

# COMPILATION OF COMMENTS RECEIVED IN RESPONSE TO REQUEST FOR INPUT ON TAX CHALLENGES OF THE DIGITAL ECONOMY

*Rapport de l'OCDE*



## Summary/Action

This note contains the compilation of input received from stakeholders on Request for Input Regarding Work on Tax Challenges of the Digital Economy. A request for input was published on the OECD Website on 22 November 2013, with a deadline of 22 December 2013. The following stakeholders have submitted their input:

- Association for Financial Markets in Europe (AFME) & British Bankers' Association (BBA)
- Bates White Economic
- BEPS Monitoring Group (BMG)
- Chartered Institute of Taxation (CIOT)
- Consultative Committee of Accountancy Bodies (CCAB) - Ireland
- Deloitte LLP
- Digital Economy Group: Baker & McKenzie LLP
- European Banking Federation (EBF)
- Greenwich for FTélécoms
- GSM Association (GSMA)
- Informa Group plc
- International Bar Association (IBA)
- International Bureau of Fiscal Documentation (IBFD)
- Cnonymous
- Solocal Group
- Swiss Banking
- WTS Tax Legal Consulting

**Delegates to the Task Force on the Digital Economy are invited to discuss the input received and how it should be reflected in the draft report on the tax challenges of the digital economy at their meeting of 3-4 February 2014.**

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20 December 2013

**By email to: [CTP.BEPS@oecd.org](mailto:CTP.BEPS@oecd.org)**

Dear Sir,

**OECD's request for input regarding work on tax challenges of the digital economy**

AFME<sup>1</sup> and the BBA<sup>2</sup> welcome the opportunity to respond to the OECD publication "Request for input regarding work on tax challenges of the digital economy" published on 22 November 2013.

Banks and other financial institutions, like all business sectors, seek to deliver products and services as widely and efficiently as possible. The opportunities for all to do so have been expanded by the internet and related digital platforms. Thus the term "digital economy" potentially covers an extremely broad range of businesses, including the financial sector.

Our preliminary response to the OECD's request for general comments on Action 1 of the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) (the **Action Plan**), regarding the appropriate approach to addressing the tax challenges of the digital

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

<sup>2</sup> The British Bankers' Association (BBA) is the leading association for the UK banking and financial services sector, speaking for 180 banking members, headquartered in 50 jurisdictions and operating in over 180 territories worldwide jurisdictions, on the full range of UK or international banking issues. Collectively providing the full range of services, our member banks make up the world's largest international banking centre.

economy, is set against this potentially all-encompassing view, but is limited to the provision of financial services.

In developing its proposals for Action 1 of the Action Plan, we believe that it is necessary for the OECD to take into account the legal and regulatory environment in which business is conducted and which prescribes how business takes place. Critically, we urge the OECD to consider the extensive legal and regulatory environment which governs financial services, and the activities which may be undertaken by banks and financial institutions in any jurisdiction.

For example, when financial products and services are provided to a customer through the internet, invariably the relationship must be conducted so as to comply with all of the applicable legal and regulatory requirements in the customer's jurisdiction. Complying with such legal and regulatory requirements typically means conducting business through the appropriate recognised branch or subsidiary, which would recognise appropriate income and expense (whether directly or through the application of the applicable transfer pricing legislation and guidelines).

In developing its proposals for Action 1 of the Action Plan, we believe that it is necessary for the OECD to take into account the specific features of financial services, particularly given the regulatory environment in which business is conducted, which prescribes how business takes place and is not necessarily present in other industries.

Finally, in addition, we note that Action 1 of the Action Plan contemplates the GST/VAT treatment of the digital economy. We understand that the GST/VAT treatment of digital supplies is already being considered by OECD Working Party 9, and we consider it important that there is consistency between these two work streams.

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

Yours faithfully,



**Richard Middleton**  
**Managing Director, Tax and Accounting**  
**AFME**



**Sarah Wulff-Cochrane**  
**BBA**

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## **A Tale of Two Technologies: Transfer Pricing of Intangibles In the Digital Economy**

*The author examines how technology and other intangible property is priced outside the controlled environment of intercompany transactions, considering economic models applied in other relevant contexts, such as technology related to digital and mobile commerce. His analysis occurs in the context of global concern about the erosion of the overall base of taxable income that leaves large profits earned across multiple jurisdictions untaxed.*

By PAT BRESLIN, BATES WHITE ECONOMIC CONSULTING

Perhaps it is neither the best of times nor the worst of times, but tension is building between multinational companies and tax authorities residing in various capitals around the world, particularly where tax and technology issues intersect. From Paris to London, from Bombay to Beijing, and from Tokyo to Washington, D.C., there is intense scrutiny on fiscal concerns amid rapid globalization and technological advances. Collectively, these trends are having dramatic effects on economic activities and relationships.

In the international tax context, these economic trends are neither a background nor a mere “sign of the times.” They actually pose a direct challenge to the existing international tax regime, rules, and regulations, and they increasingly put multinational companies and tax authorities in conflict. Witness, for example, the U.S. Internal Revenue Service claims recently made public against Amazon.com, alleging that the major e-commerce company misreported \$2.2 billion of taxable income outside of the United States, primarily in a lower tax jurisdiction, Luxembourg.<sup>1</sup> There are considerable numbers of similar tax controversies at various procedural stages, if not yet filed in U.S. Tax Court,

<sup>1</sup> 21 *Transfer Pricing Report* 911, 1/24/13.

*Patrick Breslin is a principal at Bates White Economic Consulting and focuses on transfer pricing, intellectual property matters, and economic analysis of intangibles transactions.*

while similar cases are heard in other courts around the world.<sup>2</sup>

This article will focus on economic analysis of technology adoption and how technology and other intangible property is priced outside the controlled context of intercompany transactions—that is, at arm’s length. Intangibles valuation issues central to much of this tax controversy will be addressed, in direct reference to relevant global efforts spearheaded through the OECD’s draft revised transfer pricing guidelines on such issues.<sup>3</sup>

In particular, economic models applied in other relevant contexts will be considered, including those involving technology related to digital and mobile commerce. Such contexts include analyses applied with respect to “fair, reasonable and nondiscriminatory” (FRAND) royalty obligations required under standard-setting guidelines in those industries, as well as in intellectual property case law contexts. The author has concluded that there is general consistency in terms of both

<sup>2</sup> See, for example, “Overcoming *Veritas*: Can the IRS Make a Better Argument For the Income Method in Amazon’s \$2.2 Billion Challenge?,” 21 *Transfer Pricing Report* 959, 2/7/13. Also see “Vodafone Wins Supreme Court Case; Transfer Pricing Assessment Pending,” 20 *Transfer Pricing Report* 807, 1/26/12, covering cases regarding mobile technology heard in the Bombay High Court and the Supreme Court (Mumbai).

<sup>3</sup> See “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions” by Working Party No. 6 of the OECD Committee on Fiscal Affairs, dated June 6, 2012. Hereafter, the term “draft revised Chapter VI” will refer to this publication and the “OECD intangibles project” will refer to this draft and the related activities of Working Party No. 6.

the economic and valuation principles applied in these contexts and those that would be expected in arm's-length analysis. As discussed, this is not surprising given the many parallels among all of these contexts, with respect to intangible property valuation and other related aspects.

## OECD BEPS Report

Such issues are cited among “key pressure areas” in a recent OECD report, “Addressing Base Erosion and Profit Shifting,” referred to as the BEPS report.<sup>4</sup> The report describes the incongruous nature of various domestic tax laws and how this undermines long-standing global tax principles aimed at minimizing economic inefficiencies that can emanate from countries’ sovereign rights to tax multinational enterprises. The report also highlights growing concerns that multinational companies’ natural instincts to (legally) shift taxable profits to lower tax jurisdictions have reached much greater extremes, in part due to this dynamic environment. The result is erosion of the overall base of taxable income on a global level, leaving large amounts of income earned across multiple jurisdictions completely untaxed anywhere.

It has long been a mission of the OECD to prevent the deleterious effects of double taxation on the world economy where possible, in part by facilitating a global network of bilateral tax treaties with common rules to avoid such over-taxation. But now the Paris-based organization cites “double non-taxation” through BEPS-related transactions and structures as the greater threat to fiscal policy and economic and tax efficiency among countries worldwide.

## Transfer Pricing, Intangibles, And Digital Commerce

The BEPS report outlines key pressure areas affecting global tax systems and multinational taxpayers. Named among critical action items in the report’s conclusion are two subjects of particular relevance: transfer pricing involving intangibles (including technology) and digital commerce. In an urgent call to action for all stakeholders in the international tax community, the BEPS report seeks to stimulate global efforts toward the following ends:

- Improvements or clarifications to transfer pricing rules to address specific areas where the current rules produce undesirable results from a policy perspective. The current work on intangibles, which is a particular area of concern, would be included in a broader reflection on transfer pricing rules.

- Updated solutions to the issues related to jurisdiction to tax, in particular in the areas of digital goods and services. These solutions may include a revision of treaty provisions.<sup>5</sup>

Furthermore, the rapid change and dynamic nature of global and mobile commerce are converging to further affect issues cited by the BEPS report, which also notes, “These tendencies become more pronounced over time as the economy evolves from bricks and mor-

tar based businesses to more mobile information technology and intangibles based businesses.”<sup>6</sup>

## Contextually Relevant Economic Analysis

Economic models that focus on new technology adoption, and the business and investment decisions involved in such cases, have been developed in other commercial and policy contexts. These examples will demonstrate solutions to problems similar to those that must be addressed for purposes of transfer pricing valuation. As such, they reinforce aspects of the policy direction being developed in, for example, the OECD intangibles project. The examples also introduce helpful alternative perspectives that are consistent with the arm’s-length principle in important respects.

Estimating the inherent value associated with the adoption of one technology over another is a key element in modeling appropriate royalties for standard essential patents (SEPs)—that is, patents covering rights in technology adopted as “essential” according to standards-setting organizations. Standards setting frequently is seen in industries relevant to the digital economy such as the markets for smart phone technology, mobile telecommunications equipment, and digital audio compression and delivery technology.

The question in the standards context is the relative value of the advantages of one technology over another, prior to its inclusion in the standard—a subsequent event that confers greater certainty to the technology owner with respect to its adoption, as well as a corresponding commitment to license the technology on terms that are FRAND according to the policies under the standard.

Arm’s-length and FRAND analyses face similar problems, and the solutions posed in each context are also consistent in important respects. The problems are similar in that both FRAND and arm’s length-analyses must determine what is a fair and reasonable price, such as that to which independent parties would willingly agree. Further, both seek to preserve such market-based (or arm’s-length) pricing in a controlled context that otherwise likely would result in pricing distortions.

Models developed in the technology standards area share other common themes with arm’s-length analysis of cross-border transactions involving intangible property. The two areas are consistent regarding the need to attribute value across different assets, activities, and functions. In a transfer pricing context, this may be with respect to the contributions of different entities within the multinational group. In the standards context, the functional and user demand contributions of specific IP, technology, and business elements must be weighed against others, such that the sum total of royalties attributed to each individual IP or technology element does not exceed the compensation available to all of the IP combined, given the total market value that end users are willing to pay.

Properly applied, FRAND royalty and arm’s-length analysis also must take into account alternative or complementary technologies, related products or services, and the contributions of each of the parties to a licensing transaction. Viewed at this general level, a consistent set of economic and valuation principles af-

<sup>4</sup> OECD Publishing, <http://dx.doi.org/10.1787/9789264192744-en>.

<sup>5</sup> BEPS report, pp. 10, 52, and elsewhere.

<sup>6</sup> *Ibid.*, p. 45.

fect both transfer pricing analysis of intangibles and this IP standards context.

## Control

As noted, both FRAND and arm's-length analysis address an element of "control" that exists or is conferred on specific parties to the transaction. Both regimes seek to restrain such control that, left to its own devices, might otherwise distort the pricing arrangement demanded or concluded.

When a technology standard setting organization selects a technology element or patent as part of a standard, the licensor of that technology gains an element of control over licensees that does not predate the technology's selection as an approved standard. That is, when a license to an SEP is required to comply with the standard, it substantially reduces or eliminates alternative technology options to licensees and potentially holds them captive to SEP licensors.

At this juncture, the relative market power and enhanced bargaining position of the SEP licensor yields concerns that improper pricing practices might ensue. Such mispricing has the potential to reduce the overall welfare among producers and consumers at large. Users or prospective licensees often contest an SEP licensor's royalty offers as unfair and overpriced—that is, not compliant with FRAND obligations under the standard.

A closely related policy issue (referred to as patent hold-up) arises when an SEP licensor seeks an injunction against the products of a licensee or user that disputes the SEP licensor's royalty offer as violating its FRAND obligations. There are many current disputes in this context, including disputes involving smart phone and mobile technology standard patents owned by major companies operating in such markets.

## Comparing Alternatives

For transfer pricing purposes, arm's-length analysis must heed the fact that independent parties compare alternatives in making decisions about whether to invest, approve projects, or conclude transactions. This fact is equally relevant to decisions about adopting or acquiring rights in technology. Existing OECD transfer pricing guidelines emphasize this aspect of arm's-length behavior.<sup>7</sup> Meanwhile, Section D.1.(i) of draft revised Chapter VI also is consistent in its discussion of "options realistically available" to the parties in an intangibles-related transaction in paragraphs 80-83.

It is in fact necessary to compare alternatives in order to maximize value or benefits, or minimize related costs associated with any transaction, and it is simply rational commercial behavior to compare alternatives to get the best value at the best price. Additionally, no decision is taken that independent parties foresee would leave them worse off than if they had done nothing at all. In this sense, "no action" is always one of the available options.

As will be seen in contextually relevant examples below, options realistically available may be hypothetical, but they have very real effects on prices negotiated between independent parties. Such opportunity costs (and

benefits) are not fiction—they largely inform most commercial activity (consider comparison shopping, capital budgeting decisions, or alternatives like renting versus buying a home).

## A Tale of Two Technologies

In an economics paper entitled "Standard Setting, Patents, and 'Hold-up,'" Joseph Farrell, John Hayes, Carl Shapiro and Theresa Sullivan provide a model for setting FRAND royalties and measuring pricing distortions resulting from the patent hold-up problem (hereafter referred to as the FRAND model).<sup>8</sup>

The FRAND model examines a number of considerations that fit neatly into the context of comparing alternatives, reflecting aspects of arm's-length analysis of intangibles as discussed above. It includes a form of cost-benefit analysis applied to two competing technologies, Technology 1 and Technology 2, which a licensee must compare in making informed investment decisions regarding developing and producing its products.

The model describes the "inherent value" of Technology 1 and Technology 2, respectively, as  $N_1 = B_1 - C_1$  and  $N_2 = B_2 - C_2$ . This demonstrates that a technology user will receive the benefits ( $B$ ) and incur the costs ( $C$ ) under each alternative. In each case,  $N$  reflects the value realized by the user in selecting a given technology before paying a royalty. Of course, there is a third alternative not explicitly shown here—if both  $N_1$  and  $N_2$  are negative, then the user will not choose either technology. It sounds simple, but this issue resurfaces in transfer pricing controversy in which taxing authorities question whether independent parties would have undertaken transactions that appear to leave multinational company affiliates worse off, whether such transactions involve intangible property or otherwise.

In the FRAND model, even if the two technologies are royalty-free, there are assumed differences in their inherent values,  $N_1$  and  $N_2$ . For example, each requires a user to incur different costs and make investments, and each produces different benefits. In the model, the FRAND paper authors assume Technology 1 to be superior and so define its "inherent advantage" ( $V_A$ ) as a net positive— $V_A = N_1 - N_2$ —when compared with Technology 2. The inherent advantage,  $V_A$ , reflects the mutual gains from trade that the licensor and user combined will realize if the technology is licensed. It also is the maximum royalty the user will pay before Technology 1's attractiveness is reduced to that of Technology 2.

The royalty equation for Technology 1 is the same whether one assumes that:

- both technologies are patented (or otherwise covered by intellectual property), or
- only Technology 1 is patented because it is superior.

In either case, the user will select Technology 1 over Technology 2 if  $N_1 - R_{1A} \geq N_2$ , where  $R_{1A}$  denotes the royalties charged by its licensor/owner.<sup>9</sup>

<sup>8</sup> Farrell et al., 74 *Antitrust Law Journal* No. 3 (2007).

<sup>9</sup> In this pure form, the owner of Technology 2 cannot successfully negotiate a royalty regardless of whether it is patented, because the user always will strongly prefer the superior technology, and its pursuit of a share of its inherent advantages will substantially eliminate the bargaining power of the Technology 2 owner.

<sup>7</sup> OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, paras. 1.34, 9.59-9.64.



Accordingly, it also can be stated that  $N_1 - N_2 >= R_{IA}$ , so it must hold that  $V_A >= R_{IA}$ . This means that royalties for Technology 1 can only be charged up to an amount that is equal to the inherent advantage,  $V_A$ , it provides over and above Technology 2, and no more. Of course, the IP licensor and the user will negotiate this royalty. The ultimate outcome will result from the relative bargaining power ( $B$ ) of the IP licensor over the user. Thus, the model also holds that  $R_{IA} = BV_A$ .

Here it is clear that the proper “price,” a royalty, is derived substantially through a process of comparing alternatives available to the buyer (the technology user), taking into account its opportunity costs and benefits including those associated with the option *not* taken.

The FRAND model also incorporates other aspects relevant to arm’s-length analysis of intangibles. For example, the investments made by a licensee that relate to its expectations regarding the use of Technology 1 affect the royalties it is willing to pay. This is true because such investments will be wasted if the user cannot conclude or maintain a deal with the owner of Technology 1 and must switch to Technology 2. Thus, the user’s opportunity costs associated with its investments in assets related to Technology 1 become part of the licensor’s potential gain and pricing advantage.

After this investment by the user, the new royalty equation is  $R_{IP} = B(V_P + K)$ , with  $K$  denoting the user’s investment in assets related to Technology 1. The owner of Technology 1 experiences a similar pricing advantage when it has SEP status, as it can extract additional value from licensees related to their commitments to using Technology 1 under the standard.

## Ex Ante Analysis

Of course, no one can predict the future. But whenever a commercial transaction takes place, the parties’ expectations about the future inform the decisions they make about purchases (or sales), related investments, and activities as well as the amount they are willing to pay (or receive) for products, services, or rights to use property related to the transaction. They also will take into account other related costs and benefits. In a general sense, every arm’s-length transaction includes some *ex ante* aspect.

