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Building a better working world

6 March 2019

Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
Tax Policy and Statistics Division

Sent via email: TFDE@oecd.org

Subject: Comments on Public Consultation Document "Addressing the Tax Challenges of the Digitalisation of the Economy"

Ladies and Gentlemen:

We appreciate the opportunity to submit these comments on behalf of EY on the public consultation document "Addressing the Tax Challenges of the Digitalisation of the Economy" released by the OECD on 13 February 2019 and to contribute to the ongoing global discussion of these important tax policy matters.

In these comments, we focus first on the project overall and then turn to the two specific substantive topics addressed in the consultation document.

Overall Comments – Process and Timing

We believe it is important to begin with some big picture considerations regarding the significance of the project and the importance of a deliberative process and a schedule that recognizes the complexity involved.

The OECD should be clear about how fundamental and far-reaching the proposals being considered really are. This project is not merely an extension of the BEPS project. At stake in this project is the potential for changes in how taxing jurisdiction is divided among countries. All participants in the project – country policymakers and stakeholders alike – must recognize the magnitude of the matters proposed to be addressed.

Similarly, while the digitalization of the economy is a factor that fuels this project, the project has implications that go well beyond digital business models and potentially affect virtually all cross-border activity. We would encourage the OECD to limit the use of digital references in describing this project. It should be clear to country policymakers and stakeholders that this project is more sweeping than a digital label might suggest.

Given the magnitude and reach of this project, we believe it should proceed deliberately. The starting point should be agreement on the nature of the problems to be addressed and the objectives to be achieved. Clarity and consensus on the problems and objectives are essential to the evaluation of the proposals on the table.

We believe that a cautious approach should be taken in considering proposals that would be dramatic departures from long-standing international tax norms. Advancing major changes without laying the groundwork would increase the risk of unilateral action by countries, contrary to a key aim of the project.

Given the focus on new and evolving business models as a driver for this project and the potential for significant changes in the tax treatment of such models, we believe it is important to recognize the nuanced differences across business sectors and to seek to achieve balanced results for all sectors. In this regard, we would also note that the OECD should take into account the special circumstances of the tax-exempt sector in order to ensure appropriate treatment of cross-border investors in that sector.

We urge the OECD to ensure that any recommendations are spelled out in sufficient detail so that consensus on such recommendations reflects an informed meeting of the minds and represents a stable global agreement. Moreover, given the need for consistent global action, careful attention should be paid to ensuring that any recommendations can be reasonably administered by all countries, taking into account resource constraints.

We appreciate the OECD offering the opportunity for stakeholders to provide input at this early stage of the project. We are hopeful that the OECD will continue this consultative approach throughout the project, recognizing that stakeholder input will become even more valuable as proposals are fleshed out in more detail.

Finally, we urge the OECD and the participating countries to devote the time that is needed for a project of this significance and complexity. This is not work that can be done properly in haste or under unrealistic deadlines.

Comments on Revised Profit Allocation and Nexus Proposals

The consultation document states that the proposals outlined on nexus and profit allocations *"would require fundamental changes to both the profit allocation and nexus rules and expand the taxing rights of user and market jurisdictions."* Because these concepts represent the foundation of long-standing international tax norms, fundamental changes in these two areas would represent a transformation of the international tax system that would have dramatic implications for cross-border trade and investment.

The current standards for nexus have long been reflected in the OECD Model Treaty and in domestic laws and bilateral treaties of countries around the world. Over the years, the OECD has focused on refining and updating these rules to address questions that arose and to reflect developments in the global economy. More recently, the standards were updated with the BEPS recommendations that are being implemented by many countries. However, the proposals outlined in the consultation document would effectively abandon these long-standing standards. Under these proposals, it appears that taxing nexus could be found where a business itself has no activity in the country, with the potential for a country to have jurisdiction to tax a business based solely on activity of unrelated parties. This expansion of taxing jurisdiction would be unprecedented. We are concerned about the uncertainty that would be created for global businesses and the collateral effects for all the countries where such a business does conduct activity.

