. VNO-NCW strongly counsels that this be avoided.

Furthermore, VNO-NCW feels that also the rest of the underlying principles of taxation as mentioned above will not be met by following these options. This would suggest that these options are not viable.

For instance, introducing any of the options in the Discussion Draft could mean that a small or medium sized enterprise (SME) running a webshop that sells in any new jurisdiction would be compelled to register and file a corporate income tax return in such new jurisdiction. If, consequently, the sold item is returned, the SME will be faced with a loss in that jurisdiction. However, under Dutch legislation the loss of a permanent establishment (PE) cannot be offset in the Netherlands until it is clear there will be no further activities in the other jurisdiction. Since any webshop can be approached from anywhere in the world, it is impossible to say whether a new sale might occur in that same jurisdiction. The end result therefore is that the digital business that sells through a webshop might never be able to deduct the loss incurred and thus is placed at a disadvantage in relation to a business that sells through a physical location. This issue, and more generally compliance costs, would potentially be prohibitive and SMEs
operating in the digital domain would likely feel compelled to refuse to make sales in jurisdictions where the compliance costs would exceed the potential profits of doing business there.

Putting the options in the light of the Ottawa Taxation Framework Conditions:
- The creation of a digital nexus will not necessarily lead to a situation where the taxation is technological neutral.
- Also it is not efficient, since it cannot be said that compliance costs will be kept at a minimum if all digital business have to file for corporate income tax purposes in all jurisdictions they might make or have ever made a sale.
- This situation also does not lead to more certainty and simplicity. In fact, the presented options might scare off businesses from engaging in international trade. It seems to VNO-NCW this cannot be the desired effect of the Discussion Draft.
- In that sense, it might also not be flexible since these options might even stand in the way of commercial and technological developments.
- As stated above, the options present a significant risk of double taxation because the proposed approaches to create a digital nexus will spill over to businesses that do have physical presence. In doing so the options are not effective and fair, since the options might give two jurisdictions the right to tax the same profit and thus cause double taxation.

**Attributing profits to a digital nexus**

It is emblematic that in the Discussion Draft no mention is made as to the fact that if a digital nexus would be created how profit then should be attributed to this nexus. It is very unlikely that there is a way to attribute profits to a digital nexus that is simple, effective and fair in the sense of the Ottawa Taxation Framework Principles. By definition a merely virtual presence would mean that no “significant people functions” would be present in the country where e-sales are made. Substantial profit allocation would be incompatible with the OECD’s principles on profit allocation to permanent establishments. Furthermore, uncertainty about – or different methods of – profit allocation would potentially seriously hamper digital enterprises doing business abroad and would open the door to potential double (non) taxation, which does not seem compatible with the aims of the BEPS project.

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

VNO-NCW feels that the Discussion Draft already puts forward enough problems with this option so that it is not really an option that should seriously be considered. More fundamentally, VNO-NCW would deem it out of place for the OECD to consider introducing a withholding tax that would essentially discourage instead of promote cross border trade and investments.

**Indirect tax comments**

With regard to the paragraph “Opportunities for BEPS with respect to VAT” (paragraph 3 on page 46) VNO-NCW would like to emphasize that the mentioned collection of “an
inappropriately low amount of VAT” is mostly caused by a lack of either adequate VAT legislation or cross-border cooperation between tax authorities. The wording of paragraph 3 may inadvertently give the impression that businesses always structure their affairs in such a way that the result is the lowest possible VAT. To avoid this incorrect impression VNO-NCW advocates to refine the wording “an inappropriately low amount of VAT” by adding a distinction between unintended effects of inadequate legislation and the effect of structures aiming at the misuse/abuse of legislation.

VNO-NCW underlines that cross-border cooperation between tax authorities in the field of compliance controls is also of major importance to prevent enterprises (particularly SMEs) from differing positions taken by tax authorities in the many countries where an e-business could be active.

With regard to digital supplies to a multi-location enterprise the report mentions the example of processing of data relating to banking transactions (paragraph 3.2.). In the view of VNO-NCW the example is not solely related to the digital economy. It would be more useful to focus on the strong growth in cross-border digital supplies to consumers (B2C) as described in paragraph 6.2., a growth directly related to the digital economy.

Regarding the growth of cross-border B2C electronic services VNO-NCW advocates a broad adoption of the principles of taxation on the place of supply for electronically supplied services which will be introduced in the EU on 1 January 2015. From that date VAT on electronic services supplied by a supplier established within the Community to non-taxable persons also established within the Community will be charged in the Member State where the customer belongs. This major change includes the mini One Stop Shop. A broad adoption would ensure that in case foreign traders render electronic services they would pay VAT/sales taxes in the country of consumption, taking away possible competitive advantages over locally operating enterprises, while minimizing compliance burdens by offering the mini One Stop Shop scheme.