Technology adoption such as that demonstrated in the FRAND model involves investments whose benefits are generally realized over longer periods of time. In other relevant contexts, these time horizons extend further, such as when technology development is considered. This is the subject of highly controversial transfer pricing and intangible valuation issues associated with R&D cost sharing arrangements such as those confronted by Amazon in its Tax Court case.

## Transaction Value Versus Structure

Arm’s-length analysis must carefully distinguish between the *form* of arm’s-length compensation versus the amount, or *value*, of compensation. The purpose of arm’s-length analysis is to establish the latter; value itself is only indirectly determined by the form or structure of the transaction.

This is not to suggest that different forms of compensation are less relevant to an analysis. To the contrary, in order to make an apples-to-apples comparison of otherwise comparable transactions, it is necessary to un-

derstand any differences in the forms of compensation under each and to take into account any adjustments to such payments (for example, differences in credit terms) to put the transactions on an equal footing.

Of course, when payment terms or income streams vary between transactions in a comparative analysis, it is also necessary to consider them on a net present value (NPV) basis in order to make a truly valid comparison. The success of this analysis depends on the availability and quality of data (and the quality of related assumptions). One must also take into account interrelated aspects of each transaction, its terms, and the different risks associated with such terms.

For example, assume an analysis of royalties based on three agreements, all between unrelated parties, licensing similar technology. Assume that each of these arm’s-length-royalty agreements provides for a 2 percent running royalty on sales. All evidence mentioned thus far supports a 2 percent royalty.

However, assume that Agreement 1 includes a minimum guarantee of \$200,000 per year over five years, Agreement 2 includes a one-time lump-sum payment of \$1 million (treated as a minimum payment in the first year), and Agreement 3 includes no additional payment. In this case, one must look beyond this 2 percent royalty rate for an accurate picture of the compensation paid to use the technology. In addition, the different payment terms reflect very different allocations of risk between the parties.

Carrying the example further, assume that all three licensors expected licensees to achieve sales of \$10 million in each of the first five years. On an NPV basis, the licensor would realize the same absolute royalties (\$758,000) and the 2 percent royalty rate under both Agreements 1 and 3.<sup>10</sup> Under Agreement 2, however, the effect of the lump sum increases the effective royalty rate to nearly 4 percent on sales over the same period when examined on an NPV basis.<sup>11</sup> This agreement also substantially limits the licensor’s risk and shows a guaranteed absolute amount of royalties that effectively doubles the expected total royalties when examined during the five-year period.

If we instead assume that all licensees’ expected sales are of only \$5 million per year, the licensor under Agreement 1 sees the same result in absolute terms (that is, the same royalty amount)—the minimum guarantee has mitigated the licensor’s risks. But note that the royalty rate is now effectively 4 percent (that is, \$200,000 divided by \$5 million in each year). This higher royalty rate is likely to be less important than the fact that the overall expectations regarding the licensee’s success are reduced. The licensor’s real preference is presumably to exceed the minimum and maximize royalties, not royalty rates. In any event, the stated 2 percent running royalty rate alone is incomplete information in this scenario, as is the case with the lump

<sup>10</sup> All examples in this section assume a discount rate of 10 percent. Agreements 1 and 3 each realize royalties of \$200,000 per year over five years, which is equal to \$758,000 on an NPV basis, when assuming \$10 million per year in sales.

<sup>11</sup> For Agreement 2, a year 1 payment of \$1 million and royalties of \$200,000 in each of years 2 through 5, discounted at 10 percent, produces an NPV of \$1.48 million in royalties. The NPV of 5 years of sales at \$10 million is \$37.9 million. Thus, 1.48 divided by 37.9 produces an effective royalty rate of 3.9 percent on an NPV basis.

sum agreement. In Agreement 3, the licensor's royalties are now cut in half along with the royalty base—there is no risk alleviation in this royalty structure.<sup>12</sup>

The point illustrated here is not only that an NPV analysis is necessary to compare alternative transaction values when variations in their payment terms or income streams are present. An analysis must also examine all relevant aspects of the transaction as a whole, taking into account compensation for interrelated costs and benefits regardless of whether they are accounted for separately under different transactions as structured. The risk effects of different terms should also be considered. Not taking account of such issues can produce unwanted effects on the analysis and lead to wrong conclusions.

Nevertheless, sometimes analyses separate the valuation of rights to use intangibles, such as software, from the rights to receive updates and improvements, even when the latter are customarily part of the overall transaction at arm's length. Similar issues can occur with respect to R&D cost sharing arrangements when the valuation of a buy-in payment for all rights in existing technology is made without considering all the relevant costs and benefits under the entirety of the arrangement—though the arrangement itself has the express purpose of further developing and commercializing the technology. Analyzing one part of a transaction (for example, a lump sum buy-in payment or software licensing fee) without considering the interrelated aspects of other parts (for example, rights to new developments and improvements) results in an incomplete picture that can undermine the overall analysis and conclusions.<sup>13</sup>

As discussed below, a royalty value derives from the parties' separate expectations about the success of the relevant business activities. These expectations may not be equal, but they may produce a range of potentially agreeable royalties where such expectations overlap.

Issues regarding varying transaction terms also may pertain to FRAND dispute resolution contexts. For example, a paper by chief economists of U.S. and European antitrust agencies recently called for cash basis (present-value) licensing term options on the part of licensors in a dispute, to overcome transparency issues when complex payment streams occur between parties to cross-licensing arrangements. The report states:

The F/RAND dispute resolution process should require that the licensor specify a cash price for its SEPs as an alternative to other pricing arrangements to aid in evaluation of the proposed license terms by the third party. Determining if a complex package of cross licenses satisfies F/RAND is difficult for a third party. If the licensee has the option to choose a F/RAND cash price, but instead chooses to cross-license, then clearly it is better off.<sup>14</sup>

The passage above also reflects the basic principle that a licensee will compare the *value* associated with

its alternatives— independent of the form or structure of the deal—in considering its best options.

## Transfer Pricing Valuation of Intangibles And OECD Examples

Independent parties to a transaction usually compare the present values of income streams from their alternatives involving the same or similar assets and investments. This is true whether or not there are intangibles that are legally protected. These arm's-length conditions are well depicted in Example 19 of the draft revisions of Chapter VI of the OECD guidelines, where they are applied to hypothetical related parties that operate under such conditions.

In Example 19, a parent company (P) considers transferring intangibles to a related manufacturer (S) in a lower-cost, lower-tax country. Note that in this case, as would occur at arm's length, the starting point for the analysis involves P computing the present value attributed to its intangibles under the status quo.<sup>15</sup> This is an *ex ante* condition described in other contexts above (in some litigation contexts referred to as a “but for” analysis—that is, “but for” a subsequent event such as the proposed transfer of the intangibles). It is the baseline scenario upon which P considers its alternatives.

This baseline NPV is compared to the NPV of the alternatives faced by P. Similarly, S computes and compares its own alternatives on an NPV basis. These separate valuation processes done by each party form the bases upon which they negotiate (see Tables 2 and 3 in Example 19 of draft revised Chapter VI).

It is worth noting that the analysis in Example 19 neither separates nor determines relative values for the different types of intangibles to be transferred (patents and trademarks). There is no need to separate them in this case because these intangibles operate collectively, and no scenario is contemplated in which they would not, which suggests that no such scenario would maximize the return on these intangibles. This often occurs in arm's-length scenarios when various intangible property items are bundled, such as in a software license.

However, in transfer pricing contexts, cases where two separate affiliates contribute different intangibles are more common, raising challenging valuation issues. Here, a profit split is often required; the draft Chapter VI defers much to the existing Chapter II of the OECD guidelines on this subject.

As in Example 19 and the FRAND model, unrelated parties negotiate by formulating their own separate analyses of the returns related to their investments associated with a transaction. The acceptable threshold for investment in the transaction is that the return is equal to or better than the company's alternatives when using the same or similar assets and resources. At arm's length, the views of *both* parties must be taken into account, as both perspectives form the negotiating positions that ultimately produce an arm's-length result.

Furthermore, at arm's length, independent parties do not necessarily value the total transaction in the same way, much less with respect to each of the underlying intangibles or other assets combined in such a transaction. They will likely exchange forecasts and other information necessary in negotiating the deal, but they

<sup>12</sup> The author provided this example during the OECD's public consultation in Paris Nov. 12-14.

<sup>13</sup> Such issues have been the subject of major transfer pricing controversy. See *Veritas Software Corp. v. Comr.*, 133 T.C. 297 (2009).

<sup>14</sup> “Standard Setting Organizations Can Help Solve the Standard Essential Patents Licensing Problem,” Kai-Uwe Kühn, Fiona Scott Morton, and Howard Shelanski, *CPI Antitrust Chronicle*, March 2013 (Special Issue).

<sup>15</sup> OECD draft revised Chapter VI, (Table 1, page 54).

will not necessarily share equal views and assumptions regarding such information. After a negotiation, the only agreed arm's-length value is the actual transaction price.

These arm's length-conditions explain why, contrary to some critiques of the draft revised Chapter VI,<sup>16</sup> it is unlikely that independent parties share identical and equal views on the definition and value of each underlying component when intangibles operate or are transacted collectively. This should be clear when the parties' respective starting points for the value of the entire transaction are not equal in the first place.

## Insights from Other IP Contexts

There is much common ground between IP infringement damages estimation and transfer pricing analysis of intangibles as described in existing and draft OECD guidance. This should not be surprising, because both concern intangibles, and the hypothetical processes that underlie each (the "but for" analysis and the arm's-length standard) are grounded in the same economic principles.

In IP damages contexts, as in transfer pricing, facts and circumstances and the resources, capabilities, and market conditions faced by the parties weigh heavily in the analysis, as do the uniqueness of the IP and its profit potential.

Interrelationships among other activities and assets are also highly relevant to this discussion, despite the fact that IP infringement damages often relate to a single intangible asset (such as a patent). IP damages analyses also consider interrelated assets (including production assets and potentially other intangible assets), related products and business activities, services, contributions of other parties, and other options available to both the IP owner and the infringer. Moreover, IP damages are calculated on a base of infringing product revenue that derives from the assets and resources of an entire business, in addition to the IP itself. This all sounds consistent with issues from a transfer pricing perspective.

Two primary approaches are used to calculate IP infringement damages: the "lost profits" method and the "reasonable royalty" method. The former measures the lost incremental profits that the IP owner would have earned "but for" the infringement—that is, profits on infringed sales. The standard for awarding lost profits is higher than that for a reasonable royalty, requiring proof that there were no non-infringing substitutes and that the IP owner had the capability (for example, the production capacity and distribution networks) to meet demand related to the infringing products.<sup>17</sup>

If lost profits cannot be proven, the floor on damages is based on a "reasonable royalty" determined using 14 criteria that closely resemble the application of a comparable uncontrolled price (CUP) method in Chapter II

of the OECD guidelines.<sup>18</sup> Items 1 and 2, respectively, are the existence, if any, of an established royalty received by the licensor for the same IP; and rates paid by the licensee for any similar IP. Item 3 asks the nature and scope of these licenses, including any restricted or nonrestricted terms. Other items go down similar paths—a form of CUP analysis.

Having established comparable IP and royalty rates, the analysis turns to the commercial relationship of the licensor and licensee and whether they are competitors or collaborative (item 4). Interrelationships between patented and unpatented products and derivative business (convoyed sales) are then considered (item 6). Various other factors regarding both the IP itself and evidence found in comparable licenses are weighed as well.

Item 13 requires a form of residual profit analysis. This factor allocates "but for" profits across elements that are not patented, such as services provided with the product, manufacturing processes and costs, business risks, and other product or feature improvements that may have been contributed by the infringer and not the IP. In other cases, infringement damages are computed by directly deducting a "normal" rate of profit earned on the infringer's other product sales from the total profit on infringed sales. The residual forms a basis for IP profit.

Not unlike Example 19 in the draft, the reasonable royalty calculation weighs all of these factors and the opportunity costs (that is, other options available) to both parties. An ex ante hypothetical license negotiation is premised on the minimum and maximum acceptable royalties for the licensor and licensee, given their best available alternatives at the time the infringement period began.

In IP infringement suits, one of the more contentious issues is how to split the "residual" represented by the range of royalties that both parties would be willing to pay or receive. Here, the guidance from case law remains somewhat limited. Nevertheless, the assets, resources, and capabilities of the infringer are weighed, and it is generally assumed that some of the compensation should go to the hypothetical non-infringing sales that the infringer would have made in a "but for" scenario.

Thus, opportunity costs weigh heavily in these analyses as well; they can relate to either or both parties and cut either way. For example, the availability of substitutes cuts into the amount of infringed sales, reducing the award to the IP owner (that is, assuming that absent the use of the infringed IP, the infringer would have used an alternative technology). Additionally, the IP owner may have lost sales of products related to the patented product (convoyed sales), and lost profits from these sales can increase its award (even though the infringer and other sellers did not infringe with respect to such related products).

Weighing the relative contributions of various items is often a challenge where IP-related disputes are concerned, not unlike in transfer pricing contexts.

<sup>18</sup> Referred to as the *Georgia-Pacific* factors, these derive from case law resulting from *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116, 1119-20. (S.D.N.Y. 1970), modified and aff'd, 446 F.2d 295 (2d Cir. 1971). A 15th factor posits the hypothetical negotiation itself, based on full consideration of the other factors.

<sup>16</sup> Comments on draft revised Chapter VI may be viewed at [http://www.oecd.org/ctp/transfer-pricing/Intangibles\\_Comments.pdf](http://www.oecd.org/ctp/transfer-pricing/Intangibles_Comments.pdf).

<sup>17</sup> Four criteria applied in finding "lost profits" are collectively referred to as the *Panduit* test after *Panduit Corp. v. Stahlin Brothers Fibre Works Inc.*, 575 F.2d 1152 (6th Cir. 1978), in which they were outlined. The other two include proving the existence of demand for the patented product, and proof of the amount of profit lost per lost sale.

## Conclusions

The foregoing discussion on measuring various contributions to value in an intangibles transaction brings us full circle to the problems posed in the BEPS report: how to ensure fair, consistent, and efficient treatment in taxing the many affiliates of global companies across different tax jurisdictions. Indeed, such questions are fundamentally related to the relative value contributions of those affiliates in different countries, based on their functions, activities, assets, and risks.

Taxing authorities look at the separate-entity results of multinational companies' affiliates in their jurisdictions to determine whether there is additional taxable income due to them. When they assert that an affiliate has underpaid its taxes in the local country, they are effectively stating that the affiliate should earn more income given its contribution of value—value that was allegedly understated or mispriced in its transactions with affiliates in other countries. This is the case whether or not such value is itself directly or indirectly related to intangibles or other forms of contribution.

Note that where one affiliate should earn more income in one jurisdiction, an affiliate it transacts with in another tax jurisdiction may thus earn less income. Otherwise, double taxation may occur. But as the BEPS report notes, the current global tax system facilitates the potential that the taxable income reported by all affiliates combined understates the combined value they create. This state of affairs produces detrimental effects on fiscal policy worldwide and economic inefficiencies that disadvantage local companies (and others) that cannot undertake such international tax arbitrage, according to the BEPS report.

An accompanying aspect of the BEPS report concerns rules regarding taxation of the activities of multinational companies that have no corporate legal presence in the jurisdiction (nonresident taxpayers). The business profits from these nonresident affiliate activities may be taxable to the extent that they constitute a

permanent establishment within the local, or source, country.

A reasonably consistent set of rules define PE status within the global network of tax treaties now in place. But as the BEPS report highlights, these rules relate largely to physical presence in a given country and other considerations that emerged in the first half of the 20th century—at a time when the concepts of “virtual company” and “electronic commerce” were hardly imagined. As the BEPS report notes in two key passages:

Updated solutions [are needed to address] the issues related to jurisdiction to tax, in particular in the areas of *digital goods and services*. These solutions may include a revision of treaty provisions.<sup>19</sup> (Emphasis added.)

These tendencies become more pronounced over time as the economy evolves from bricks and mortar based businesses to more *mobile information technology and intangibles based businesses*.<sup>20</sup> (Emphasis added.)

Such issues thus are closely related to the intangibles valuation issues discussed above—though detailed discussion on PEs, for example, goes beyond the scope of this article. Nevertheless, all of these trends coincide with a period of worldwide fiscal crisis and post-globalization. As such, governments in capitals across the globe are understandably concerned about securing their fair share of a potentially shrinking pie of taxable income, in an age of global e-commerce, “mobile information technology and intangibles based business.”<sup>21</sup>

<sup>19</sup> BEPS report, pp. 10, 52.

<sup>20</sup> *Ibid.*, p. 45.

<sup>21</sup> For more examples, see “French Report Urges OECD, G-20 Action to Boost Taxation of Global Internet Giants,” 21 *Transfer Pricing Report* 971, 2/7/13. Also see “China, U.S. Perspectives on Intangible Property Transactions,” 17 *Transfer Pricing Report* 571, 11/20/08, which includes an earlier discussion by the author on these issues.

Patrick Breslin Comments in Response to the  
Request For Input Regarding Work On Tax Challenges Of The Digital Economy  
(hereinafter, the “Request”)

Issued by the OECD Committee on Fiscal Affairs and Country Delegates  
under the OECD Base Erosion and Profit Shifting (BEPS) Action Plan

(Comments submitted December 22, 2013)

I would like to thank the OECD Committee on Fiscal Affairs, country delegates and other participants in the OECD BEPS initiative for the opportunity to comment on this important project.

My views are informed by my experience as an economic consultant, which has focused on transfer pricing, including intangibles-related transactions, as well as non-tax-related intellectual property (IP) matters. I also relate my experiences as an entrepreneur and business executive for a digital technology company (Relatable) that participated in early stages of the market for digital distribution of music over the Internet. Prior to Relatable, I was also a technology (i.e. “new media”) division project manager for a major public broadcasting network (National Public Radio, or “NPR”), during the period in which it internally developed technology to deliver its on-air programs and content through the Internet and other digital channels.