We are equally concerned about the implications of a global effort to identify, define, and quantify some additional element of profit to be allocated formulaically to these new nexus jurisdictions. Such an effort could be a first step toward abandonment of the arm's length principle. That would be a fundamental transformation of the long-standing international tax system and would effectively divorce taxation from economic realities. We believe that any move in this direction should be approached cautiously and with full consideration of the ripple effects throughout the international tax system.

While the consultation document asserts that the arm's length principle has inadequacies, there is no real discussion to support those assertions. Given the dramatic changes embodied in the proposals, we believe that the work should start with a thorough evaluation of the arm's length principle and clear agreement regarding the specifics of any inadequacies that policymakers believe should be addressed. It should be recognized that the arm's length principle in practice leads to a relatively objective, symmetrical, and fit-for-purpose allocation of profits, with flexibility to adapt to differences in circumstances and changes that happen over time. In addition, the arm's length principle ensures a level playing field with respect to transactions between associated companies and those between independent companies. Proposals that involve departures from the arm's length principle should be tested against these positive attributes.

Any move to prescribed formulary methods such as are outlined in the consultation document would involve significant risk and new complications that should be weighed against the perceived problems that the proposals are aimed at addressing. One key issue would be the necessary trade-off between administrability and the flexibility that is required in order to ensure a fit-for-purpose profit allocation. The less complex the rules, the more prescriptive they would have to be, with the attendant risk that such rules would be rigid and would lead to significant deviations from the underlying economics. Such deviations would have a distortive effect on business arrangements. In addition, it would be difficult to resolve the disputes that would inevitably arise, as there would be no underlying principles on which to rely.

All of the proposals laid out in the consultation document envision splitting "profits" in some manner, but this is not the same as profit splitting under the arm's length principle. Paragraph 82 recognizes this, stating that "*existing [profit] provisions look at transactions between enterprises or parts of an enterprise, whereas the new proposals look at the combined profit of multiple entities within an MNE group*." In effect, what is being discussed is unitary taxation, and agreeing on specific unitary rules under which such profits would be calculated would be immensely complicated. A clear illustration of this is the EU experience with the proposals for a common consolidated corporate tax base.

We are concerned that any of the proposals would essentially represent a move toward global unitary taxation. However, there is no "universal profit margin" for a company group. Most company groups have several different business lines or segments, with different levels of profitability. It would not make sense for a country where a company group may be active in one business segment to be able to tax part of the profit of other business segments that are not conducted in that country. Such a result would be distortionary and would create an unintended incentive for groups to separate business segments even where such separation is less efficient in commercial terms. However, it would be complicated to apply a formulary approach on the appropriate business line by business line basis. It would be difficult to define the business line activities and the associated profit allocation rules with clarity and precision, and it would be difficult to ensure agreement on any such definitions. Moreover, any formulary rules would likely become outdated quite quickly, as the global economy and global business activities continue to evolve.

Any fundamental change in the nexus and profit allocation rules also would necessarily require that upgraded dispute resolution mechanisms be put in place to handle the pressures that would result. It would be essential that effective and efficient bilateral and multilateral Advance Pricing Agreement (APA) programs be created specifically for such new rules. It also would be critical that mandatory binding arbitration be available when disputes arise and that countries permit full access to the Mutual Agreement Procedure (MAP) to taxpayers to address issues under any new rules in this area. In addition, new standards for MAP would need to be developed. For example, if a company does not otherwise have a taxable presence in a country but would be required to pay taxes there based on any new rules, the company would need to have the right to invoke a MAP between its home country and such country. Moreover, it must be recognized that the new rules outlined in the consultation document would create new complexities with respect to dispute resolution. Any approach that uses group profit as a starting point would mean that cases of double taxation would by definition be multilateral rather than bilateral. Therefore, dispute resolution processes would need to be adapted so that they work effectively and efficiently on a multilateral basis.

