Promoting Innovation Worldwide

ITI Response to OECD Public Consultation: The Secretariat Proposal for a Unified Approach to the Nexus and Profit Allocation Challenges Arising from Digitalisation (Pillar 1)

November 12, 2019

The Information Technology Industry Council (ITI) hereby submits feedback to the Organisation for Economic Co-operation and Development (OECD) on its consultation document on the Secretariat Proposal for a Unified Approach to the Nexus and Profit Allocation Challenges Arising from Digitalisation (Pillar 1).

ITI represents the leading information and communications technology companies from around the world. As the global voice of the high-tech and tech-enabled community, we advocate for policies that advance technology, promote innovation, open access to new and emerging markets, protect and enhance consumer choice, and foster increased global competition. ITI's member companies include wireless and wireline network equipment providers, computer hardware and software companies, Internet and digital services providers, mobile computing and communications device manufacturers, consumer electronics, and network security providers.

As we have shared in the past, our broad objective is to ensure a functioning and dependable international tax system that promotes investment and innovation, while providing certainty and predictability for businesses. ITI strongly supports the OECD as the best forum to achieve these goals. As you continue to develop policy recommendations, we must ensure the final outcomes are not primarily focused on simply raising revenues but that they achieve critical policy objectives and are grounded in responsible tax policy. Recent comments from the Secretariat elaborating on the work to date seem to suggest that the changes proposed will shift tax liability away from investment hubs and increase revenues without adversely impacting the business environment. This assertion appears under-analyzed. We would encourage further review of the impacts of any proposal on economic growth and investment. In a global context, where digitalization is a key driver for economic growth and employment, taxation should be mindful and aim at advancing investment and international trade.

Beyond analyzing the economic impact of the proposed changes to the international tax system, there are a number of additional high-level principles that should guide this work:

Multilateralism is key. Policies around cross-border taxation are complicated and their application relies on the coordination and cooperation of jurisdictions around the world. There is widespread global recognition that elements of the system need to be modernized in addition to strong interest in pursuing reforms. As such, we strongly believe such global problems require a coordinated solution.

Unilateral measures must be removed. Since the end of the BEPS project, unilateral measures have proliferated, including diverted profits taxes (DPTs), equalization levies, multinational anti-avoidance laws

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(MAALs) and digital services taxes (DSTs). The current OECD process must be explicitly predicated on removal of these measures in exchange for a global solution such as that discussed in this submission.

A principled approach that avoids double taxation is essential. As the OECD contemplates innovative approaches beyond standard transfer pricing practice, it is important that the policy outcomes be principled and focused on avoiding double, or even multiple, taxation for taxpayers.

Optionality for countries must be avoided. In the past, OECD negotiations have resulted in a menu of options for jurisdictions to choose from. Given the novel elements of these reforms, that outcome must be avoided in this context. Countries cannot be given license to cherry pick elements of these policies to achieve bespoke outcomes. If options are provided, the clear result would be a patchwork of competing systems and rampant incidence of double, or multiple, taxation.

Certainty and administrability must be achieved. Policymakers must have an eye towards effective implementation and compliance. Some of the ideas under consideration would mandate the development of complex compliance systems for governments and businesses alike. Every effort must be made to avoid adding unnecessary complexity to the system. We believe simplified filing systems, including a one-stop-shop (OSS), combined with strong and dependable dispute prevention and settlement mechanisms are absolutely essential components to the final outcome.

Scope

Determining the appropriate scope for application of the rules under discussion is an essential threshold consideration. ITI represents 70 of the most innovative companies in the world. It is a diverse group, reflecting different sectors and business models. Given our diversity, this section of our response reflects a number of perspectives and viewpoints of differing levels of concern to our member companies.

The proposal intends to focus on "consumer-facing" businesses and offers a window into how you are approaching this key definition: "consuming-facing businesses for whom customer engagement and interaction, data collection and exploitation, and marketing and branding is significant, and can more easily be carried out from a remote location." You further state that "consumer-facing" would be defined to include "user-facing" businesses.