These direct experiences with developing business models in the digital economy spanned formative periods in the markets for digital music and media distribution and foreshadowed their continuing evolution. In these contexts, I have also negotiated multiple arm’s length technology license agreements and other transactions involving intangibles, such as rights to copyrighted works, and valued technology solutions and enterprises.

I also weigh my experience as a consulting expert in litigation involving intellectual property, as well as IP valuation and related issues. This consulting experience often directly relates to the digital economy, including Internet and mobile technology-related business models. I believe all of these experiences are contextually relevant to this BEPS initiative, as it focuses on international tax issues in the digital economy.

## **General Comments on Action 1 Regarding The Appropriate Approach To Addressing The Tax Challenges Of The Digital Economy.** (per paragraph 7 of the Request)

Paragraph 6 of the Request notes the following,

*Examining the tax challenges of the digital economy requires a thorough analysis of the various relevant business models involved. In particular, it is of utmost importance for the work of the Task Force to be based on a full understanding of how digital economy businesses create value and make their profits.*

It is my view that a focus on technology investment and innovation itself as a business activity (along with its corresponding risks) is at least as important to understanding value creation as a thorough analysis of different business models and supply chains. The contributions of parties that manage and control risky technology investments greatly impact value creation in the digital economy, notwithstanding other potential contributions that may also arise.

In this light, I attach as part of my comments in response to this Request a recent publication I submitted to *Tax Management Transfer Pricing Report*, entitled “A Tale of Two Technologies: Transfer Pricing of Intangibles In the Digital Economy.”<sup>1</sup> This paper focuses on economic analysis of technology investment and adoption, and on how parties to technology-related transactions value such contributions to their business profits. Economic models applied in relevant contexts are considered, including those involving technology related to digital and mobile commerce.

### **2. Request for specific input**

In the following sections, I will note experiences with digital economy-focused business models across different phases of my career, both as an entrepreneur and business executive operating in relevant industry sectors (e.g. digital music distribution) and as an economic consultant focusing on intellectual property matters for companies operating in such sectors. While some of this discussion is focused on my former role and experience within a technology company, most of the industry issues and types of technology discussed remain relevant to the issues in this Request overall. These experiences also inform my current economic consulting work.

#### ***A. Nature of work/activities undertaken by your organisation***

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<sup>1</sup> Tax Management Transfer Pricing Report, Vol. 21 No. 23, 4/4/2013. Copyright 2013 by The Bureau of National Affairs, Inc.

A.1. Please describe the background of your organisation, including the nature of the work or activities performed.

In 1999, I co-founded and was CEO of Relatable® (“Relatable”), an early provider of music identification and recommendation technologies for the digital distribution of music. (I remained CEO of Relatable through 2003, at which point I renewed my prior focus on economic consulting in areas including international tax, transfer pricing and IP and intangibles-related transactions.)

Relatable® technologies were designed to help create a new level of personalized digital music and media services. Its technologies included advanced acoustic fingerprinting technology that was used for identifying digital music and media files in peer-to-peer (P2P) networks and in other applications. A goal of this technology was to help transform popular P2P networks into paid subscription services by identifying the recordings shared and transmitted from each end user’s music library. This “digital bar code” would enable royalty allocation and compensation to copyright holders. Relatable technology was integrated into the original Napster system as Napster’s investors (including the major record label owned by the Bertelsmann group) attempted to develop such a paid subscription model.

Acoustic fingerprint technology identifies sound recordings based on acoustical properties; effectively it is software-based machine listening. Relatable technology was developed to achieve a high level of accuracy in discriminating between different sound recordings regardless of audio file format, bit rate or common signal distortions. The technology achieved unprecedented speed and an ability to scale to meet the needs of large-scale distributed networks such as the Napster P2P network.

Other technology solutions included The Relatable® Engine, a recommendation technology for digital music. This technology could combine user preference analysis with an analysis of the content properties of the music individuals listen to such as a song's genre, beat, tempo or acoustical properties. This combination of user preference and music property analysis can result in a much higher accuracy rate in terms of recommending new music that meets a user's interests. The Engine was designed to integrate with and learn from any Internet-enabled device that delivers digital audio.

***B. Impact of information and communication technology on the activities of the organisation***

B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.

Traditionally, music recordings were distributed and sold at retail on physical media, such as vinyl records, electromagnetic tape, and more recently on digital compact disks. This required the record company to utilize or engage large distribution operations, maintain

inventories of records, tapes and CDs, and provide retailers with additional levels of support to ensure the right mix of product were available to end customers.

On the promotional side, record companies pursued various different campaigns to promote major and upcoming artists. In most cases, traditional broadcast media (i.e. radio and television) were the major avenues to gain publicity and end customer interest in potentially purchasing recorded music.

As the Internet advanced in its reach among consumers and its ability to transmit larger amounts of data (i.e. mid-1990s period), its potential role as an alternative to *both* traditional physical distribution and retail channels *and* traditional promotional avenues through broadcast became increasingly viable.

However, given earlier technology limitations and hesitation on the part of incumbent companies in the record industry, the evolution in digital distribution would take place gradually before reaching the commonplace position it enjoys today. Different business models for digital music performance and distribution developed incrementally, with varying degrees of initial and longer term success. Major disputes also arose related to copyright licensing and alleged infringement, which further stalled what has since become a successful digital marketplace for music.

B.2. How do these models leverage new technology to change organisational structures and supply chains?

Music is distributed over the internet via a “download” which generally entails transmitting a permanent copy of a recording to the user’s PC and/or mobile devices. Downloads are a direct substitute for physical CD sales of recordings and, by giving equivalent levels of control to the end user, demand a higher copyright royalty than other Internet transmission. “Streaming” entails delivering music playback temporarily through a single performance or playlist of performances. End users do not retain a copy of the streamed recording.

There are advertising and subscription based music streaming services that are generally classified as either “interactive,” which means end users control which recordings they hear, and “non-interactive” Internet radio, which competes with traditional broadcast radio and often customizes radio stations based on data regarding listeners’ explicit and implicit preferences. Like other radio, these services do not allow the user to directly control what songs are played. Therefore, copyright holders have traditionally charged a lower royalty than for interactive services.

B.3. In each of the business models identified, what assets and activities contribute to the generation of value?



New digital music services have relied on long term development of technology and related databases that improve the listeners' ability to discover new music that they might enjoy. User preference data is increasingly leveraged to personalize the listener's experience. Various providers have internally developed their own systems, using algorithms and databases of music and user preference information, and combining such information to customize the introduction of music for sale (e.g. download) and/or to generate playlists for streaming.

B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?

As discussed above, digital distribution has created an alternative to physical retail sales of music (e.g. CDs) and enabled individuals to purchase (or stream) music from virtually any location on a PC or mobile device.

B.5. How have changes in underlying business models impacted the way in which business is organized as a legal or tax matter?

No comments.

B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?

No comments.

B.7. How do you see business models and supply chains evolving in the future due to advances in information technology?

Digital music and media distribution models will continue to progress in the directions already seen, with the likelihood of even greater access through mobile devices, in-car audio systems, etc. Internet radio is competing with traditional on-air radio and increases in bandwidth and Internet access will further this.

### ***C. Other comments***

C.1. Please provide ***Any other comment*** you may have regarding Action 1, including any additional information ***that you would consider useful*** in identifying ***the challenges that the digital economy poses for the application of existing international tax rules.***

See attached publication and comments above.

## BEPS MONITORING GROUP

### Response to OECD Request for Input Regarding Tax Challenges of the Digital Economy

This response is submitted by the BEPS Monitoring Group (BMG). The BMG is a group of experts 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 Sol Picciotto, and reviewed by other members of the Group.

#### General

The specific questions listed in section B of the Request seem to be addressed to businesses. We approach the issue from a more general perspective. We will therefore put forward three main points which we consider should be central in consideration of this issue.

#### 1. Nature and Impact of the Digital Economy

The question posed is *'the challenges that the digital economy poses for the application of existing international tax rules'*. In our view, these challenges do not arise from a specific sector or group of firms which might be described as *'the digital economy'*. A strict definition of firms that are purely digital would be limited, for example, to those which produce products or services only in digital form. Although a few such firms are well-known large transnational corporations (Facebook, Google, Yahoo etc.), very many are SMEs, often engaged in business-to-business services and consultancy, primarily national and even local in scope.<sup>1</sup>

Rather, the challenges result from the general effects of digital technologies on business models. The digital economy is a feature that has permeated all business sectors, it is hard to think of any sector which remains unaffected. The application of information and communications technologies dates back some three decades, and is now ubiquitous. Use of communications networks especially through the internet is a little more recent but is now also everywhere. Indeed, the digital economy can be seen as part of a broader transformation to the knowledge economy or the information society, which includes the exponential growth of services, and major changes in the organization of manufacturing.

In our view, these transformations involve two features which pose major challenges for existing international tax rules:

- (i) they create new opportunities for reorganizing corporate structures by separating functions and organizing international value chains to exploit locational advantages, including those resulting from loopholes in international tax coordination; and

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<sup>1</sup> See for example M. Nathan and A. Rosso (2013) *Mapping the UK's Digital Economy with Big Data*, National Institute of Economic and Social Research. The extensive OECD work on the Information Economy is available at <http://www.oecd.org/internet/ieconomy/>

(ii) they involve new relationships between firms and their customers, and/or users of their products.

We will comment on each of these.

## 2. Tax Driven Corporate Reorganizations

The digital economy has greatly facilitated tax-driven restructuring of firms, which has become ever more sophisticated. Firms can now reorganize their activities into various functions, assign them to different affiliates, and locate them so as to minimize tax liabilities. Coordination is assured through intra-firm communications systems linked through the internet.

Examples have been publicized, mainly of high-tech firms, as highlighted in news reports<sup>2</sup> and inquiries by legislatures.<sup>3</sup> These are well known, so we will highlight only the salient features for our purposes here. For example, Amazon separates the functions of sales, website operation, customer support, warehousing and order fulfillment. From the perspective of the customer, Amazon appears as a single firm providing an integrated service. The customer selects and orders items on a national website, e.g. [www.amazon.co.uk](http://www.amazon.co.uk) , or [www.amazon.fr](http://www.amazon.fr) . Not only is the language that of the country in question, the products offered are country-specific. A customer who is for example in Spain and attempts to buy from [www.amazon.co.uk](http://www.amazon.co.uk) is unable to do so, even if they have an account with Amazon UK. Amazon takes pride in extremely rapid order fulfillment, which is only possible because warehousing and delivery are close to the customer. Customer support is also organized on a national basis, although of course call centres may be located elsewhere. Yet sales are booked to Amazon SARL in Luxembourg. Under current tax rules, this company must be treated as having no taxable presence (Permanent Establishment) in the countries where its customers are located, and where it has logistical and customer support operations, because these operations are attributed to different affiliates and must be treated as independent.

A similar example which has been publicized is that of Google, which books its advertising sales in an affiliate in Ireland, while this income is routed through to a Bermuda-resident affiliate, which also owns the intellectual property rights to the Google software. Yet, as has been reported in the press and publicized in the UK Parliament, Google employs as many staff based in London as in Ireland, many of whom deal with customers. Yet Google

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<sup>2</sup> In particular: Jesse Drucker, "Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes," *Bloomberg*, (October 21, 2010) <http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html> , and more recently Tom Bergin, "Special report: How big tech stays offline on tax," *Reuters* (July 23 2013), <http://www.reuters.com/article/2013/07/23/us-tax-bigtech-idUSBRE96M08W20130723> .

<sup>3</sup> Notably, Australia: Graeme S. Cooper, "News Analysis: An Aussie View of the Digital Tax Disruption" *Worldwide Tax Daily*, (December 3, 2012); France: N. Colin and P. Collin, "Mission d'expertise sur la fiscalité de l'économie numérique," France, Ministry of Finance and the Economy (January, 2013), <http://www.economie.gouv.fr/rapport-sur-la-fiscalite-du-secteur-numerique>; UK: House of Commons Committee of Public Accounts, "HM Revenue & Customs: Annual Report and Accounts 2011–12", 19<sup>th</sup> Report of 2012-13; and "Tax Avoidance – Google", 9<sup>th</sup> Report of 2013-4, <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf>; House of Lords Select Committee on Economic Affairs, "Tackling corporate tax avoidance in a global economy: is a new approach needed?", 1st report of session 2013-14. HL 48; US: Senate Permanent Subcommittee on Investigations, "Offshore Profit Shifting and the U.S. Tax Code - Part 2 (Apple Inc.)", Hearing May 21 2013, and Memorandum of Senators Carl Levin and John McCain; House Committee of Ways and Means, Hearing on "Tax Reform: Tax Havens, Base Erosion and Profit-Shifting", June 13, 2013.

describes the functions performed in the UK as 'marketing', and actual sales are booked to the affiliate in Ireland.<sup>4</sup>

Although Google could be described as a pure digital economy firm, Amazon of course is a retailer delivering physical products. Nevertheless, they are using similar techniques: separation of functions coordinated through digital networks, with functions attributed to affiliates resident in locations chosen for their tax advantages. Nor are these techniques confined to high-technology firms. Two examples involving manufacturing firms were presented at a meeting organized on 29 November 2013 by the OECD's Trade Union Advisory Committee (TUAC).<sup>5</sup> We will discuss one here.

Briefly, this firm reorganized its European operations some ten years ago, and a new company created in Switzerland became the primary contractor for the entire operations in Europe. In France, the commercial companies changed status to become 'limited risk distributors', and the industrial sites were designated sub-contracted manufacturers with specific terms of reference and pricing set by the Swiss entity. The French holding company, which previously had a primary contractor role, became a service provider for the other French entities or for the Swiss entity.

As a result of the restructuring, profits reported by the business entities in France fell sharply. The French tax administration launched a tax audit of the French subsidiary, claiming several millions of euros in tax arrears. The firm contested the assessment by defending the primary contractor status of the Swiss entity and arguing that the fall in the profitability of the French subsidiary was simply due to the transfer of risks to the Swiss entity. The Swiss entity held the licensing rights for the use of the global brands in Europe, and the firm claimed that its controlling role meant that it was exposed to operational and market risks in France regardless of the fact that essential functions were subcontracted to the French entities. It also submitted a comparability analysis which showed that its transfer pricing policy between the French and Swiss entities was indeed within the range of its competitors, although towards the top end.

On appeal, the tax commission rejected the decision by the tax administration on the ground that it had not challenged the 'legal reality' of the contracts binding the French subsidiary with the Swiss entity. The commission did concede however that the application of the arm's length principle should not be limited to contractual terms only but should include a 'realistic' analysis of the distribution of risks and responsibilities. Rather than capturing all the profits made in France, the Commission suggested that the Swiss entity be remunerated like the headquarters of a TNC (that is, remunerated for the costs plus 6%).

This tax-driven reorganization also had direct impacts on the firm's workforce in France. First, it affected the employee profit-sharing scheme, which under French law is dependent on the capitalization of the company. The restructuring plan resulted in high levels of capitalization of the French subsidiaries due to their supposedly reduced exposure to market and operational risks. Combined with the overall decrease in profits attributed to the French affiliate, the share of profits redistributed to workers fell sharply. It is estimated that the net gains for the firm were €1.6m per year for 2005-2007 compared with 2000-2004 period. Workers' rights to information and to representation have also been impacted. As a result of the restructuring, the status of the French entities shifted from *Société Anonyme* (S.A.) to

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<sup>4</sup> UK Parliament (2013) *Tax Avoidance - Google*. House of Commons Committee of Public Accounts 9th Report 2013-14, HC 112.

<sup>5</sup> Report available at [http://www.tuac.org/en/public/e-docs/00/00/0D/FE/document\\_doc.phtml](http://www.tuac.org/en/public/e-docs/00/00/0D/FE/document_doc.phtml).

*Société Anonyme Simplifiée* (S.A.S.). The SAS status was introduced in French corporate law to meet the specific situation of SMEs; compared with the S.A. it grants much lower access to worker representation and information.

The fragmentation of the French affiliate into multiple 'simplified' incorporated entities also led to considerable loss of information and of rights to consultation for the trade unions and for works councils, and thereby to considerable loss of bargaining power. It also led to a downgrading of the quality of the collective agreement covering the workers. Overall, the quality of social dialogue deteriorated fast following the restructuring, to the point where it can be considered as close to non-existent.

Although this, and other examples, do not concern firms which could be described as themselves part of the 'digital economy', this reorganization was made possible due to the ease with which dispersed business functions can now be coordinated using digital networks. We stress that we do not contest the right of firms to reorganize their activities for good operational reasons. These can legitimately include factors such as availability of workers with suitable skills, and access to markets. Our point is that location decisions have become distorted by tax rules which allow, indeed encourage, the artificial separation of functions and their attribution to affiliates which are in fact under common control, but are treated as separate and independent for tax purposes. Functions that can be considered as high-value, such as control and direction of operations, or ownership and control of intellectual property rights, can be attributed to affiliates in jurisdictions which offer favourable tax regimes. Affiliates in other countries which do not offer either low tax rates or tax preferences are designated for functions to which low rates of profit can be attributed. Firms are able to defend such low profit margins under current tax rules, by pointing to 'comparables'. Yet the business reality is that these large firms are integrated and under common control, and it is this synergy which generates higher levels of profit.

### **3. Changing Relations with Customers and Users**

The shift to the digital economy also entails new relationships with customers and users. The firm which is a supplier of either goods or services now has a more interactive relationship with its customers. This is so not only for services, which have always had a personal character to some extent, but now also for supplies of goods.

This takes a number of forms, which have been extensively studied and discussed,<sup>6</sup> so we will only outline them here for the purposes of our own analysis. First, many firms can now use large-scale data-collection techniques to categorize customers and identify their preferences. These techniques can be used both for marketing and supply-chain management purposes. Such systems can also be used to organize feedback which can be used to improve and enhance products and services. Data gathered in this way can also be used to offer related products or services, either from the same firm or others, by data pooling or sharing.

Second, and relatedly, these interactions may entail a more active role for the customer or client. Firms provide facilities on their websites for customer comments and reviews, which provide information for other customers, while also enhancing the firm's offerings. Similarly, continuous use of services via a website creates a long-term interactive relationship. This can be seen for Amazon, which has expanded to offering customers a wide range of products through a single account. Somewhat different, though still exploiting the interactive relationship and data-gathering, are services such as online games, social networking, and

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<sup>6</sup> See especially N. Colin and P. Collin (2013) *Mission d'expertise sur la fiscalité de l'économie numérique*. Paris: Ministère des Finances et de l'Economie.

gambling. In this case, the service itself is interactive. Taking this one stage further, some business models depend on content contributed by users. The best known are social networking applications such as Facebook, YouTube, LinkedIn, and Twitter. These are distinctive in that the users who contribute the content generally do not pay for the service itself. Revenue is generated from other customers, generally for advertising.