In addition to these overarching concerns about the risks and complexity that would be involved in any fundamental rewrite of the existing nexus and profit allocation rules, there also are several key design, technical, and administrative matters that would need to be fully addressed in order for a real consensus to be reached:

- Significant work would need to be put into clearly defining any new nexus standards and to specifying the threshold level of activity that would be considered to create nexus under such new standards. For example, is it intended that sales into a jurisdiction alone would be considered to give rise to tax nexus or would some activity in the jurisdiction be required? Any new standards would need to be memorialized in the OECD Model Treaty and would likely require revisions to Articles 5, 7, 9, and 10-13. The new standards would need to be spelled out precisely so that there is a clear common understanding of how the standards are to be applied and administered.

- While transfer pricing principles may ultimately come into play in determining the allocation of profits to the new nexus country, it would need to be made clear whether for this purpose the applicable principles are intended to be more aligned with the rules for profit attribution under Article 7 or the rules for transfer pricing under Article 9 of the OECD Model Treaty. Either approach would give rise to significant complexity, but the details would be different, so it is important to be clear about this.

- Any new rules on nexus and profit allocation should apply equally in situations where the results to be allocated are losses rather than profits.

- It also is imperative that there be no retrospective application of any new rules that are developed in this area, either formally or in practice. The changes being contemplated clearly would be new rules, not new interpretations of any existing rules. Furthermore, the OECD should monitor and issue reports on the implementation and ongoing administration of such rules.

- In addition, it is imperative that a consensus on new rules represent the agreed solution in this area. The new rules should not be considered as an alternative, or addition, to any other actions countries have taken. Ensuring that there is no cascading of measures is another aspect of country implementation that the OECD should monitor and issue reports on.

- We are concerned that the profit allocation proposals outlined in the consultation document would effectively erode the importance of (and reward for) risk-taking. For example, it is not clear in the consultation document how years of marketing investment that have been made by entities other than those in new nexus countries would be treated if future marketing returns are to be taxed in those countries. The difficult question of past expense and investment is avoided in the document by simply discussing current risk allocation. We believe that it is essential that past investment be adequately compensated, particularly in cases where the economic cost was borne by entities in other countries and reported for tax purposes in those countries. Moreover, this issue would arise not only for marketing-related investments made prior to adoption of any proposal, but also on an ongoing basis for all situations in which marketing-related costs are incurred in different years than the years when the marketing-related returns are realized.

- With respect to the marketing intangibles proposal in particular, we believe that the label could cause confusion. The proposal is not really about marketing intangibles as that phrase is used in transfer pricing rules. Rather, the proposal is about market country taxation rights and, specifically, about expanding the taxation rights of such countries beyond the current treatment. It is about moving more in the direction of a destination-based income tax by adding new mechanisms to the existing international tax norms. Accordingly, we think it would be clearer to re-label this proposal to avoid confusing a traditional transfer pricing concept (marketing intangibles) with a much broader policy objective (increasing destination or market country taxing rights).

- Also with respect to the marketing intangibles proposal, the consultation document presumes that it would be appropriate to determine profits to be allocated to *trade intangibles* and then allocate all other non-routine profits (as residual profits) to *marketing intangibles*. We are concerned that such an approach would risk significantly overstating the contribution made by marketing intangibles. In addition, there needs to be a clear definition of the concept of "consumer" in order to avoid confusion and complexity. For example, would it mean sales to end-consumers? Or would it mean just being connected to end-consumers by digital platforms?

Comments on Global Anti-Base Erosion Proposal

We are concerned that the global anti-base erosion proposals outlined in the consultation document would erode the sovereign right of countries to choose the corporate tax rate that is best for their particular economic circumstances and their particular tax system. The OECD has long supported the principle that decisions as to tax rate are left to each country and that low tax rates cannot be viewed as a harmful tax practice. These proposals represent a substantial departure from the OECD's historic focus on harmful tax practices that involve ring-fencing to protect the domestic economy or a lack of transparency or substance.