Our members uniformly agree that the "consumer-facing business" standard introduced by the consultation is unclear and could lead to significant disputes and/ or very complicated compliance and segmentation challenges. Some ITI companies are purely business-to-business and never interact with consumers in any "market". In these cases, the presumption is they are outside the bounds of this proposal. Other ITI companies have questions concerning whether they would fit into this standard. It seems clear that some business-to-business activity is also likely in scope, rendering the consumer-facing terminology confusing. Many ITI companies sell to consumers, businesses and governments. We believe sales to governments should be excluded. However, what about cases where companies sell to all three customer bases? Separating and tracking these sales may be difficult, and often our member businesses could include a mix of models within internal segmentation for a particular product area. Overall, it seems the parameters of the scope are quite fluid. Additionally, ITI companies are concerned that use of a consumer-based legal standard could expose companies to other liability related to consumer testing and product liability. Language must be included to clarify that the standards adopted apply purely for purposes of applying these new rules, and not implicate other regulations or tax rules (e.g., VAT). Model treaties include clarification along these lines. We would encourage any new language added to treaties have accompanying clarification from the OECD.

The user-facing concept raises additional concerns for some of our members. It appears the concept is intended to ensure digital businesses are brought within scope. ITI has long held that it is appropriate and necessary to address the transformations digitalization have brought to commerce and how these changes have tested the international tax rules. However, a user-facing approach will not lead to a workable solution.

Specifically, we see significant implementation difficulties across platforms and businesses who, in many cases, do not track or generate revenue based on user location. Even if companies could appropriately identify user location for tax purposes doing so would be highly unreliable across businesses. Oftentimes, the most readily available information that can be used to establish the customer's location - the geolocation corresponding to the device's IP address - may or may not be reliable in terms of either the customer's actual location or the location where the content is or will be accessed or used, and could be subject to disputes. Indeed, customers' IP addresses may not represent their actual location or the location where the copyrighted articles will actually be used for practical reasons – such as the customer downloading content while traveling, click farms, spam (requiring refunds or credits) the customer intentionally or unintentionally obscuring their IP address and location using a virtual private network (VPN) or software to "spoof" their IP address - causing them to appear to be in a different city, state, or even halfway across the world. Additionally, if a customer is logged on through a business network, the data often only shows the location of the business's gateway, not the actual location of the user themselves. In light of these technical limitations, the most readily available information – the customer's IP address – may or may not be reliable and may or may not represent where the content is likely to be used. Also, user data required to support location would be extremely voluminous, unaudited and tracked differently from company to company. It may also be impossible to tie this data to accounting systems if they are not linked. Due to these challenges, user location data is bound to be unreliable. Sales or revenue are far more reliable and consistent. Rather than relying on user location, we encourage focusing on more reliable metrics to provide needed certainty in implementation.

There is further complexity beyond just the difficulty of determining where the customer was actually located when the download took place, because as part of the same sale, the customer may download the same content multiple times, onto multiple devices, at different times that may extend even across multiple tax years. This presents the taxpayer with the difficult situation of reconciling conflicting information about locations where a download or multiple downloads of the same material may have taken place and having to show which location is more accurate or reliable or should be controlling. Moreover, a sale may not require the customer to download the content at all, and they may specifically choose not to do so in light of technical limitations or for reasons of convenience. In those circumstances, it is not clear how the seller should characterize the customer's location.

With respect to taxpayer burden, we do not believe any taxpayers currently base the source of their sales on the geolocation of the IP address of the device used for download or streaming due to the difficulty in obtaining accurate information about the customer's actual location as described above, and the privacy issues discussed herein. Updating systems to track that information in a way that is usable for tax reporting and/or income sourcing purposes would be both challenging and, as discussed above, not necessarily particularly meaningful or applicable to many sales. This could also impose substantial costs on businesses. Additionally, tracking this information for tax reporting and/or income sourcing purposes may conflict with reporting for sales tax/transaction tax purposes, adding additional complication.

Finally, there may be conflicts with data privacy laws created by collecting and using this information in this way. Many jurisdictions around the world are enacting or proposing to enact data privacy laws that may limit taxpayers' ability to retain IP geolocation data – whether or not that data is reliable – which would make auditing of this data by taxing authorities difficult or impossible and would create an unnecessary risk and liability for taxpayers.

Similar questions apply to the inclusion of integrated products. Several of our members manufacture products that are incorporated and significantly transformed into different products that are ultimately sold to the customer. While marketing plays a role, it is less important than other consumer facing industries as these products are incorporated/transformed into other products or sold in bulk to a third party. As such, the taxpayer generally does not know where the ultimate use of that product is occurring. There is no feedback loop from the consumer to the taxpayer or to the manufacturer in relation to the taxpayer's component products. Therefore, no customization or value is being added by the ultimate user. Without the ability to access information about the destination, it is impossible to determine whether it has been supplied for consumer or business use. Companies cannot be expected to have knowledge (or access) to unrelated entities' supply chains. In general, in many cases it is impossible for ITI members to look through third party distributors and wholesalers.