It has been argued that these developments entail a fundamental change in the nature of the firm, since users are also acting as (unpaid) workers.<sup>7</sup> In our view, it is clear that customers are now no longer just passive consumers or purchasers of discrete mass-marketed products. Firms are now able to develop more long-term and interactive relationships with customers, and strive to do so.

However, the issue of the changing nature of work, and of 'unpaid work', is not relevant to consideration of corporate profits taxation. It is true that some digital economy firms aim to build a large user base, often on the basis of user-supplied content. This can lead to a firm establishing a large market presence and capital value, with low or even negative profitability. The users who supply content and other inputs often have free access to the application in question. The income derives from sales to customers, frequently of advertising. But the 'unpaid work' input does not itself generate revenue, it builds market share and therefore the capital value of the firm. It is therefore relevant to capital gains, and not profits. Profits still derive from sales to customers.

Nevertheless, it is clear that the ability to develop such customer networks in many countries worldwide is an important element of the value creation, and hence profits, of transnational corporations. It is taken a stage further when it occurs through digital networks, but firms such as Starbucks and MacDonalds can also be said to benefit from fostering longer-term and interactive relationships with customers, based on offering lifestyle products with universal appeal enhanced by branding. However, this customer loyalty cannot be attributed solely or even mainly to the design of a brand or logo. It is built up over a long period of successful selling to customers, as well as the appeal to customers of availability of a known and reliable product or service, in diverse locations worldwide. Similarly, the profits from sales of a pharmaceutical drug depend as much or more from its marketing, often involving close relations with clinicians and health services, as from its original invention and development. The profitability of such firms therefore results from their market presence and close relationships with customers worldwide.

The implications of this for international tax rules are that the traditional dichotomy between Residence and Source taxation is no longer valid. It is no longer the case that a firm based in state A can simply supply a product to a customer in state B as a one-off passive sale. Certainly, most such firms are transnational, in the sense of having an ultimate parent in a home country, but their worldwide market presence and continuous and interactive relationships with customers are key to their enhanced profitability. It is true, however, that firms which are more highly digital can more easily exploit these advantages under current tax rules, since they can have a major presence in a market without a taxable presence at all, i.e. without needing a Permanent Establishment.

#### **4. Implications for International Tax Rules**

The new elements introduced by the shift to a digital economy, which affects virtually all business sectors, require a reorientation of the international tax rules designed nearly a century ago. We concur with the mandate from the G20 to the OECD, asserting that:

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<sup>7</sup> See Colin-Collin report, *ibid*.

‘the existing 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’.

In our view, however, a more comprehensive approach is needed than the various points put forward in the BEPS Action Plan. It should by now be plainly evident that transnational corporations operate as integrated firms under central direction. They must therefore be treated as unitary firms for tax purposes. This entails reconsideration of the independent entity principle in tax treaties.

The concept of a permanent establishment, based on physical presence, also clearly needs revision. In our view, this should go further than seems to be suggested in the BEPS Action Plan. The problem is not simply one of ‘abuse’ of the concept: it needs to be rethought to meet the needs of the 21<sup>st</sup> century. At the minimum, the OECD should go back on the changes of 2008 and 2010 described as the new ‘authorized OECD approach’. This has not been accepted by developing countries, and is even rejected by some OECD countries. The long-standing concept that a subsidiary can be treated as a dependent agent and hence constitute a PE in appropriate circumstances should be restored, along with the previous article 7(4) of the model treaty permitting apportionment of the profits of a PE. The OECD should also go back on the revisions to article 5 of the Commentary to the model tax treaty, introduced in 2005, which specified that a website could not constitute a PE.

The G20 also expressed another mandate, the development of:

‘a common template for companies to report to tax administrations on their worldwide allocation of profits and tax’.

In our view this will be a major step forward towards enabling tax administrations to ensure that the tax paid in each country is commensurate with the real activities of the firm in that country. We consider that it is both necessary and possible to redesign the international tax rules to begin a transition towards treating transnational corporations as unitary firms. Our submissions on other consultations relating to the BEPS project will aim to show various ways in which this can be done. This is the only effective way to establish a sound foundation for rules which could ensure that profits are taxed ‘where economic activities occur and value is created’.



## The Consultative Committee of Accountancy Bodies-Ireland

Chartered Accountants Ireland  
The Association of Chartered Certified Accountants  
The Chartered Institute of Management Accountants  
The Institute of Certified Public Accountants in Ireland

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19 December 2013

Dear Sirs

### ***REQUEST FOR INPUT REGARDING WORK ON TAX CHALLENGES OF THE DIGITAL ECONOMY***

We refer to the above titled document. We propose to address one of the questions you raise, as per below, while looking forward to the public consultation to follow in the first half of 2014.

#### **A. NATURE OF WORK/ACTIVITIES UNDERTAKEN BY YOUR ORGANISATION**

***A.1. PLEASE DESCRIBE THE BACKGROUND OF YOUR ORGANISATION, INCLUDING THE NATURE OF THE WORK OR ACTIVITIES PERFORMED.***

This response is from a representative body.

The Consultative Committee of Accountancy Bodies – Ireland is the representative committee for the main accountancy bodies in Ireland. It comprises Chartered Accountants Ireland, the





Association of Chartered Certified Accountants, the Institute of Certified Public Accountants in Ireland, and the Chartered Institute of Management Accountants, which represent a combined membership of some 40,000 accountants. Brian Keegan, Director of Taxation at Chartered Accountants Ireland (brian.keegan@charteredaccountants.ie, +353 1 6377 347) may be contacted if any further details in relation to any points made in this submission are required.

*B.6. WHAT CHALLENGES DO DIGITAL ECONOMY PLAYERS FACE IN DETERMINING THEIR TAX LIABILITY FROM A CORPORATE INCOME TAX AND VAT/GST PERSPECTIVE?*

We note that the Action Plan on Base Erosion and Profit Shifting does not define “Digital Economy” but instead outlines a number of characteristics appropriate to it, including:

- an unparalleled reliance on intangible assets
- the massive use of data (notably personal data)
- the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and
- the difficulty of determining the jurisdiction in which value creation occurs

The Collin/Colin report<sup>1</sup> develops further the characteristic of the massive use of data by noting that digital economy consumers often provide free labour, perhaps by voluntarily inputting their personal data in connection with a purchase. Those authors maintain that the value of this “free labour” is not reflected in any tax system.

The principal challenge from a Corporation Tax perspective is derived from the last item on this list - to establish the country of residence of the company concerned, and hence the jurisdiction with tax charging rights. This challenge is not unique to companies within the digital economy. The thinking on this issue should not be clouded by its relative novelty. We suggest that one important facet of the work being undertaken should be to more clearly define the industries and entities involved when considering digital economy issues. There must still be recourse to the first principles of corporate residence as established by the domestic legislation of the countries concerned, Case Law, and the principles of construction of Double Taxation Agreements.

Among the established principles of Case Law are:

- Corporate residence is not always defined by the place of incorporation, but by the place of central management and control (cf *De Beers Consolidated Mines v Howe*, 5 TC 198)

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<sup>1</sup> Collin, P; Colin N *Task Force on Taxation of the Digital Economy* Paris, 2013



- There is a necessary distinction drawn between the place of central management and control of a company, and the location of its day to day operations (cf American Thread Co v Joyce 6 TC 163)
- The determination of central management and control is a question of fact (cf Unit Construction Co v Bullock 38 TC 712)

As the OECD Commentary on the Model Tax Convention has it, –

“the place of effective management’ has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.<sup>2</sup>”

These principles are well established and with good reason; they have served well. In particular, for those countries which are Member States of the European Union, they have constituted a critical part of the legislative infrastructure supporting both the free movement of services and freedom of establishment within the EU. It will be recalled that the European Commission Proposal for a Council Directive on a Common Consolidated Corporate Tax Base<sup>3</sup> sought to set many of these principles aside. At the time of writing it is unclear as to the acceptability of this Proposal, although it has been in existence for almost three years and the discussions predating it lasted for a decade before that again.

The tax challenges posed by digital economy entities may therefore not be derived from the core principles themselves, but rather how those core principles are to be applied. As far back as 1999, a position paper by the Irish Revenue Commissioners identified that the areas for examination include the concept of permanent establishment under the OECD Model Tax Convention and the characterisation of payments for digitised products. Since then, there has been much development in the thinking underlying these core concepts, both for Corporation Tax and VAT purposes. This development in thinking has to the credit of all concerned largely avoided any conflation of Corporation Tax and VAT issues; the former having mainly to do with producers, the latter to do with consumers. We would urge that these distinctions should continue to stay in sharp focus.

We suggest that a useful and pragmatic resolution of any of the ambiguities associated with the taxation of digital economy enterprises lies in the provision of guidance and consistent

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<sup>2</sup> Commentary on Article 4, at para. 24

<sup>3</sup> COM(2011) 121/4



*CCAB-I Input to OECD, December 2013*

application of existing taxing rights principles, rather than a restructuring of the legal principles underpinning them.

Central to such guidance and application is the recognition that in reality, there is no such thing as “international tax”. Taxes are paid to the competent authority of a National Government of a State by reference to the amounts which are subject to the taxing rights of that State, and levied at the rates charged by the State. Taxing rights are, in the vast majority of the developed countries, governed by the bilateral Double Tax Conventions and the majority of such Conventions are derived from the OECD model.

Yours faithfully

***Paul Dillon, Chairman, CCAB-I Tax Committee***



Chartered  
Institute of  
Taxation

Excellence in Taxation

8 January 2014

OECD  
BEPS Project  
Task Force on the Digital Economy

via e-mail: [CTP.BEPS@oecd.org](mailto:CTP.BEPS@oecd.org)

Dear Sirs

### **Tax Challenges of the Digital Economy**

In November 2013 you published a Request for Input Regarding the Work on Tax Challenges of the Digital Economy. This letter is in response to that request and, in particular, paragraph C asking for general comments.

We suggest that the first question that should be considered and answered is whether digital businesses are sufficiently different from non-digital businesses such that the OECD, and the international tax community, should support an approach enabling countries to tax them differently.

The factors that are important in making a corporation successful and profitable are many, varied, and evolve with time. Some businesses are asset rich, some employ many people, some leverage funds or take on risks, some are based on a single bright idea (of someone), and others are reliant on what products or services individuals want to buy or use. Globally businesses – digital and non-digital - have different combinations of each of these factors in each country in which they operate and business models are diverse and constantly evolving.

The position is complicated further as most digital businesses have some physical infrastructure or activities. Indeed, many traditional businesses have a digital element. For example, a retailer with physical stores may also have an online business. Newspapers, for a subscription, offer individuals a hard copy delivered to their homes together with an electronic copy on their notebook. It would be hard (if not impossible) to split the results of an integrated business into two parts, to enable the digital part to be taxed in a different way. So, in the event that the debate concludes that digital businesses should be taxed differently there are two further questions that must be addressed:

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UK REPRESENTATIVE BODY ON THE  
CONFEDERATION FISCALE EUROPEENNE

- When does a business become a digital business? and
- What position can or should be taken in relation to those countries that decide they should levy tax on a different basis?

We suggest that digital businesses are not sufficiently different from non-digital business to merit a distinct set of tax rules. There may be specific issues around permanent establishments (PE) and profit attribution, but these are capable of resolution by existing law and principle.

That said, any changes to the definition of PE based on recognition of a new kind of 'digital' PE which lowers the threshold of what constitutes a PE should be approached with caution. Any changes should only be adopted once there has been full consideration of the impact on a full range of businesses. This is an area where, without due care, there is scope for many countries to claim taxing rights over the same profits, resulting in double taxation.

Similarly, any change to the methodology under which profits are allocated to a PE, to incorporate as a factor, for example, the customers or market place, needs very careful consideration. The UK, the OECD and a large part of the international tax community have endorsed the separate entity approach, together with the transfer pricing guidelines, and the latter's increasing focus on Significant People Functions. An approach based on global formulary apportionment has been rejected, and even in Europe between those countries that wish to adopt the CCCTB, the formula for apportioning profits continues to be debated. It is hard to see these two approaches to tax the profits a multinational group of companies as anything other than mutually exclusive.

A significant issue with any new approach will be the bilateral nature of treaties. With the recent revisions to the business profits articles, we already have a situation where a PE in one country could be treated for tax purposes as earning more profit than the company of which it is a part earns. If there is a lowering of the PE threshold and scope for multiple countries to claim there is a PE, some form of multilateral mutual agreement facility may well be needed. By their very nature tax treaties are bilateral instruments and should several countries be able to contend that a PE exists, some form of order will need to be established.

We are at best at an intermediate stage in the development of the digital economy. The first phase of selling things previously sold physically to selling them online (either through online stores, or more fundamentally in the case of e-books, iTunes music, streamed services etc) has progressed to a second phase where companies are selling distinct digital products such as music subscription services (for example where you are sent a selection of music every month). However, these are still 'creator driven' products. It is not currently possible to know whether there will be further progress into a third digital phase of consumer led products: where consumers effectively monetise their own 'digital signatures'.

We do not think at the moment that it is possible to reliably measure network effects. Networks offer a platform for selling advertising and subscription services, but do they create value between participants? Although data is an important aspect of digital businesses, data itself has no intrinsic value. Value is created by properly analysing data, and knowing what data to throw away.

There is a danger of assuming the digital economy is moving into a more consumer led environment and designing a tax system with that in mind – only to find the digital economy goes in a different direction altogether.

Digital technology has definitely removed certain stages/items from the supply chain: for example, it is no longer necessary to capture music in a physical form to distribute it. However, whilst this change may have resulted in some taxing opportunities to be lost, it is not a reason to necessarily create new ones, when fundamentally the supplier/customer relationship is still the same.

The development of digital technology has altered the relationship between supplier and customer. Notably, there is now often an on-going relationship because the customer expects the supplier to retain a copy of the information supplied (in perpetuity) and provide updates etc. Thus the relationship does not end at the time of a single point of sale of a physical product. However, it is still a relationship based on the delivery of valuable content (whether physical or digital) and remains fundamentally the same.

Consequently, we do not think the digital economy is at a point which demands a re-write of the tax system. As mentioned above, specific issues around PE and profit attribution can be resolved by existing law and principle.

Yours sincerely

Glyn Fullelove  
Chairman, International Taxes Sub-Committee

cc: Zoe Leung-Hubbard, UK Government HM Treasury – [zoe.leung-hubbard@hmtreasury.gsi.gov.uk](mailto:zoe.leung-hubbard@hmtreasury.gsi.gov.uk)

### **The Chartered Institute of Taxation**

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

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

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

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By email to [CTP.BEPS@oecd.org](mailto:CTP.BEPS@oecd.org)

19 December 2013

Our ref: BD/AL

Dear Sirs

## Request for Input Regarding Work on Tax Challenges of the Digital Economy

Thank you for the opportunity to provide some general comments on some of the business models that we see employed by businesses in the digital economy, and the approach to addressing the tax challenges of the digital economy.

There is no clearly defined and separate digital economy. Instead, there is integration of digital models into traditional businesses and also the evolution of wholly digital business models. For example, digital retailers may often benefit from having a physical presence as well, where consumers may try out or look at products before choosing to buy online. In these circumstances there needs to be recognition (most likely through appropriate application of transfer pricing and the arm's length principle) that lower sales in store are enabling higher online sales.

There are many variations of business model and approach, and it is very hard to make general statements as to how businesses operate. There are also many factors influencing how businesses choose to structure their operations, such as access to markets, access to skills and resources, infrastructure, regulation, legal protection, business and tax environment, political stability etc. For digital businesses that have more freedom than those in other industries in deciding where to establish operations, all such factors will be important but will have various weighting depending on individual business circumstances and objectives. The challenge for the OECD/G20 will be in designing tax principles that deal with the inevitability of digital business models having a smaller number of locations to deliver a wide choice of services and products, enabled by technology. It is worth noting here that the locations of developers and content providers will be broadly the same as for non-digital businesses and any tax system should attempt to value and tax such contributions on the same basis. It is also important to recognise the value produced, for some digital business models, by the interaction between the business and the consumer, referred to as 'the network effect' in some discussions.

Digital businesses and models continue to evolve with advances in technology, and it is essential that there be flexibility in taxation (and regulatory) models to accommodate changes. In particular, it remains important that the digital economy is allowed to continue to flourish and, through its growth, provide benefits to the global economy.

There are three business models that we have prioritised for consideration, each of which poses different challenges: high frequency trading, cloud computing services and advertising models. We have set out some thoughts on each of these in the attached appendix, responding to questions A to B.6. of the request for input. Questions B.7. and C are covered separately at the end of the appendix.

If you wish to discuss any of the points raised in this letter, please do not hesitate to contact either me ([bdodwell@deloitte.co.uk](mailto:bdodwell@deloitte.co.uk)), or Alison Lobb ([alobb@deloitte.co.uk](mailto:alobb@deloitte.co.uk)).

Yours faithfully

A handwritten signature in blue ink, appearing to read 'WJI Dodwell', is positioned below the 'Yours faithfully' text.

**WJI Dodwell**  
**Deloitte LLP**



## APPENDIX

### High frequency trading

#### **A. Nature of work/activities undertaken**

The first model relates to high frequency trading. Under this business model, complex algorithms run on servers located remotely from traders and the algorithm developers.

This issue combines the 'remote' part of the digital challenge – there need not be any personnel in the country of the server where the trading takes place. At the same time, it also incorporates the 'location specific' issue, in that the business advantage from proximity to the Exchange gives the location additional value over and above alternatives.

Some countries, including the UK, currently take the view that a server cannot of itself constitute a permanent establishment (see for example the UK tax authority's published guidance at <http://www.hmrc.gov.uk/manuals/intmanual/INTM266100.htm>). Not all G20/OECD member states agree with this interpretation. As a general principle, it would be helpful for there to be one agreed view from countries on points like this, in order to minimise opportunities for tax arbitrage or double taxation.

