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OECD – TFDE

VIA EMAIL (TFDE@oecd.org)

Subject: Request for input on work regarding the tax challenges of the digitalized economy

Comments by Harlow Higinbotham, Pim Fris, Vladimir Starkov and Emmanuel Llinares[1]

Dear Madam, Dear Sir,

In the context of BEPS Action 1, the OECD has released on September 22, 2017, a request for input on work regarding the tax challenges of the Digitalized Economy (the Request for Input).

We thank you for the opportunity to provide comments in this regard.

We are pleased to provide our input on some of the questions raised by the OECD in the Request for Input.

1.   Introduction

In line with the overall conclusions of the BEPS project and specific conclusions of the 2015 Report on "Addressing the Tax Challenges of the Digital Economy", we are of the view that the arm's length standard is relevant in the context of the digital economy just as it is relevant in any industry. In the current environment, many multinational enterprises may have at least a portion of their business that relates to the digital economy, often strongly intertwined with the traditional business. Hence, having a different standard for the digital economy alone would be both unjustified and ineffective.

In other words, we firmly believe that there should not be an industry specific treatment of the digital economy. In addition to this, we are of the opinion that the main concepts developed in the context of international taxation *(i.e.,* the arm's length standard, and in that context the link between the allocation of taxation rights and role of local entities in value creation, the

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[1] This document expresses the view of the authors and not necessarily the views of NERA Economic Consulting.

permanent establishment concept and the attribution of profits based on the Authorized OECD Approach – "AOA") potentially offer a powerful and effective toolset, and should continue to be defined in terms that are common to all industries.

2. Input on Section A. "Digitalization, Business Models and Value Creation"

In Section A.2 of the Request for Input, the OECD asks for the role that IP may play in highly digitalized businesses. In this context, it is beyond dispute that the concepts developed in Chapter VI of the 2017 release of the OECD Transfer Pricing Guidelines (2017 TPG) should be relevant. In line with the definition of intangibles included in the 2017 TPG, we wish to point out that the concept of "intangible property" or "IP" may not be the most suitable one. The term IP overly suggests the use of a legalistic concept. Across all industries and in particular in the digital economy, a more relevant concept would be that of "intangibles." In our opinion, intangibles are a broader concept than IP. The identification of relevant intangibles needs to be framed in the broader analysis of value creation (as pointed out in a number of occasions in Chapters I and VI of the 2017 TPG). Such intangibles may not be restricted to the illustrations provided in Section A.4 of Chapter VI of the 2017 TPG. Many of these intangibles go beyond the definition of IP for legal purposes and often are not reflected on companies' balance sheets. Nevertheless, they embody major parts of the value of enterprises, whether digital, traditional or a mix thereof.

In our opinion, the analysis of value creation should be the foundation of the analysis of the role of intangibles in the context of any industry and company, and, ultimately, enable the identification of a "significant economic presence". Only a value chain analysis which includes the identification of the critical success factors and the strategic risks associated with the business concerned enables the proper identification of relevant intangibles and forms the foundation of the assessment of their contribution to value creation (and ultimately their remuneration). The analysis of functions, assets, and risks needs to be framed in the context of the overall value creation analysis, *i.e.,* in light of the value drivers that were identified for a specific enterprise involved. Then, and only then, it is possible to understand the role of related entities (including the possible existence of permanent establishments). In this context, a characterization in terms of responsibility profiles (investment center, profit center, revenue center, cost center or expense center), as used for management control purposes, is much more relevant than the overly simplistic "routine" vs. "entrepreneur" characterization. In summary, in our opinion, only a proper value chain analysis of the specific company concerned can enable to provide consistent answers to the questions raised in Section A3 and A4 of the Request for Input. Looking for generic explanations of "drivers for remote selling models" or "the role of data" is an illusion. Namely, the relevant business considerations driving remote selling business models are likely to be specific to each multinational enterprise or at least to sub-segments of the industry concerned. They are also likely to evolve in time. Similarly, the role of data collection and analysis and the type of data being collected and analysed are also likely to be specific to each multinational enterprise or the industry sub-segment. Moreover, in both

cases, only an enterprise-specific value chain analysis can assess the relative contribution to value creation of each of the factors concerned in the specific case at hand.

One of the key features of the digital economy is that physical location of assets and operations is much less relevant to the operation of the business than in traditional business models. This means that the ability to generate business may not be as closely tied to physical presence as in traditional models. In section A5 of the Request for Input, the question is raised as to whether the establishment and operation of such global (or at least cross-country) user networks is new and specific to certain highly digitalised business models, and as to what would be the potential implications for value creation.

In this context, we believe that the analysis of where value is created and of what the responsibility profile is of entities involved needs to be addressed before a conclusion can be drawn on what constitutes an "enterprise", per the meaning of Article 5 paragraph 1 of the Model Tax Convention. An enterprise can be defined as a durable organisation of capital and labor aimed at carrying on business in the market. In this respect, key characteristic of an enterprise is the responsibility for the continuity of the business. Many of the entities involved in the digital economy business models, often seen as "routine", will in fact be expense centers or revenue centers. These entities may not have control of, and thus cannot carry the responsibility for, their own continuity. Consequently, they should, under circumstances, be characterized for purposes of article 5 paragraph 1 as part of the enterprise of their principal – with direct impact on their potential status of PE. The subsequent issue of attribution of a suitable remuneration to the PE can be faced following the AOA, with the toolset elaborated in the 2017 TPG.