<u>Nexus</u>

The consultation document suggests the simplest way of operating the new nexus rule would be to "define a revenue threshold in the market" that would "take into account certain activities, such as online advertising services, which are directed at non-paying users in locations that are different from those in which the relevant revenues are booked." Again, we strongly reiterate the challenge with accurately locating these users and encourage the OECD to rely on audited and reliable information when applying nexus rules.

Any new nexus standard should be standalone and apply only for purposes of allocating Amount A and for no other non-tax purposes. ITI agrees that the new rules should have a global threshold of €750 million, which is in line with the Country-by-Country reporting requirement. We note that paragraph 22 of the consultation states that the new nexus rule would consider "sustained and significant involvement in the economy of a market jurisdiction" and also include a revenue threshold for the market jurisdiction. We believe the definition of "sustained and significant involvement in the economy of a jurisdiction" requires at least three consecutive years of revenue exceeding a specified, non-de minimis amount before a company would be deemed to have nexus in the particular market jurisdiction. Anything less than this would not reasonably appear to constitute a "sustained and significant involvement in the economy."

We believe the new nexus rules should be designed to solve specific failures in the existing rules. We recommend the headquarter country be solely responsible for audit and positioned to certify any formula/ methodology agreed to with the relevant market jurisdiction be only applied to local sales. We would further propose for those companies that already have nexus (tax residence) in a jurisdiction that they be able to simply allocate additional profit to the existing nexus rather than creating a new one.

Lastly, the legal ramifications of this new standard have raised a number of concerns in addition to those raised above. However, some have expressed concern that there will be no right to appeal in situations where there is nexus but no physical presence. We would encourage clarification on that point.

Profit Allocation

The Secretariat's proposed new profit allocation approach raises many questions. Broadly speaking, the proposal creates a new three tier mechanism (Amount A, B, and C). To ensure that routine and residual profits are not double counted, it should be made clear that income can only be categorized into a single tier. For example, if income is determined to relate to Amount A, that same income cannot also be calculated under Amount B and/or C. In cases where a taxpayer compensates a market jurisdiction in an amount equal to, or greater than, the amount agreed to by Inclusive Framework countries, then no additional return should be allocated to the market. There should be no double counting and surrender mechanisms are necessary to prevent companies from paying a double tax upfront. To that point, insofar as some digital profits are already taxed via withholding under existing multilateral tax treaties, these withholding taxes should either be eliminated or the profits subject to withholding tax should be subtracted from profits computed under the proposed three-tier mechanism to avoid double counting. Lastly, any double taxation resolution must be by deduction, not credits since existing credit regimes do not anticipate the application of these rules and could be ineffective and subject to unintended limitations. Moreover, the deduction must be taken from the entity, which would otherwise have reported the reallocated profit, and care should be taken to ensure the entity receives a tax benefit for the deduction.

Overall, we would encourage striving for certainty through a principled, straightforward approach. At the outset, we would suggest the simplified allocation factors (e.g. a percentage of revenue) be determined primarily by the application of the arms-length principle. Further, the new mechanisms should be applied on a top-down basis to avoid double taxation. Much of this current discussion relates to the activities of the parent company and their subsequent allocation to their subsidiaries. Therefore, the three proposed mechanisms should use the parent company (and its corresponding accounting standard) as the starting point for any of these calculations. The profit allocation calculations should be performed centrally at the parent company level using the parent company jurisdiction's tax and accounting principles. This would ease compliance and more accurately reflect the economic reality of the company.

An accounting standard consistent with a company's books and records rather than a new, arbitrary standard for calculating Amount A is essential to reducing disputes and avoiding double taxation. As different countries apply different accounting principles, companies need to be able to utilize a consistent basis for the starting point of calculations and use a single methodology consistent with its books and records for any appropriate tax adjustments.

We would encourage maintaining advanced pricing agreements (APAs) under the new rules. Unilateral and multilateral APAs have existed for years and permit a taxpayer and taxing authority to solve potential tax disputes in a cooperative manner. These arrangements generally take years to establish and reduce uncertainty for all parties. APAs should continue to play a strong role and remain in force regardless of the changes made in this new system. These mechanisms are important to reducing disputes, particularly under Amount C.

Given the interactions between Amounts A, B and C, an effective dispute prevention and settlement mechanism needs to be prioritized as a necessary condition of any agreement. We believe mandatory binding arbitration should be applied across all amounts A, B and C. Further, to give certainty to businesses operating in the new system, the binding dispute resolution should be agreed to before the final agreement is effective.