#### **B. Impact of information and communication technology on the activities of the organisation**

*B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.*

The algorithms set parameters for the trades, and the computers therefore buy and sell within these parameters. The volume of trading is extremely high, and speed of trading is one of the key advantages of using computer algorithms rather than human activity. This advantage outweighs downside risks such as mistakes in the algorithms leading to losses (which are minimised by automatic shut-down and other monitoring).

Because of the importance of speed in making the trades, the location of the server conducting the high frequency trading adds significantly to the value of the business. For trading, the closer the server is located to the Exchange, the smaller time gap ('latency') for completion of transactions. Where high-frequency trading is being undertaken remotely via complex algorithms (that may or may not have been developed in the country where the server and Exchange are situated) the proximity to the server makes all the difference between transactions being completed at the bid/offer price, or others being able to close out the transactions first.

*B.2 How do these models leverage new technology to change organisational structures and supply chain?*

The advantages of high-frequency trading are wholly dependent on technology. In addition, proximity to the Exchange provides a competitive advantage currently for traders who are able to locate there.

*B.3. In each of the business models identified, what assets and activities contribute to the generation of value?*

The assets are servers, infrastructure (eg fibre optic cables), computers, and intangibles such as algorithms (which may be protected as intellectual property or business secrets in the form of know-how). Capital is also required for the trading activities.

The activities are writing and developing the algorithms, writing 'shutdown' programmes to prevent fast-accruing losses and monitoring the operation of the algorithms for unusual activity. There will also be computer and server set up and maintenance activities. In some countries and circumstances there will need to be activities to ensure compliance with regulation, e.g. obtaining a licence for trading.

*B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?*

High frequency trading has enabled traders to take advantage of small variations in price where humans are too slow. Technology has enabled trading without the presence of people close to the Exchanges.

*B.5. How have changes in underlying business models impacted the way in which business is organised as a legal or tax matter?*

High-frequency trading models are driven by the commercial advantages from technology. However, there are requirements for servers to be in specific locations, and as discussed some countries do not treat a server as a permanent establishment.

*B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?*

There are challenges in determining whether or not the server and the trading activities constitute a permanent establishment under domestic and treaty provisions. There are also transfer pricing issues in determining arm's length pricing of the trading activities vs. say, the reward to the algorithm developers and others in the global value chain. There may also need to be a value attributed to capital used to finance trading activity.

If a server does create a permanent establishment for the high-frequency trading activity, then normal transfer pricing principles will operate to allocate profit on an arm's length basis, depending on all facts and circumstances. Where the location of the server is a key value driver, this will entail more profit being recognised in the server location than for other businesses operating through a remote server. There remains of course the need to remunerate adequately the location of the algorithm developers, providers of capital and other aspects of the value chain on an arm's length basis.

## Cloud computing services

### **A. Nature of work/activities undertaken**

A separate issue that potentially arises in relation to servers is where the server space is provided to a third party or a 'fragmented' related party business, and the third party conducts business through the server. This issue is likely to become much more significant

### **B. Impact of information and communication technology on the activities of the organisation**

*B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.*

One consideration in relation to cloud computing services is the extent to which the business model requires servers to be located close to key markets, for example as a result of regulatory requirements or ensuring speed of delivery to consumers. This may, if true, mean that server location is a useful starting point for consideration of nexus and creation of a taxable presence in the local market. However, this is likely to vary from business to business depending on factors such as volume, size and type of content being transferred, geography (e.g. countries bordering one another), legal and/or regulatory constraints and infrastructure (e.g. quality and number of fibre optic cables). Other technologies, such as content delivery networks (CDNs), may in some circumstances be used to help offset the fact that end users are not located near to the point of origin of the services.

It is not possible to predict how this may change over the medium and long term as technology and infrastructure developments make transfers more straightforward.

*B.2 How do these models leverage new technology to change organisational structures and supply chain?*

The advantages of cloud computing are varied but are largely driven by economies of scale in setting up the infrastructure and then maximising server usage by offering sharing of the space amongst clients who need more or less space on a flexible basis. There are also services offered in relation to secure data handling and storage.

*B.3. In each of the business models identified, what assets and activities contribute to the generation of value?*

The assets are typically clusters of interconnected servers requiring space, and associated facilities such as temperature control (important to prevent servers overheating). There will also need to be access to infrastructure (e.g. power supply and fibre optic cables). Depending on the business model and the types of cloud services offered, there may also be intangible assets such as software protected under intellectual property law.

The activities required will vary, but will include design, installation and maintenance of servers and data connections, monitoring of efficient utilisation of server space, developing software and associated computer programming. There will also be sales and marketing activities to sign up customers to the cloud providers' services (which may take various forms, e.g. subscription or payments for one-off content access).

*B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?*

Technology has enabled the remote provision of software and content services to business customers and consumers in a technologically convenient and efficient manner.

*B.5. How have changes in underlying business models impacted the way in which business is organised as a legal or tax matter?*

Cloud computing enables software and other hosting services to be supplied remotely.

*B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?*

One key challenge that arises in the current international tax system is around the characterisation of payments for software etc., and whether these are royalties or ‘technical services’, and potentially subject to withholding tax. Treatment varies among OECD and G20 countries. Withholding taxes on royalties cause a number of practical problems for businesses, and as such an expansion of the classification of royalties or increase in withholding tax rates does not appear to be a practicable or useful solution to issues around the digital economy. Some of the issues that arise are:

- Taxes at the gross income level do not adequately take into account profitability, and can act as a deterrent to international trade by making expansion uneconomic;
- Responsibility for collection of the withholding tax rests with the payer even though the withholding tax is borne by the recipient. In areas of complexity, such as whether a payment is a royalty under the appropriate treaty, the tendency is for payers to deduct withholding tax as a matter of precaution against penalties or interest.
- As a result of the above, recipients of royalties may try to seek gross-up clauses in commercial agreements to push the burden for the withholding tax onto the payer in the source country.
- These issues are difficult to deal with within multinational groups but are even more so between third parties, and there are significant levels of royalties or payments for software etc between unrelated parties in normal commercial business or consumer relationships. The compliance burden is magnified between third parties.

On balance, it seems to us that having a server location create a permanent establishment is the most appropriate interpretation, and having established a taxable nexus the facts and circumstances of each value chain will determine whether there are location-specific factors that increase the value attributable to the server location. If not, the server location will constitute merely a low value cost-plus service (in which case any third party cloud services fee may adequately remunerate the location for the services provided).

As remote activity gets more sophisticated, there is also a question of the value created by the server compared to the value of the programmers remote from the server location, and whether the low-cost service provided by the cloud provider adequately remunerates the server-location country. In this scenario, there remains a question of whether the server’s location is intrinsic to the cloud user’s business model.

There are also challenges around VAT/GST, including compliance questions arising out of changes in 2015 to the place of supply of services for VAT within the European Union.

## Advertising models

### **A. Nature of work/activities undertaken**

There may be merit in considering a separate approach for online businesses that rely on advertising income models. In such business models, websites and information or tools are provided free to consumers over the internet, and income is received from third parties in the form of advertising revenues.

It would be difficult, perhaps too difficult, to establish a boundary to limit changes to 'dominant' businesses that rely on a global network, as this will vary from country to country and business to business, and businesses that may be categorised as dominant today may not be in the future as new technologies develop.

### **B. Impact of information and communication technology on the activities of the organisation**

*B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.*

Under the advertising model there are two transactions: one that is free between unrelated parties (consumer and the global business), and one that is paid for between unrelated parties (the global business and, often local, advertisers).

*B.2 How do these models leverage new technology to change organisational structures and supply chains?*

The technology used will vary from business to business, but will typically involve, information, tools, calculators etc. hosted on websites that are accessible and useful to consumers. For some businesses the value is greatly increased by having global or near global coverage.

*B.3. In each of the business models identified, what assets and activities contribute to the generation of value?*

The assets will vary by industry and business but will often involve electronic tools or products such as search engines, free information or guides, calculators etc. These products may be based on complex algorithms that may be protected as intellectual property. Significant computer servers may be required to support the electronic tools or products (with similar needs to cloud computing), as well as access to infrastructure such as cabling etc. It may be important for this infrastructure to give as much global coverage as possible.

Activities required will vary, but are likely to include developing, maintaining and updating the information, tools or algorithms, design, installation and maintenance of servers, software and infrastructure, and sales and marketing activities to encourage advertisers to sign up to advertising space.

*B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?*

The global reach of the internet has encouraged advertising models based on consumer reach rather than direct payment.

*B.5. How have changes in underlying business models impacted the way in which business is organised as a legal or tax matter?*

Advertising models are driven by the commercial requirements. There are practical considerations as to whether local market sales and marketing activity is required.

*B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?*

We do not consider that there is any meaningful, principled way of taxing the free transaction (between the business and the consumer) where there is an obvious question of valuation of something that is given freely between unrelated parties.

However, there is a challenge in finding a suitable principle for determining that local advertising revenues are attributable to the local market country. In some circumstances there may be local marketing activity that is not sufficient to create a permanent establishment of the contracting entity under current fixed place of business or agency permanent establishment concepts and guidance.

Where the entire value chain is dependent on advertising revenues, changes to the permanent establishment rules could ensure that local marketing activity could be sufficient to create a taxable presence for attribution of advertising revenues. Any such change would be a departure from existing principles which look for the location of people and property to determine the existence of a taxable presence. The principles underlining why digital advertising might be treated differently to other digital activities would need to be set out clearly, with clear boundaries from other digital activities.

There will be separate questions concerning the attribution of value to advertising revenues treated as pertaining to the local country, vis-à-vis value for the creation of intangibles, data algorithms, investments in technology etc., and in particular how (or if) this will be related to third party pricing.

*B.7. How do you see business models and supply chains evolving in the future due to advances in information technology?*

Any new taxation model needs to be sufficiently flexible and open to permit business models to continue to evolve.

## **C. Other comments**

*C.1. Please provide any other comment you may have regarding Action 1, including and additional information that you would consider useful in identifying the challenges that the digital economy poses for the application of existing international tax rules.*

### **Compliance**

One of the concerns for business on potential changes to allocation of taxing rights in relation to digital business is how this will effect tax compliance management. It would be helpful for there to be appropriate de minimis limits for creation of a permanent establishment (as there are for other areas of the permanent establishment definition, such as the time limits for construction or installation projects) so that there is appropriate compliance for significant activity (including recurring activity) without restricting small, one-off trading activities in other countries.

## Regulation

For some companies operating digitally, regulatory requirements already play a large part in compliance costs and business models (e.g. for financial services). It would be useful if, wherever possible, tax requirements could be aligned with regulatory ones.

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Sydney  
Taipei  
Tokyo  
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& Africa  
Abu Dhabi  
Almaty  
Amsterdam  
Antwerp  
Bahrain  
Baku  
Barcelona  
Berlin  
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Budapest  
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Casablanca  
Doha  
Dubai  
Dusseldorf  
Frankfurt/Main  
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December 23, 2013

Mr. Pascal Saint-Amans  
Director, Centre for Tax Policy & Administration  
Organisation for Economic Co-operation and Development  
2, rue André Pascal  
75775 Paris Cedex 16  
France

Re: Response to Request for Input Regarding Work on Tax Challenges of the Digital Economy

Dear Mr. Saint-Amans,

On November 22, 2013, the Task Force on the Digital Economy (the "Task Force") released a Request for Input Regarding Work on Tax Challenges of the Digital Economy (the "Request"). We are writing to provide the specific input of the Digital Economy Group, described below, in response to the Request.

We recognize that the Action Plan on Base Erosion and Profit Shifting imposes on the Task Force an ambitious mandate to formulate within a short period of time options to address the "difficulties that the digital economy poses for the application of existing international tax rules". We thank the Task Force for the opportunity to provide input on the digital economy and hope that our input will assist the Task Force in developing these options.

### **A.1 Nature of Work / Activities Undertaken by Your Organisation**

The Digital Economy Group is an informal coalition of leading U.S. and non-U.S. software, information / content, social networking, and e-commerce companies that provide goods or services through digital and nondigital means. Our members pursue a wide range of businesses on a global basis, including:

- Developing, marketing, and selling business- and consumer-oriented search, advertising, hardware, software, cloud, and infrastructure solutions;
- Creating on-line platforms through which consumers and businesses interact to share information, enjoy entertainment, and network;
- Retailing goods and services and providing on-line marketplaces through which consumers and retailers can transact;
- Providing subscription-based and free content to consumers and businesses;
- Providing on-line platforms through which consumers and businesses can create and make available content and software;

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- Providing hosting services for consumers and businesses.

While all of our members provide at least some part of their goods and services through digital means, some operate exclusively through digital delivery methods while others operate a combined model.

### **B.1 Detailed Description of the Business Models that Have Emerged in the Context of the Digital Economy Due to Advances in Information and Communications Technology**

The recent public discussion of the digital economy has focused heavily on high-profile cases involving two specific business activities: remote sales and on-line advertising. In a remote sales business, a nonresident enterprise sells goods and services to consumers over the internet. In an on-line advertising business, a nonresident enterprise makes free content and services available to users and hosts paid advertisements to be viewed by those users. Remote sales and on-line advertising businesses indeed use the internet to communicate with users and suppliers, but they do not define the boundaries of the digital economy. Properly construed, the phrase, "digital economy", describes all businesses that use digital communications technologies to enhance or otherwise improve their internal operations or their external offerings to customers. These digital communications technologies include e-mail, which is now ubiquitous in all sectors, the development and deployment of website hosting technology to allow the use of web pages to advertise goods and services and to transact with suppliers and users, remote hosting of data which can be accessed internally by employees of the enterprise or externally by suppliers and customers, and bandwidth capacities that allow transmission of large volumes of data and content.

We assume that the purpose of this first question is to identify certain types of businesses that offer their goods and services principally, or exclusively, through digital means, and perhaps constitute business sectors that are principally occupied by newly emerging companies. It certainly is possible to describe a variety of business sectors that have appeared recently, and whose emergence has been facilitated by the efficiency of internet communications. Examples would include the following (among many others):

- Companies facilitating the "sharing economy", including personal services, transportation, and other shared use of resources;
- On-line platforms facilitating transactions between remote buyers and sellers, including those focusing on B2B transactions which facilitate the acquisition of supplies or components, financial transactions, and the like;
- Distributors of paid or free content that can be delivered digitally, including news, information, entertainment, and scientific research;
- Platforms which provide software functionality to remote business and consumer users; and

- Platforms that aggregate data, including review sites, social networking sites, and many other types of data or information, supplied under both paid and free models.

Many of these enterprises are newly emerging enterprises, and since they use the internet as their principal method to deliver goods and services, including communicating with users and suppliers through hosted web pages, they are referred to as "pure play" digital companies.

We believe that a focus on pure play digital companies, however, may distract the Task Force from an appreciation of the fact that enterprises across an extremely wide spectrum of industries have capitalized on the efficiencies of digital communications models. In some cases, an enterprise will adopt a distribution channel that is very much like a "pure play" digital company, perhaps in parallel to its traditional distribution method. For example, universities now offer entire degree programs on-line, and many traditional retailers have created a parallel on-line presence. In other cases, established enterprises adopt the efficiencies of digital communications to make their existing business operations more efficient. Examples of this would be banks which use the internet to process financial transactions around the world in real time, and heavy manufacturing enterprises which use digital communication tools to improve production line and supply chain efficiencies. In still other cases, enterprises use efficient communications technologies to outsource business functions to lower cost or more efficient providers. These examples all may involve cross-border transactions that are enabled by digital communications, just as pure play digital enterprises are able to offer their goods and services to remote users. In fact, given that digital communication resources are available to all enterprises worldwide, businesses in many sectors are finding it essential to adapt their business to digital communications models simply to remain competitive.

We also note that the public discussion of the digital economy has given the impression that digital companies are a U.S. phenomenon when, in fact, the universe of digital companies is characterized by wide geographic diversity. Red Herring, a global media company, recently released its list of this year's top 100 technology startups around the world based on criteria that include "IP in the solution created through internal R&D", "disruptiveness of the solution in its respective markets", "growth rate", and "international footprint".<sup>1</sup> As the list shows, the top 100 technology startups exhibit significant geographic and business sector diversity, with more than half of the startups based outside the United States. Moreover, the top technology startups are spread widely around each particular geographic region, such as Europe. By way of illustration, Red Herring's list of this year's top 100 technology startups in Europe contains a number of enterprises from larger European countries, such as Anatole, a French enterprise that focuses on telecommunications management solutions, Parstream, a German enterprise

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<sup>1</sup> <http://www.redherring.com/events/red-herring-global/rhg2013winners/>; <http://www.redherring.com/top-100/>.

that focuses on big data analytics, and Sefaira, a U.K. enterprise that develops software for high-performance building design.<sup>2</sup> At the same time, the top 100 technology startups in Europe also include enterprises from smaller countries, such as Sievo, a Finnish enterprise that focuses on procurement software solutions, Phinergy, an Israeli developer of zero-emission, high energy-density systems based on metal-air energy technologies, and Evmanya, a Turkish home and decoration e-commerce site. On a global level, leading startups are truly found around the world, with startups such as Tiger IT Bangladesh Ltd., a Bangladeshi software development enterprise, and Transterra Media, a Lebanese on-line media enterprise, emphasizing that innovation in the digital economy is taking place around the world.

Furthermore, the "hottest" pure play digital companies may be emerging outside the United States.<sup>3</sup> We set forth below examples of some of the leading non-U.S. pure play digital companies.

#### E-Commerce

- The China-based Alibaba Group owns China's two largest e-commerce platforms, Taobao Marketplace and Tmall. In 2012, Taobao and Tmall handled \$153 billion in transactions. If Tmall sustains its growth, Tmall is expected to overtake Amazon in 2015 to become the world's largest internet retailer.<sup>4</sup>
- The Argentina-based MercadoLibre is said to "dominate[] e-commerce" in Latin America.<sup>5</sup> In 2012, MercadoLibre had nearly 66 million registered users and listed an average of nearly 11 million products for sale daily.<sup>6</sup>
- Rakuten, Japan's largest on-line retailer, continues to engage in cross-border acquisitions in an effort to best its non-Japanese rivals, such as Amazon.<sup>7</sup>
- Vente-Privée, the French on-line retailer that "sells luxury fashion, wine and music at steep discounts to its 19 million European members in 'flash sales' that last three to five days", is said to "dominate" Europe.<sup>8</sup>

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<sup>2</sup> <http://www.redherring.com/events/red-herring-europe/2013-red-herring-europe-top-100-2/>.