The consultation document describes the global anti-base erosion proposals as aimed at addressing *"the continued risk of profit shifting to entities subject to no or low taxation."* This was the concern at which the BEPS project was aimed. Countries around the world are in the process of implementing the BEPS recommendations and the results of the BEPS work should be allowed to play out before undertaking an evaluation of whether and where there may be continuing areas of concern. Moreover, any new proposals to address base erosion or tax avoidance through profit shifting should be coordinated with the BEPS recommendations in order to ensure that the combined rules are appropriately integrated.

However, we believe that the proposals in the consultation document are not designed to tackle what has historically been viewed by the OECD as base erosion or tax avoidance through profit shifting. Rather, the consultation document's proposals would apply in situations involving real economic activities with none of the attributes of harmful tax practices. Under long-standing principles, there would be no question that the country where the commercial activities are performed is fully sovereign in deciding whether and how to tax these activities. By deviating from these principles, the consultation document's proposal for a global minimum tax would have the effect of creating barriers to investment, even where these are genuine investments that lead to real economic activity. Similarly, the consultation document's proposal for denying deductions for payments made to lower tax jurisdictions also would have the effect of creating barriers, even where the payments represent real economic costs and are made to real business operations. While the overall impact would depend in part on the level of the minimum tax rate, we are concerned about the distortive effects of any establishment of a one-size-fits-all global minimum tax rate on the choices that countries make regarding their tax mix, including the choice whether to include a corporate income tax and at what rate and the choice to provide tax incentives for particular activity. More fundamentally, because the consultation document's proposals target real economic activity, any implementation would have real economic effects that countries should carefully evaluate.

As work on this project continues, it is important that these implications of the proposals be fully reflected in the discussions and that it be recognized that the effects of the proposals could go well beyond targeting any potential for artificial profit shifting or use of structures without substance.

There also are several key design and technical matters that would need to be clearly addressed if a consensus is to be reached on a global base erosion proposal:

- It is critical that any global minimum tax be coordinated with existing rules aimed at base erosion, including controlled foreign company rules. Because countries are currently in the process of implementing the BEPS recommendations in these areas, this would require integration of both existing and still-evolving regimes into the design details of a proposed minimum tax.
- The treatment of foreign tax credits also must be specified in detail in order to minimize the instances of double taxation.
- How any minimum tax would be calculated is an essential design point. The consultation document suggests it would apply on a jurisdictional basis. We believe that a better approach would be to do the calculation on a global basis. Such an approach would be far simpler than a per-country regime and would better reflect the overall activity of global businesses.
- With respect to the proposal on denying deductions, we believe any rules in this regard should apply on a net basis, rather than a gross basis, so that all the components of a transaction are taken into account. We also believe that a more than 50% minimum ownership standard would be more appropriate than the 25% level suggested in the consultation document. A more than 50% standard would be consistent with control concept that is commonly used in existing tax law.

Finally, it is essential that special circumstances of tax-exempt investors be recognized in the development of any minimum tax proposal. During the BEPS project, the OECD worked closely with the tax-exempt investor sector in order to specifically address whether and how the recommendations applied to cross-border investment by tax-exempt entities, including pension funds and government entities such as sovereign wealth funds. We believe that these BEPS recommendations have appropriately addressed any potential for profit shifting in this sector. As further work is done on a minimum tax proposal focused on the denial of deductions or treaty benefits for payments to lower tax jurisdictions, an exclusion should be provided for interest payments to tax-exempt investors. Without such an exclusion, a deduction or treaty benefit denial proposal that is based on the level of tax imposed could effectively sweep in all payments to such investors simply because of their tax-exempt status. Such a result would be contrary to the treatment accorded such entities under domestic tax law and tax treaties and would not further the underlying aims of the proposal. Moreover, the international tax rules on the deductibility of cross-border interest payments recognize that payments of passive income made to a tax-exempt investor will not be subject to tax in the investor's home country.

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We welcome the opportunity to discuss these comments in greater detail and to continue to participate in the dialogue as the OECD and country policymakers advance the work on this important project.

If there are questions regarding this submission, please contact me at +1 202 327 5824 or barbara.angus@ey.com.

Sincerely,

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