In conclusion, many of the questions raised in Section A of the Request for Input can and should be addressed through concepts detailed in the 2017 TPG and considering Article 5 par. 1 of the Model Tax Convention. We would recommend that the OECD continues to frame the debate on the digital economy in the context of these concepts, the robustness of which has been enhanced following the BEPS project. The practice of taxation for globally active enterprises should take shape on this basis. If there is progress to be achieved, it is in the practical application of these concepts. Value chain analysis and the conclusions thereof as to the longer term relationships between, and attribution of jointly generated profits among, corporate entities of a multinational enterprise should become the foundations for an internationally consistent and acceptable global taxation practice.

3.   Input on Section C.1, "Implementation of the BEPS Package" Actions 3, 6, 7 and 8-10

We agree with the Action 1 report on the notion that the digital economy does not present unique BEPS concerns, although certain features of the digital economy may exacerbate BEPS (OECD/G20 *Addressing the Tax Challenges of the Digital Economy,* 2015, para 241). As mentioned earlier in this document, we believe that multiple measures targeting BEPS as

expressed in the Actions 3, 6, 7, and 8-10 should be effective when applied to the digital economy.

Transition of many types of economic activities to the digital platform brought about a profound transformation of the value chains for different types of businesses making the digital businesses simultaneously more integrated and more fragmented. For example, activities such as development of the software and data analysis may be centralized in one or a few locations of a multinational enterprise while data storage and user data collection may be distributed across the globe.

Because business models in the digital economy vary considerably from one company to the other and, in addition, digital companies tend to revise their business models at a rapid pace, the importance of applying the *value chain analysis* to the digital economy businesses cannot be overstated.

The value chain analysis builds on the concept of the value creation (the key concept for the BEPS project) that is addressed in paragraph 1.51 of the 2017 edition of the OECD *Transfer Pricing Guidelines* ("TPG") and is further referred to in the context of its application to intangibles (TPG, 6.133).

We believe that the value chain analysis is especially important for the companies in the digital economy because their business models may be different in many ways from the "traditional" business models and because similar parts of the value chain may have different value in the context of different business models. For these reasons, we would recommend to include explicit references to the value chain analysis into the future editions of the Action 1 deliverables.

4.   Input on Section D.1

4.1.   D.1.A - Tax nexus concept of "significant economic presence"

First, we would like to emphasize that the issue of the definition and identification of a "significant economic presence" ("SEP") should in the first place be approached with the toolset available within the BEPS toolkit, and cannot be considered separately from the attribution of profit to the SEP.

Practically, we believe that at arm's length or under the principle of separate and independent enterprise, the existence of a "SEP" without any function, risk or assets would not be entitled to any return.

For the avoidance of doubt, the mere access to a market may not necessarily give access to any compensation at arm's length. The arm's length compensation for, respectively, a non-resident operating company and the resident SEP would mirror the outcome of negotiations between

independent parties. SEPs have neither costs nor distinctive features. If the SEP requests a non-nil compensation, it could be considered that the non-resident company could seek a lower price from another (hypothetical) SEP. Economic theory suggests that this competitive process would decrease the profit of the SEP down to zero.

In conclusion, we believe that the concept of "significant economic presence" is not needed per se. The sought concept can be identified with a proper use of the existing toolset of the international taxation, based on value chain analysis and with a correct characterization of entities within a multinational enterprise. The current Article 5 paragraph 1 of the Motel Tax Convention, based on a relevant, *i.e.,* economic, interpretation of what constitutes an "enterprise", will then allow the systematic and consistent identification of a "significant economic presence" for purposes of international taxation. For this reason, we would suggest not introducing this new concept as it is not needed

4.2.   D.1.C - Digital equalisation levy

The BEPS Action 1 Report explores the possibility of implementing a digital equalization levy. The levy "*could be imposed on data and other contributions gathered from in-country customers and users*" (§305). We understand that such a levy would be determined as a fixed charge multiplied by a certain base, for instance, the average number of monthly active users or the volume of data collected from in-country customers and users.

Such a levy would be completely disconnected from the results of the analysis of the value creation process within the company concerned. Such a levy could also result in disproportionally high charges in certain contexts and would be negligible in other contexts. We think that such levy would be both arbitrary and ineffective, and would result in radical distortions of the markets.

5.   Conclusion

We firmly believe that the arm's length principle can and should be the relevant concept to address many of the issues related to the pricing of transactions in the digital economy. BEPS Actions 8 to 10 in particular have led to changes in the application of the arm's length principle which, we believe, could help manage many of the challenges related to the digital economy. In this respect, the analytical tool of value chain analysis is essential, although its application in practice leaves room for significant improvement of its use in international taxation and of the digestion of conclusions therefrom to identify "significant economic presences". We are of the opinion that alternative means of taxation of digital enterprises would be ineffective and

counterproductive as alternatives to the arm's length principle are likely to provide more arbitrage opportunities than one can envision at the moment.

We would strongly encourage additional work to strengthen the application of the arm's length principle to the digital economy as needed (e.g., the value chain analysis and possibly AOA and profit split), in combination with the full implementation of its findings for the identification of SEPs in terms of Article 5 par 1 MTC, rather than seeking industry or country specific measures which are unlikely to be effective and likely to result in distortions

We hope that the above is useful.

With kind regards,

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