<sup>3</sup> Glenn Solomon, *The Hottest New Internet Companies Are Growing Up Outside the U.S.*, Venturebeat.com (Oct. 24, 2011).

<sup>4</sup> Eileen Yu, *Asia's E-Commerce Sites Can Outsell Amazon*, ZDNet.com (Dec. 8, 2013).

<sup>5</sup> Richard McGill Murphy, *MercadoLibre: How It Rules the Latino Internet*, Cnn.com (May 9, 2012).

<sup>6</sup> *Id.*

<sup>7</sup> Jay Alabaster, *Japan's Rakuten Continues Amazon Pursuit, Will Buy US Logistics Firm*, Pcworld.com (June 6, 2013).

<sup>8</sup> Dominique Vidalon & Pascale Denis, *Flash Sale Pioneer Vente-Privée Eyes Smartphone-Driven Boom*, Reuters.com (Oct. 8, 2013).

### Social Networking

- Tencent QQ, a Chinese instant messaging platform, claims 800 million monthly active users and serves as a "jumping off" point for a number of other popular networking sites, such as WeChat, a Chinese messaging application that rivals Twitter in terms of the number of its users.<sup>9</sup>
- VKontakte, Russia's most popular social media network, offers profiles, messaging, photo sharing, and a "like" button to its reported 100 million monthly active users.<sup>10</sup>

### Streaming Media

- Spotify, a Swedish enterprise, provides streaming music services to 24 million active users in 55 markets worldwide.<sup>11</sup>

### Search Engines

- Yandex, a Russian search engine, is the world's fourth-largest search engine and controls 60 percent of the Russian search market.<sup>12</sup>

As the examples above show, non-U.S. pure play companies control a significant share of the global e-commerce, social networking, streaming media, and search markets. We expect that the non-U.S. pure play companies will considerably increase their share of the global market in the coming years, as entrepreneurial skill and experience in these sectors grows around the world.

In addition, we note that the Request seeks input on business models that "have emerged" in the context of the digital economy. In many cases, the new enterprises that "have emerged" are not really new business models, but instead are more efficient ways of delivering goods and services of the sort that consumers and businesses demand. The novelty of the digital economy thus lies more in the conversion of existing business activity to delivery methods that allow more direct communications with users through digital and other technological means.

To demonstrate this point, it is useful to observe that many pure play enterprises have direct analogues in the pre-digital economy. Examples of these pre-digital analogues include the following:

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<sup>9</sup> Ryan Holmes, *Foreign Social Networks Take on Facebook*, Businessinsider.com (May 18, 2013).

<sup>10</sup> *Id.*; Helen A.S. Popkin, *Meet the Four Social Networks Bigger than Facebook (in Some Countries)*, Nbcnews.com (Jan. 3, 2013).

<sup>11</sup> Dana Kerr, *Spotify's Mobile Users Skyrocket Since Free Streaming Launch*, Cnet.com (Dec. 19, 2013).

<sup>12</sup> Clay Dillow, *Yandex Searches Past Its Language Barrier*, Cnn.com (Nov. 13, 2013).

- Radio and television, which fund free programming through fees from advertisers and sponsors, preceded advertising-supported free content.
- Mail-order catalogues, which sold goods to customers across borders, preceded on-line retail platforms.
- Newspapers, magazines, and similar paid media preceded subscription information aggregation sites.
- Product test marketing, the Nielsen rating system, customer research to attract advertisers, and other similar activities preceded data collection regarding on-line user behavior.

It is also important to note that many of these pre-digital economy analogue enterprises have responded to the competitive pressures by making their own businesses more efficient. In many cases, they have made their products and services available through similar channels. Globally, many of the leading internet websites in terms of user traffic are hosted by traditional media companies. Remote sellers which used to rely on paper catalogues supplement their paper catalogues with on-line catalogues. For example, the French company La Redoute, which began selling to customers using mail-order catalogues in 1928, is now considered the leading on-line fashion retailer in France.<sup>13</sup> In addition, major retailers adopt on-line strategies to supplement their in-store sales.

For both pure play and other enterprises, digital communications efficiencies find their antecedents in other communications innovations: telegraph, telephone, radio, television, and telefax. These communications technology innovations also enabled enterprises to deliver goods and services in a more efficient manner. Internet communications technology is different from these antecedents principally in the wide variety of manners in which it can be applied.

That said, we believe that it is useful to identify various business attributes that are the principal features of enterprises which have adopted digital technology. These business efficiencies may be captured by both pure play and other enterprises.

#### 1. Customer and supplier interaction by enterprises

Enterprises with important supplier and customer relationships may use communication technology to interact and transact with suppliers and customers on a real-time, and sometimes automated, basis, regardless of the supplier or customer location. This allows the enterprise to expand its commercial relationships across borders, and increases efficiencies as a result of the real-time communications.

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<sup>13</sup> Press Release, *La Redoute Turns to ChannelAdvisor for International Expansion*, Wsj.com (Dec. 5, 2013).

2. Market information available to consumers about product and service offerings

Enterprises that engage in customer-facing activities are finding that the efficiency of internet communications goes two ways. Consumers have access to greater market information due to the increased visibility of competitor offerings on-line. Consumers now are accustomed to having access to a wider variety of sellers which offer a wide variety of high-quality products and services, since consumers are no longer limited to transactions solely with local suppliers. As a result, consumer oriented enterprises face more intense competition for a particular customer base, including from enterprises located outside the customer's jurisdiction. This phenomenon is most notable in price competition, as consumers are able easily to compare prices of competing offerings.

Consumer receptivity to new product offerings is one of the reasons that we expect the non-U.S. pure play companies to increase substantially their global market share in the near future. Consumers are now alert to new product offerings, and are willing to switch their purchasing preferences when superior offerings emerge.

3. Efficiency savings

A principal goal of adopting digital communications technology is to achieve cost savings through greater efficiency. Accordingly, enterprises that are in industries with active competitors place a premium on continuously developing and using technology to reduce costs and improve the productivity of procurement, manufacturing, distribution, and customer support processes. The cost reduction and improved processes ultimately yield improved customer offerings and lower prices for both businesses and consumers.

4. Competitive pressures

The internet is available to any enterprise that wishes to access it. Accordingly, no enterprise that secures a cost advantage by virtue of adopting internet-based efficiencies can exclude competitors from doing the same. Enterprises that rely on these efficiencies for a competitive advantage are subject to significant competitive pressures, as other enterprises also are free to exploit that resource.

Pure play enterprises are subject to unique competitive pressures based on the fact that the cost of entering such markets is relatively low, and users frequently incur no costs to switch providers. The enterprises necessarily must place strong emphasis on rapid innovation to establish differentiation in the market. In some cases, enterprises may invest heavily in internal research and development in an effort to continuously improve their products. In other cases, enterprises may emphasize marketing-oriented innovations in an effort to remain competitive.

Enterprises that rely on technology for a competitive advantage face the competitive reality that their technology and operating systems must be updated continuously. The life of technology is short.

## **B2. How Do These Models Leverage New Technology to Change Organisational Structures and Supply Chains?**

We believe that three significant impacts of digital communications technology are to increase efficiencies in supply chains, to allow emerging enterprises to have global reach, and to flatten management structures.

### **1. Supply chain efficiencies**

The digital communications model results in supply chains that are more efficient from both a procurement and a distribution standpoint.

On the procurement side, enterprises are able to communicate more effectively with suppliers. Enhanced communication reduces costs at many stages of the procurement process, including design, production, quality control, and shipping. Enhanced communication reduces the risk and uncertainty otherwise inherent in procuring from remote (or nearby) suppliers. On the distribution side, increased efficiencies of course are most pronounced for pure play or mixed model enterprises that supply digital goods and services. Realizing these efficiencies by avoiding distribution costs allows enterprises to devote more of their resources to activities that create value for customers. For enterprises that supply digital goods and services, the quality of technological innovation and business acumen often separates successful and unsuccessful enterprises.

A wider range of enterprises realizes marketing efficiencies through having access to more useful customer information. Enhanced two-way communications and the ability to structure and analyze customer data allow enterprises to make informed decisions to improve the functioning of their supply chains. For example, if data shows that customers of a particular profile prefer a particular good or service, an enterprise can devote resources to refine its product or service offering to such customers.

Supply and distribution chain efficiencies produce economic gains across multiple jurisdictions. In the supplier jurisdiction, suppliers are able to more efficiently access remote markets. The growth of export-oriented manufacturing and service sectors in lower cost jurisdictions has been materially enhanced by these efficiencies. In the customer jurisdiction, customers are able to purchase goods and services at a lower cost from enterprises that reduce inefficiencies. The economies of both the customer and the supplier jurisdiction are thus likely to enjoy the multiplier effect of more available wealth for reinvestment or consumption.

### **2. Global reach**

Digital communications models allow emerging companies to operate on a global scale from day one. A travel services company based in the United Kingdom may hire coders located in multiple jurisdictions, all of whom collaborate on a single product through the cloud. The travel services company may then use an on-line resume database to locate representatives in jurisdictions around the world, with whom the U.K. management team

communicates using Voice over Internet Protocol and who use an on-line version of the software that the coders develop. The representatives, the coders, and management may rarely meet one another physically. Examples of so-called "micromultinationals" include:

- Viewdle, "a Kiev-based startup that uses facial-recognition technology to search for tagged individuals in video files". Viewdle obtained capital from the United States, developed technology in the Ukraine, and hired engineers in Uruguay.<sup>14</sup>
- Local Motors, an automotive design enterprise with 12,000 freelance designers from 121 different countries.<sup>15</sup>
- WorkEtc, a business management enterprise with its company headquarters in Australia, development teams in China and Romania, chief technical officer in Malaysia, local support in the United Kingdom, the United States, and New Zealand, and dedicated sales team in the United States.<sup>16</sup>

Digital communications models greatly reduce the capital barrier to entry into the global economy for even the smallest businesses. Furthermore, in contrast to some of their larger counterparts, micromultinationals are also better able to leverage technology to offer to consumers and businesses around the world a wider array of products and services at a lower cost. These companies are "born global", with the business ambition to expand their scale as they are able to make customers aware of their offerings.<sup>17</sup>

### 3. Management structures

Organizational structures of enterprises that employ the digital communications model tend to be flatter - i.e., less hierarchical - because the value of digital economy enterprises lies in "knowledge workers" and the technology and processes they create. Examples include software engineers, product developers, and personnel who have a deep understanding of markets across jurisdictions. Enterprises place a premium on knowledge workers because the market for technology-enhanced offerings demands rapid and continual improvement in the functionality of the service and product offerings. To avoid falling even one feature behind, and to deal with increasing challenges of scale, enterprises must invest in and retain talent to continue to develop their technology.

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<sup>14</sup> Marcia Stepanek, *Micro-Multinationals Rising*, STANFORD SOCIAL INNOVATION REVIEW (May 14, 2010). Google reportedly acquired Viewdle in 2012.

<sup>15</sup> Ann Mettler & Anthony D. Williams, *The Rise of the Micro-Multinational: How Freelancers and Technology-Savvy Start-Ups Are Driving Growth, Jobs and Innovation*, LISBON COUNCIL POLICY BRIEF, v. V, no. 3 (2011).

<sup>16</sup> Suzanne Lucas, *What if Your 16 Employees Resided in 7 Countries?*, INC.COM (May 17, 2013).

<sup>17</sup> The "born global" description apparently dates from a McKinsey study published in 1993. See Stoyan Tanev, *Global from the Start: The Characteristics of Born-Global Firms in the Technology Sector*, TECHNOLOGY INNOVATION MANAGEMENT REVIEW 5 (Mar. 2012).



Similarly, to understand customer behavior, enterprises must retain personnel who can access and synthesize information about local market preferences.

### **B.3 In Each of the Business Models Identified, What Assets and Activities Contribute to the Generation of Value?**

Labor, capital, and innovation drive value in enterprises that exploit the efficiencies of digital communications. This is no different than for any other enterprise operating in a competitive market.

Compared to many other enterprises, a pure play digital enterprise may have a greater part of its assets embodied in intellectual property as opposed to physical assets such as machinery or equipment. In these cases, the principal value-drivers will be those personnel who pursue those business innovations necessary to maintain a competitive advantage. An enterprise that offers digital goods and services to consumers depends on employees and contractors to operate the business, third party or internal research and development to maintain and improve the offerings of the business, and capital to fund the business. Labor, capital, and innovation would remain the primary value drivers if the enterprise were only to offer tangible goods or provide in-person services. In this case, however, the enterprise's value would likely be more attributable to tangible personal property and real property than to intangible property.

It is worth noting the contributions to value in the enterprise's external economic environment. The "multiplier effect" theory notes that "[e]very time a local economy generates a new job by attracting a new business in the traded sector, additional jobs are created in the local service sector".<sup>18</sup> Many digital economy enterprises, including the newly emerging pure play enterprises around the world, create multiplier effects in their local economies since they are creating new trading activity in these economies. Evidence suggests that the multiplier effect is considerably greater where high-technology enterprises are concerned.<sup>19</sup> Thus, a regional service sector should experience a rate of job growth that is several times greater if the region attracts high-technology professionals as opposed to unskilled workers.<sup>20</sup> By way of illustration, a study of Scottish e-commerce estimated that Scotland's e-commerce sales support 146,000 non-e-commerce positions.<sup>21</sup>

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<sup>18</sup> Enrico Moretti & Per Thulin, *Local Multipliers and Human Capital in the United States and Sweden*, 22 INDUSTRIAL AND CORPORATE CHANGE 339 (2013).

<sup>19</sup> Moretti & Thulin, 22 INDUSTRIAL AND CORPORATE CHANGE at 340.

<sup>20</sup> *Id.* at 357; Enrico Moretti, *Local Multipliers*, 100 AMERICAN ECONOMIC REVIEW: PAPERS & PROCEEDINGS 373, 376 (May 2010).

<sup>21</sup> SQW, *Scottish E-Commerce Study* at 39 (May 2012).

**B4. How Has New Technology Impacted the Way and the Location in Which Value Is Created or Monetised Under These Business Models?**

Enterprises that employ digital communications models continue to create value by investing capital in labor, development facilities, and innovation and taking entrepreneurial risks. These activities continue to take place at the location of production, not the location of consumption. Accordingly, a digital economy enterprise with a pan-European and pan-Asian customer base, which houses management in France, engineers in Russia, European sales representatives in the Netherlands, and Asian sales representatives in Hong Kong, creates value in France, Russia, the Netherlands, and Hong Kong, not in the European and Asian jurisdictions of its customers.

This point is demonstrated most clearly by the example of a company that uses digital communications technology to create supply and distribution efficiencies, but otherwise sells tangible goods. The enterprise may have invested in technology and data center assets in order to support its supplier and customer communications, and may have invested in logistics systems to support long range fulfillment, but the value of the enterprise's offerings still is created through investments in capital, labor, and innovation.

This point applies equally to an enterprise that provides on-line services. For example, an enterprise that develops and deploys software to process and store medical records does not create value in the location in which its customer hospitals or physicians are located. Rather, the enterprise creates value in the jurisdictions in which it develops the software and in the jurisdictions in which the enterprise's personnel use the software to provide services to the users.

We assume that one purpose of this question is to develop information regarding the use of user data by enterprises. Enterprises of all sorts value user data, as such data allows them to tailor their offerings to users to enhance sales. It is true that digital technologies have allowed enterprises to capture user data in greater volumes than before. Enterprises with access to such user data will endeavor to structure and analyze such data in ways to maximize their business opportunities. In this example, the enterprise creates value in those jurisdictions in which the enterprise's personnel structure and analyze the data, not in the jurisdictions from which the data originates.

We note that question B4 refers to both the creation of value and the monetization of that value. The reference to both value creation and monetization is useful, as that distinction serves as a reminder that profitable monetization is an event subsequent to value creation, and that value creation is economically the more significant event. This is shown by the observation that the market may give significant value to emerging innovative companies considerably before the time the company is profitable. In some cases, the market will give significant value to an enterprise even before the enterprise has revenue. Investors are willing to contribute capital to loss-making enterprises on the belief that these enterprises are investing heavily in the creation of value which at some point in the future might be successfully monetized. This value is created through innovation in the

company's intangible property, market visibility or other assets. For example, investors may consider a pure play streaming media enterprise, which has attracted users across many jurisdictions but which has yet to turn a profit, to be worthy of continued investment because the enterprise has the potential to become a profitable company.

These investments are not without risk. The enterprise may fail to retain the talent necessary to continuously innovate, lose market share to one or more competitors, and fail before generating any return on investment. The enterprise's technological approaches may not be sufficiently advanced or stable. The point for tax policy is that the return on making risky investments to create value and the return on commercializing a business's valuable assets are different, and tax policy should not allow the value created by investment to be taxed in jurisdictions whose only connection to the business is commercialization.

**B5. How Have Changes in Underlying Business Models Impacted the Way in Which Business Is Organized as a Legal or Tax Matter?**

Enterprises that employ digital communications models do not organize their business operations differently as a legal or tax matter. As a legal matter, digital economy enterprises seek to limit liability through the incorporation of separate legal entities to house different operating units, and seek to protect their IP through license and employee confidentiality agreements. Emerging enterprises generally use legal entities rather than branches when establishing physical presences outside their home jurisdictions. Mature digital economy enterprises generally establish local taxable affiliates in most major market jurisdictions.

That being said, enterprises adopting digital communications models frequently exhibit business process modifications that can have an effect on the enterprises' legal and tax structure. Communications technology allows virtually any major enterprise to centralize functions and automate business processes. As a result, major enterprises are more readily able to centralize sales, service, customer support, finance, management, legal, and other similar functions in a single geographic location. Centralizing these functions in a single location improves efficiency by eliminating duplicative personnel, premises, travel and related costs. Centralizing functions also improves the efficiency of the functions themselves by streamlining interdepartmental communication and cooperation.

In addition, as noted above, micromultinationals commonly access markets remotely from a central location at a very early stage - in some cases, from day one - through the application of technology to their business lines. Thus, as increasing numbers of micromultinationals emerge, it is increasingly common for enterprises that employ digital communications models to both centralize functions in and access markets from a single location.