Amount A

The consultation paper contemplates allocating residual profits on a business line basis. Tax jurisdictions are not positioned to evaluate and determine a company's business segments. Even if one used the segmentation set forth in companies' annual reports and applied those groupings across countries, there may be issues around expense allocation and other matters. If one does choose to use the information provided in annual reports, it must be clear that management segment reporting does not bear all costs. Overall, given these issues, companies should have the option of using consolidated worldwide profits.

We would also raise some thoughts about treatment of losses. In years where losses occur, the deemed residual profit subject to the Amount A reallocation should be determined net of any losses in the current year or losses carried over from other years.

The document contemplates whether to use a withholding tax mechanism to implement the policy. We strongly urge against that outcome for a number of reasons. We will begin with allocations. Withholding taxes apply a fixed percentage to a base amount. Because Amount A would result from the allocation of a portion of the non-routine profits generated by an enterprise, the withholding tax could not easily estimate the amount of tax due from such an allocation. Next, there are issues with losses. Withholding taxes are applied on a gross-income basis and do not take into account losses, whether generated by the taxpayer or by any related group member in the current year or other years due to loss carryovers. Therefore, it is unreasonable for Amount A to be an allocation of profits without taking losses into account. Also, a withholding tax is a tax on gross, not net, income. Gross income taxes apply a fixed margin to all transactions and do not take into account actual profit margins generated by a business. Such a tax is inconsistent with determining Amount A based on an allocated amount of a portion of non-routine net profit. Additionally, the Unified Approach focuses on taxing value generated by consumer-facing-businesses. In transactions with consumers in a market jurisdiction with no physical presence, the only party capable of withholding is the consumer. However, it is difficult to expect a high compliance rate from individuals acting as withholding agents on payments related to their online purchases and downloads. Lastly, it appears unreasonable to require withholding tax at the time of a transaction and require a company to file for a refund, as many countries have historically refused to issue refunds of excess withholding tax.

Further, it should be clarified that trade intangible returns are exempt from the non-routine profits to be allocated under Amount A. As noted in the original consultation document, trade intangible returns are addressed in BEPS Actions 8-10. The amount of profit allocated to the trade intangibles should take into account the level of R&D investment required for the different industries/sectors. Trade intangible returns, including R&D returns, generally arise from substantial, observable activities arising in specific locations. Furthermore, the methods for compensating the cost incurred for R&D and trade intangibles are well established and often agreed on with tax administrators. Any effort to allocate R&D returns to market jurisdictions would discourage jurisdictions from supporting R&D and could impact economic growth as well as foreign direct investment.

Amount B

For Amount B, a fixed percentage would need to be limited to distribution returns. Further, this amount would need to be modest and possibly determined by industry. In practice, country audits get B + C returns, so if B is not modest and does not conform to the arm's length principle, there is no need to separately allocate an Amount A, which is the mechanism that focuses on the residual, non-routine return. To stay connected to the arm's length principle, we believe Amount B should in line with comparables data. Amount B should be provided as a safe harbor and applicable on a forward-looking basis only. Lastly, it is also important to reflect regional diversity in the approach and not rely on a consolidated global number.

Amount C

ITI members are concerned that some jurisdictions could assert a business engaged in more functions over and above baseline functions, resulting in additional profit allocation under Amount C to the market. Overall, ITI members are concerned about the complexity, additional controversy and possible double taxation associated with Amounts B and C, along with their interaction with Amount A.

Dispute resolution should include a mechanism for timely resolution of multilateral disputes that take into account the facts and views of all parties. The current bilateral dispute mechanism, the mutual agreement procedure ("MAP"), has multiple flaws and cannot work in a multilateral context. These flaws of the bilateral MAP process include (i) no guarantee a disputed issue would be resolved, (ii) no guaranteed time frame for reaching a resolution, and (iii) the absence of the taxpayer in the MAP resolution process. We believe the only mechanism to provide a workable solution for all parties to a multilateral dispute that would ensure guaranteed and timely issue resolution and a mechanism where all parties to the dispute are provided participation in the process and have their views taken into consideration is mandatory binding arbitration operating under the auspices of a multilateral forum or organization designated or designed to timely resolve such multilateral disputes.

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Thank you for your consideration of our comments. Please do not hesitate to reach out for any additional information or questions to Jennifer McCloskey, Vice President, Policy at jmccloskey@itic.org.