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,2 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[se] 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

[2] Dunning J.H. (1988) *Explaining International Production,* London: Unwin Hyman.

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 the 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 precedent over legal constructions.**

All the reports and other details of the BEPS Monitoring Group are available at http://bepsmonitoringgroup.wordpress.com/