## **B.6 What Challenges Do Digital Economy Players Face in Determining Their Tax Liability From a Corporate Income Tax and VAT / GST Perspective?**

It is appropriate that much of the international tax policy discussion regarding digital enterprises focuses on VAT / GST and similar indirect taxes. As a policy matter, indirect taxes are the appropriate tax to impose by reference to the point of consumption. Remote sales models have always created a tension between the desire to collect tax on all consumption in the jurisdiction, and the burden of imposing extraterritorial compliance obligations on remote suppliers.

The most significant issue facing digital economy enterprises is the requirement to identify the location of a user, in those jurisdictions that impose an obligation to collect VAT on sales to persons resident in that jurisdiction. For example, beginning in 2015, the supply of digital services to a consumer in the EU is subject to VAT in the consumer jurisdiction. The EU has proposed regulations that set forth irrebuttable and rebuttable presumptions as to the location of a consumer of digital services. These presumptions require enterprises to track whether the supply of services takes place through a variety of media, such as an internet café, a landline, or a mobile network. The presumptive location of the consumer is determined based on information relating to the medium through which the services are supplied. The supplier may nevertheless rebut this presumptive location in certain cases if the supplier can produce two non-contradictory pieces of evidence that identify the location where the consumer is established, has his or her permanent address, or usually resides.

Enterprises typically do not track the medium through which the cross-border supply of digital services in B2C transactions takes place. As a result, under the proposed EU regulations, enterprises typically lack the information required to determine the consumer location for purposes of the forthcoming VAT rules. Enterprises that engage in the cross-border supply of digital services must either bear the administrative, financial, and technological burdens of first developing or acquiring and then implementing tools to identify the consumer location for purposes of these rules or treat VAT as a nonrecoverable cost of supplying the services. In either case, under the proposed EU regulations, the forthcoming VAT rules impose a significant burden on enterprises that engage in the cross-border supply of digital services in B2C transactions.

These new burdens will require substantial implementation costs for affected companies. It will be some time before it can be seen how easily companies can comply and how effectively tax administrations can monitor and audit the relevant returns. Accordingly, we suggest that the Task Force exercise restraint before suggesting that such standards be applied by countries outside the EU.

## **B.7 How Will Business Models and Supply Chains Evolve in the Future Due to Advances in Information Technology?**

We anticipate that non-U.S. pure play companies will win an increasingly larger share of the global market in the coming years. As discussed above, many of the "hottest" digital

companies are emerging outside the United States. U.S. digital companies certainly were early adopters of digital communications models. The technical means to access customers remotely is available to entrepreneurs around the world, however, and there is no bar to them entering the market in greater numbers.

**C.1 Any Other Comments**

As noted above, enterprises that employ digital communications models operate in all sectors of the global economy. These enterprises constitute the digital economy. Accordingly, any options for addressing the digital economy should apply fairly and equally across all business lines. We believe that enterprises operating long-standing business models, subject to established international tax rules, should not become subject to altered rules on the basis that they have adopted more efficient means of operation.

We would welcome the opportunity to discuss our submission with the Task Force and are prepared to provide additional input as requested. This paper, of course, does not propose specific options to be included in the Task Force's draft report. We look forward to the opportunity to provide our comments on the options when they are proposed.

\* \* \*

Yours sincerely,

Gary D. Sprague

A handwritten signature in cursive script that reads "Gary Sprague". The letters are fluid and connected, with a prominent loop at the end of the last name.

Mary C. Bennett

A handwritten signature in cursive script that reads "Mary C. Bennett". The signature is written in a clear, flowing cursive style with distinct letter shapes.

Ethan S. Kroll

A handwritten signature in cursive script that reads "Ethan S. Kroll". The signature is highly stylized and fluid, with a large, sweeping flourish at the end.

Mr Pascal SAINT-AMANS  
Director, OECD Centre for Tax Policy and Administration

Mr Raffaele RUSSO  
Senior Adviser, OECD Centre for Tax Policy and Administration

Email: [CTP.BEPS@oecd.org](mailto:CTP.BEPS@oecd.org)

Brussels, 20 December 2013

***Subject: EBF comments on the OECD work on Tax Challenges of the Digital Economy (BEPS Action Point 1)***

The European Banking Federation<sup>1</sup> (EBF) very much appreciates the work of OECD and welcomes the opportunity to comment on the OECD current work on tax challenges of the digital economy as part of the Base Erosion and Profit Shifting (BEPS) project.

Since many financial institutions have websites offering online services, the EBF is interested in all proposals which are subsequently put forward aimed at applying or adjusting the existing international tax rules to the digital economy.

In this context, our letter will focus on the case of banks working in a digital world.

***Banks in a digital world***

One of the digital economy's advantages for banks and their customers is the possibility of conducting banking relations via the internet, both for private and corporate customers.

The progress of e-banking helps banks to save on costs. Larger groups in the financial services sector will attempt to streamline processes by centralising development of e-banking solutions and distribute the solutions to other jurisdictions.

The following example aims at illustrating a possible case:

A bank established in country A owns a subsidiary bank in country B. Both banks operate online banking services in addition to a network of fixed offices. The centralised IT centre in country A is the hub where all e-banking business is processed. This setting should not lead to a conclusion that the access to e-banking in country B of that same bank constitutes a permanent establishment of the parent bank. The e-bank is merely an add-on for clients of the subsidiary bank, only residents of country B are allowed access to e-bank in country B.

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<sup>1</sup> Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interest of some 4,500 banks, large and small, wholesale and retails, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

Customers in country B access the e-bank through a local website. While this may be connected to the central processing centre, for the customer it is merely an entrance to the bank. The customer belongs to the local subsidiary where the underlying deposit accounts, loans, investments, etc. are administrated. The profits and losses arising from these activities would follow the regulated customer relationship and would be recognised by the local establishment. Intercompany services, such as the centralised IT function, would be subject to and compensated by existing transfer pricing requirements.

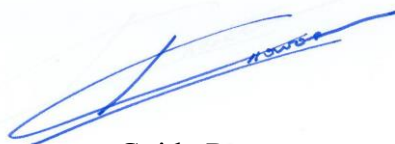
Each country's/subsidiary's e-bank must comply with local governance principles regarding regulatory and tax related matters, for example the application of know-your-customer rules. There is no possibility of *'one-size-fits-all'*. Given that the regulatory regimes e.g. customer protection rules and the tax legislation e.g. reporting to regulatory / revenue authorities differ from jurisdiction to jurisdiction, the centralised IT is mainly a tool provided to the local subsidiary. The subsidiary will claim the income derived from the e-banking run through its local website. It will pay at an arm's length fee for the use of the IT-platform.

An alternative model could be one where a bank operates only a virtual branch in a country. Given that such virtual branch also falls under stringent supervisory rules and regulations in order to protect the accountholders, such a branch would be clearly visible to the authorities. Applying the existing transfer pricing rules and permanent establishment (PE) attribution principles already in place for financial institutions should safeguard correct tax positions in the respective countries.

Bearing in mind that the main goal of the OECD models is to mitigate the effects of double taxation, the EBF recalls that any proposals to address the tax challenges of the digital economy – insofar as such proposals would apply to online banking business – should take into account the existing (and evolving) regulatory environment for banking. In particular such proposals should be addressed through the Mutual Agreement Procedure (MAP) under a double tax convention or a procedure under the Arbitration Convention in order to prevent potential events of double taxation which could incur as long as the new OECD rules have not been adopted in all the relevant jurisdictions.

We appreciate your consideration of our comments and suggestions and remain at your disposal as we would be pleased to contribute further as the work develops.

Yours sincerely,



Guido Ravoet





## Tax optimization schemes of Over-The-Top players

Summary presentation

Strictly confidential – copy prohibited



### Fiscal optimization of “OTT players”\*: An analysis of the main “Over-The-Top” players highlighted six key learnings

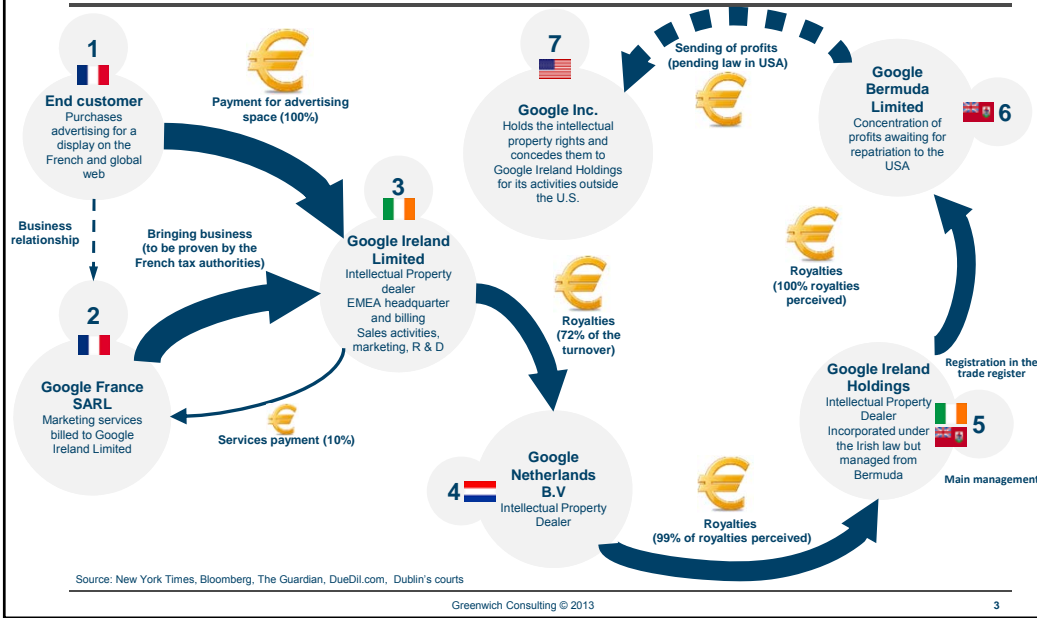
\* OTT = Over-The-Top (Google, Apple, Facebook, Amazon, Microsoft,...)

- 1 The optimization schemes of OTT players rely on tax distortions of national and European legislations as well as transfer prices between subsidiaries
- 2 Ireland, hosting many OTT headquarters in Europe, compensates the shortfall, due to its attractive tax policy regarding royalties and its low corporate taxes, by direct and indirect economic earnings (added value, employment & growth, economy expenditures, foreign direct investments)
- 3 On intangible products such as online music or digital books, Apple and Amazon pay back their entire VAT to Luxembourg, another European tax heaven
- 4 These optimizations are interesting for OTT players thanks to the historic permissiveness of the U.S. federal government, particularly to encourage the international success of these champions (Homeland Investment Act of 2005)
- 5 In 2011, OTT players would have paid more than €800m of taxes and between €400m and €700m of VAT in France, if their production activities had been subject to the local market rules (without any optimization) – compared to tens of millions euros actually paid in taxes
- 6 OTT players are neither the only economic players, nor the most important ones using tax optimization schemes in Europe (e.g. General Electric, Starbucks, Tesco,...)

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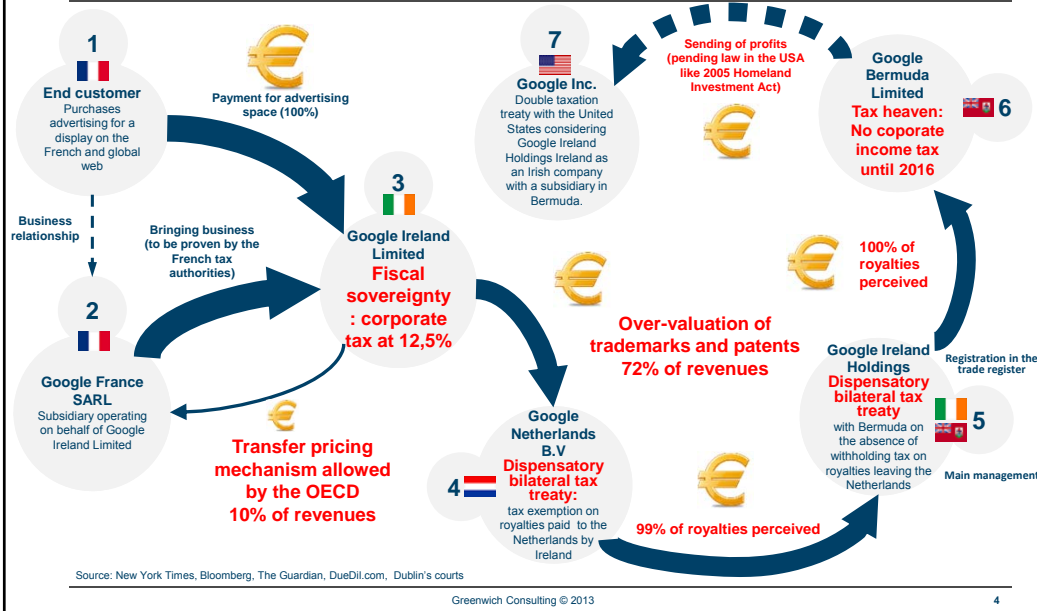
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**Corporate income taxes: Google optimizes its taxes by funneling profits through Holland and Bermuda in the form of royalties for the use of intellectual property**  
 Fiscal optimization scheme: "Double Irish" & "Dutch Sandwich"



**To achieve this tax optimization scheme, Google benefits from several specific requirements and tax treaties implemented by the various countries involved and allowed by the OECD or the EU**

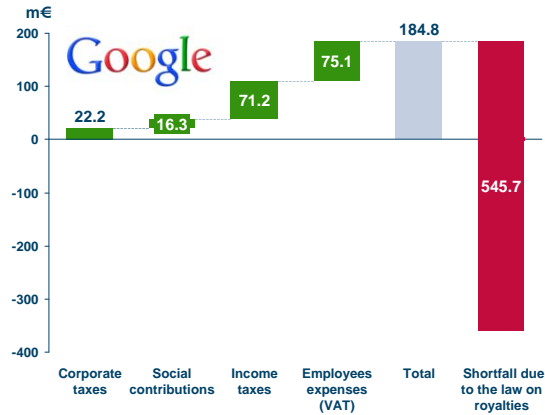
Basic conditions making both the "Double Irish" and the "Dutch Sandwich" possible



## Ireland upholds that the indirect benefits to its economy are more important than the shortfall due to its attractive taxation system

The Google case study

### Comparison of direct accounting gains for the Irish State and the shortfall due to the taxation on royalties



### Analysis

- Ireland, by the presence of Google on its soil, has a significant shortfall in terms of tax revenue:
  - 545 m€ due to the exemption from the payment of royalties
  - 1,453 m€ due to the corporate tax at 12.5% (Vs. 33.3% in France)
- However, Ireland upholds that the following indirect gains compensate this shortfall:
  - Added value created by employees
  - Indirect jobs related to the presence of Google in Ireland
  - Created value and spending in the economy generated by the indirect jobs (taxes and spending in the economy)
  - Real estate investments
- Indirect gains compensating the shortfall are still to be demonstrated
- Ireland has an attractive fiscal and economic policy that enables tax optimization: corporate tax rate at 12.5% and tax exemption on royalties paid to EU countries

Sources: Deloitte study "Measuring Facebook's economic impact in Europe", Eurostat 2009, PWC 2011, The Household Budget Survey 2009, BusinessandFinance.ie  
 Notes: This chart does not include indirect impacts created by B2B trade between Google and its subcontractors (spending in the economy, added value created by employees of subcontractors).  
 Standard gross margin reported by the group in their global income statement applied to the turnover declared by Google Ireland Limited and submitted to the corporate tax at 12.5%

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## In 2011, the OTT players paid €37.5 M in corporate taxes in France, 22 times less than what they would have paid, if their production activities were located and taxed in France

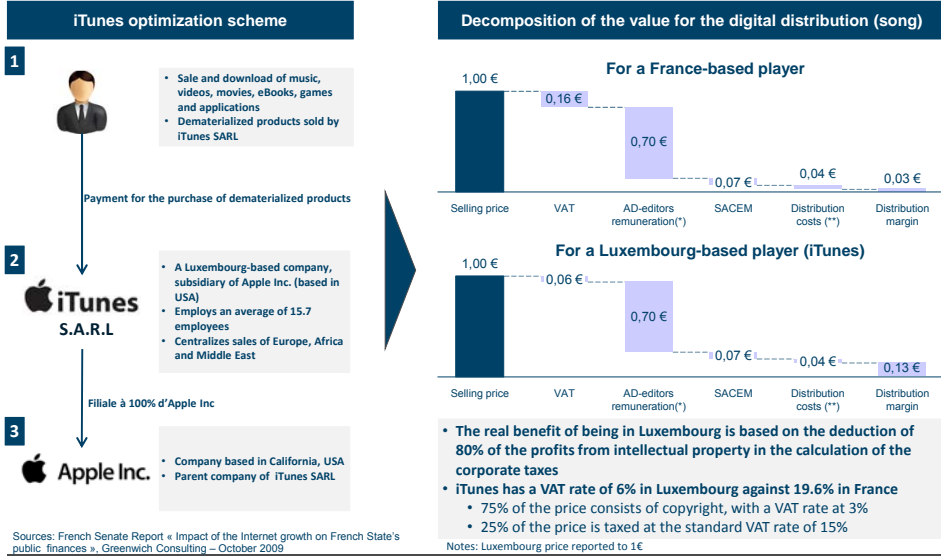
	Reported revenues in France	Estimated made revenues in France	Corporate income taxes paid by the OTT in France	Corporate income taxes that OTT players would have paid in France	Average annual growth rate of worldwide income
Google	138 M€	1.4 bn€	5.5 M€	162 M€	42%
Apple Inc.	257 M€	3.2 bn€	6.7 M€	317.5 M€	38%
facebook	ND	140 M€	50 k€	21.2 M€	123%
amazon.com	110 M€	890 M€	3.3 M€	10.9 M€	32%
Microsoft	584 M€	2.5 bn€	22 M€	317 M€	8%
<b>TOTAL</b>	<b>1.09 bn€</b>	<b>8.13 bn€</b>	<b>37.5 M€</b>	<b>828.7 M€</b>	<b>x22</b>

Sources: Paris commercial court, Income statement of companies - 2011  
 Notes: Estimates based on Facebook UK data. Apple data based on the assumption that the majority of Apple physical products sold by third-party distribution networks are in fact sold by Apple Sales International, domiciled in Ireland and not paying corporate tax in France  
 Assumptions: activities charged in France with standard gross margin reported by the group in their global income statement and submitted to a corporate tax of 33.3%

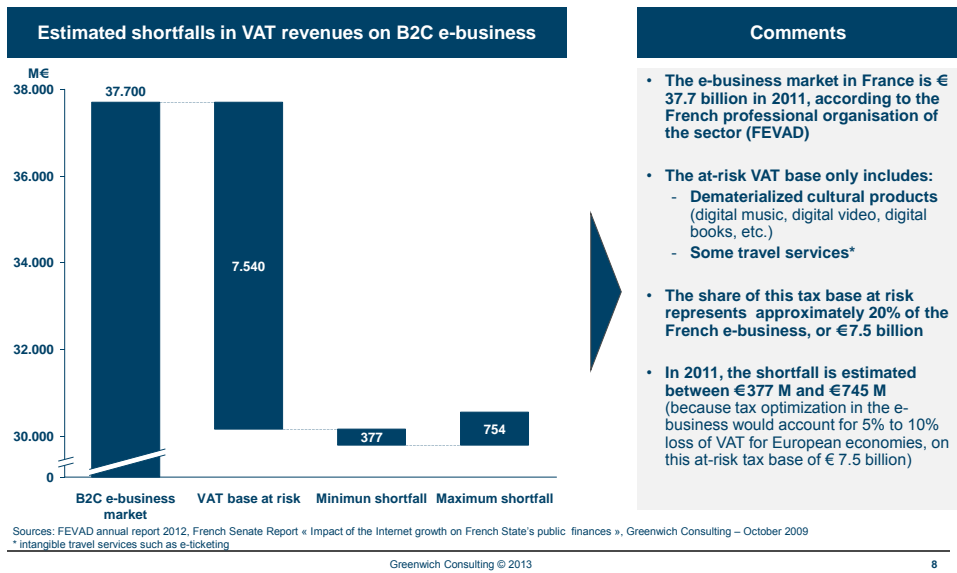
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## The Luxembourg-based iTunes service enables Apple to benefit from a reduced VAT rate on its sales and to avoid paying VAT in France



## In 2011, the shortfall in VAT due to optimizations in the e-business in France is estimated between 5% and 10% of the at-risk tax base and reached between €377 M and €754 M





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To: The Task Force on Digital Economy, OECD

19<sup>th</sup> December 2013

**RE: CALL FOR INPUT - TAX CHALLENGES OF THE DIGITAL ECONOMY**

On behalf of the GSM Association, which represents the global mobile industry, I thank you for the opportunity to share our general views in response to OECD's call for input on the tax challenges of the digital economy. We appreciate OECD's desire to seek consensual and evidence-based solutions to create a fair and predictable taxation environment for businesses operating in the digital economy. We hope our comments would help the Task Force to develop best practice taxation policy options.

We understand that the primary consideration of the current OECD Action Plan on taxation policy is the inconsistencies of international taxation systems and their consequences, but this also includes proposals on domestic tax rules. We believe it is also important to consider the inconsistencies of taxation policies within the domestic tax structures that harm the growth of the digital economies and impact international tax arrangements. We encourage OECD to also address this core issue as it is related to the digital economy, competition and international tax systems.

The digital economy, powered by the growth of mobile communications, is recognised as a key engine of economic growth for both developed and emerging countries; it is estimated that a 10 per cent increase in mobile penetration can result in a 1.2 per cent increase in Gross Domestic Product (GDP) and a doubling of mobile data use can boost GDP by 0.5 per cent. The taxation policy for the mobile sector and the digital economy should be designed to extend the benefits of this sector while striking a sensible balance with fair and proportionate revenue collection goals of governments.

Unfortunately many governments place a high tax burden on mobile consumers, that reduces service affordability, and on operators, which increase the cost of network roll out. Sector specific taxes on handsets and services are increasingly being introduced. The positive externalities of mobile communications are not accounted for in the taxation policies of many countries. This may be contrasted with the energy and fuel subsidies that are commonplace in many markets. While the overall taxation burden fell by 0.2 per cent between 2008 and 2012 across a sample of eleven countries, the mobile tax burden increased by 2.1 per cent.<sup>1</sup> For example, in Hungary, whilst the overall burden on the economy increased by 0.5 per cent annually, the burden on telecoms rose 7.2 per cent. The increase in telecoms taxation burden was mainly due to the introduction of a '*telecoms crisis tax*' in 2010.

Even within the digital economy, there are examples of differential treatment between mobile operators and other service providers, such as Voice over Internet Protocol (VoIP) providers, even though they offer functionally equivalent services. The current taxation system creates competitive distortions between services being offered by nationally regulated telecoms operators and often trans-national Internet service providers. Substitutable services, such as VoIP, can be offered without the same geographic ties and has

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<sup>1</sup> Study to be published in January 2014



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important implications for tax neutrality and competition. Internet service providers may offer services across borders that offer them advantages in terms of corporate taxes, employment taxes, sales taxes and other sector-specific levies. In addition to tax residence considerations, variation in the regulatory or legal status between traditional and non-traditional mobile services may also generate additional differences in their tax treatment.

We urge the OECD to consider the distortive and harmful impacts of mobile-specific taxes in formulating its proposals on taxation rules for the digital economies. The proposals should call for the removal of sector-specific taxes on mobile services, the key pillar of the digital economy, and should create a harmonised tax environment that provides an even playing field and certainty for all the participants in the digital economy. The proposals should be grounded on the best practice principles of taxation that call for broad based taxes and should account for sector and product externalities. Sector-specific taxes and levies should be rare departures from best practice taxation principles.

For the reasons stated above, the GSMA strongly believes that imposing high sector-specific taxes and fees on the mobile sector are against the long-term interests of consumers, operators and the country as a whole. We urge the OECD to include proposals that remove sector specific taxes and promote rules that should be applied consistently across all sectors of the economy.

We look forward to continued dialogue on this important topic.

Yours sincerely,

A handwritten signature in black ink that reads "Tom Phillips". The signature is written in a cursive style with a large initial 'T' and 'P'.

**Tom Phillips**  
Chief Government & Regulatory Affairs Officer, GSMA



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18 December 2013

OECD/CTPA

Sent by email: CTP.BEPS@oecd.org

**Re: Consultation Response to Request for Input Regarding Work on Tax Challenges of the Digital Economy**

Dear All,

The Taxes Committee of the International Bar Association (IBA) would like to take this opportunity to respond to the Request for Input Regarding Work on Tax Challenges of the Digital Economy, issued 22 November 2013.

The IBA is the global voice of the legal profession and includes over 45,000 of the world's top lawyers and 197 Bar Associations and Law Societies worldwide. The IBA is registered with OECD with number 1037 55828722666-53. The IBA Taxes Committee has 1037 members from around the world.

The IBA Taxes Committee formed a Working Group to respond to the Request for Input Regarding Work on Tax Challenges in the Digital Economy (the "Request"). The Working Group includes Philip O'Reilly, New York, NY, USA, David Shapiro, Philadelphia, PA, USA and Peter Utterstrom, Sweden.

The comments made in this report are the personal opinions of the Working Group participants (the "Working Group") and should not be taken as representing the views of their firms, employers or any other person or body of persons, including the IBA as a whole, apart from the IBA Taxes Committee.

Sincerely yours,

A handwritten signature in cursive script that reads "Stuart Chessman".

Stuart Chessman  
Co-Chair IBA Taxes Committee

**Working Group Participants:**

Philip O'Reilly  
Vice President, Tax  
Barnes & Noble  
David G. Shapiro  
Managing Member  
Shapiro Tax Law LLC  
Peter Utterstrom  
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## 1. Introduction

The Working Group has read with interest the Request and thanks the OECD for the opportunity to provide some written comments based on the practical experience we have as tax advisors. In view of the short deadline, this submission concentrates on the different ways of using technology in the so-called “digital economy”.

In summary, the IBA Taxes Committee wishes to emphasize the importance of taxing a business in the same way regardless of whether the business model used is a traditional model or a digital economy model, under which technology has made it possible to find new ways and methods of achieving basically the same result. As we illustrate below, much of the “digital economy” is merely a different way of marketing and distributing a product – goods or services - where the current rules for taxation mostly work well and, accordingly in only some cases, in our view, may there be a need to modify the current rules.

### **General observations and comments regarding new business models and tax treatment of them**

We have observed significant changes in business operations as a result of the rise of the digital economy. In large part, we believe this is because vast improvements in telecommunications infrastructure and computing power have made international operations much easier. This includes both multinational corporations that traditionally operated internationally, but also small start-up companies - even sole proprietorships - with little invested capital.

#### **1.1 Digital ordering of physical goods**

Some business models closely resemble pre-digital business models. For instance, companies that take orders electronically and ship physical goods closely resemble catalog sellers of many decades ago, but because their catalogs are posted online, they are more readily accessible to customers all over the world. It strikes us that for these businesses, there is no need to update rules; their activities are consistent with pre-digital activities. As such, they should already be captured by rules on sales of physical goods, and the online order processing should be viewed as little different from telephone or mail order processing from “old” sellers.

#### **1.2 Digital ordering of digital downloads**

Other business models are similar to old pre-digital business models, but modes of transmission have resulted in confusion and complications in international taxation. For instance, a media vendor may sell e-books that are ordered online and delivered digitally to the end user, rather than shipping physical copies of books. Similarly, a software vendor may deliver new software through digital transmission rather than submission of physical discs. In each of these cases, the primary value is in the intellectual property that is delivered as compared to the method of delivery.

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Indeed, in many instances, the “digital economy” is little more than an alternate distribution channel. Consumer goods that have historically been delivered in physical form can, in many instances, now be transferred to purchasers electronically. Similarly, many experiences and services that at one time may have required a physical presence (e.g., casinos or bookkeeping) can now be provided digitally.

In some cases, taxing authorities have sought to harmonize treatment of these different modes of delivery. For instance, in the US, Treasury Regulation 1.861-18, the so-called “software regulations,” state the general principle that transactions should have identical tax results regardless of the mode of delivery, at least as to software. Conversely, some taxing authorities have treated digital transactions differently from their physical analogues. For instance, in the United Kingdom, sales of physical books are not subject to VAT, but sales of electronic books are subject to VAT.

One implication of the development of alternative (*i.e.*, digital) distribution channels is that traditional physical distribution channels are less frequently used. For this reason, the value of physical delivery services from a third party and intercompany pricing perspective has almost certainly declined. This has likely had a significant impact on income and transactional tax revenues (to say nothing of customs revenues) in many jurisdictions in recent years. Although as discussed below, there may be reasons to distinguish between cloud-based services and their physical goods analogues, there seems little reason for a distinction between a digital download, either as a purchase or a limited-term rental, or a comparable sale or rental of a physical item.

One challenge that arises in the case of digital downloads is the determination of the location of the use of property, particularly as individuals are more mobile and may travel across borders with some frequency. While it may be theoretically possible through internet tracking technologies to identify where every download and every use of a particular product may occur, this presents practical challenges, particularly where there is prepayment for services. As such, we recommend that parties to digital transactions be able to rely on location presumptions, such as the home address or principal office address of the consumer.

### 1.3 Cloud-based services

The greatest challenges of the digital economy, in our view, relate to cloud-based services. Unlike the e-commerce models described above, these involve the maintenance of all media, software or other functions on servers owned by a third party.

In many respects, the rise of the digital economy, and the perceived difficulties relating to taxing it appropriately, evidence what has elsewhere been described as a shift from the value of a business being principally reflected in its physical assets to the value residing in the intangible assets of that business. Producing goods has, in a number of instances, been replaced by producing one instance of metadata that is readily copied. Setting up a global

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Distribution network has, in many cases, been rendered unnecessary or outsourced to logistics experts. This has resulted, unsurprisingly, in a split of profits within members of a multi-national enterprise that deviates from historical norms.

The change in profit allocations may be more visible in the digital economy, but it is far from unique to the digital economy. We believe that rules should be consistently applied across all sectors of the economy, and are concerned that an excessive focus on the digital economy risks distortions.

### **“Software as a service” and streaming media**

In some cases, there is an analogue to a physical transfer or leasing of an item. For instance, a customer may pay for access to a particular online software suite, such as Microsoft Office 365 or Google Apps, which provides functions substantially similar to productivity software that might be resident on a local computer. Similarly, a customer may pay to have streaming access to a particular video for several days, rather than borrowing a physical disc or downloading the video for limited use. While at first glance these may seem to resemble the digital download example noted above, this business model raises additional complications. A customer may only have access at the discretion of the service provider and subject to the service provider's own computers (to which the customer has no access) being operational.

That said, we acknowledge that in the interest of achieving a consistent system of taxation, it may be necessary to analogize some of these services to physical analogues. For instance, a streaming video service for which a user pays a monthly subscription fee could be treated as video rental, even though the user may not have access to any single particular film.

A further challenge of the digital economy is determining where services are performed, or where activities are conducted. It is possible for the servers that host the software or media to be located in countries different from those where the content developers are located, or where the end users are located. Appropriate transfer pricing certainly would involve at least some income treated as earned where the content is developed, but this is no different from a situation where software or media are sold to end users. While users certainly add value by their willingness to pay for products, this should not represent the primary value of a business from an income-based tax perspective (as opposed to a revenue-based taxation regime). In addition, as noted above, it is not always clear at the time of payment where the end user will be located at the time of content access. As stated above, we recommend that parties to digital transactions be able to rely on location presumptions, such as the home address or principal office address of the consumer, in the determinations of location of use.

#### **1.1.1 “Platform as a service” and “infrastructure as a service”**

Many companies do not develop their own cloud infrastructure, but instead rely upon third parties that provide infrastructure, typically described as “platform as a service” or “infrastructure as a service.” The difference between the two is the degree of control retained by the customer (typically a web site operator or “software as a service” provider).

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In “platform as a service” models, the service provider manages the infrastructure completely, determining how much storage capacity and processing power is needed and where. “Infrastructure as a service” models leave more control over what servers should be used and where in the hands of the customer, but even then the customer does not have complete control. For instance, a customer may say that most of the processing power should be housed in Western Europe, but the exact location of the server farms could be moved at the discretion of the service provider. The service provider maintains control over the servers and the customer typically has no direct access to the servers.

We believe that existing law can adequately deal with these arrangements. Typically, such an arrangement will not generate a permanent establishment at the server location, but if it were coupled with on-the-ground personnel of the customer - or if there were special arrangements that resulted in the service provider acting as an agent outside of its ordinary independent-agent role with respect to a customer - then the customer could have a permanent establishment in the country of the server location. Depending on the degree of control that a customer has over the hosting arrangements, the arrangement could be characterized as a lease or service, and once that determination is made, existing tax rules could adequately address the situation.

The service provider itself should be taxed in the country where it owns and operates the servers, and it is hard to imagine that its activities do not generate a permanent establishment.

### 1.1.2. Social media

Social media at first glance present a different challenge. As Collin & Colin argued in their French report, the value of social media stems in significant part from the users of the media - who generate content for the site. However, social media such as Facebook generate most of their revenue from advertising. This fundamentally is no different from the case of “old media,” where people watch or read because of the value of the content - and in some cases, such as sporting events or television programs that will be discussed in the office the next day - they watch in order to be able to have a conversation with their peers. Under current law, advertising income generally is treated as services income, sourced to the location of the publisher of the advertising. We see no reason that social media should change that rule. While it is clear that user data add value to a business by allowing that business to charge more for advertising, it is not the data themselves, but their analysis and aggregation, which allow a business to charge for its advertising. That is a function of the office of the social media company, not the location of the end user, and we believe that the income should be sourced to the office, rather than user, location.

### 1.1.3. Gaming

Gaming on the internet is one area which has grown exponentially; the actual gaming part is often based in countries like Malta and similar countries which may be considered as low tax or even tax havens. However, taxation is – if any – only part of the reason for establishing a

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Gaming company in e.g. Malta. The main reason is the regulatory side of the coin – many countries do not allow gaming by anyone else than by state owned company. Sweden is an excellent example of this where there are a number of gaming companies controlled or started by Swedish nationals where the development of the technology used took place in Sweden but where the company actually carrying out the gaming business is based in Malta. Considering the relatively low effective corporate tax rate in Sweden – under 20 % - it is reasonable to infer that the main reason for basing the gaming part of the business outside Sweden is regulatory. Moreover, in some cases, such as the US, cross-border casino gaming is illegal, and where gaming is allowed, it is subject to special tax rules. We believe that the challenges relating to internet-based gaming are primarily ones of regulation and, where applicable, criminal enforcement, and anticipate that the countries where end users are based may set special rules for taxation of internet gaming activities, just as they do for physical gaming activities.

### **Additional comments**

As discussed above, we acknowledge that there are some significant challenges with the digital economy. Our greatest concern is that there be consistency in the tax treatment regardless of methods for carrying out the business unless there is a demonstrable reason for inconsistent treatment, and that governments and the OECD should be hesitant to create special rules for what appear to be new business models but which are analogous in most cases to traditional business models. We have observed in other contexts that an industry-specific approach very quickly can be overwhelmed by changes in technology. For instance, the US “software regulations” were generally considered to be obsolete by the time they were finally published. They are narrowly drawn and limited in scope, not covering digital media and not accounting for the growth of cloud computing. Any rules must be set in a way that can be applied to new technologies, both those we can imagine and those we cannot yet conceive.

In order to make the rules administrable, presumptions may be required, for instance relating to the location of the end user based upon principal business office or home address. We believe that such presumptions are necessary to make rules administrable, and in particular to aid smaller businesses with less ability to track users. We also note that it may not be desirable from a privacy perspective to require companies to track the locations of their users at all times, and as such location presumptions may be required in order to protect individual privacy.

Aside from these presumptions, we believe that it is important to maintain a principles-based system of taxation that is industry neutral. As discussed above, many of the issues, tax planning opportunities, and potential abuses presented by the digital economy exist equally in many other businesses, especially those where intellectual property is valuable. A focus exclusively on the digital economy will unfairly affect the electronic delivery of goods and services without addressing comparable issues in other industries.

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# REQUEST FOR INPUT REGARDING WORK ON TAX CHALLENGES OF THE DIGITAL ECONOMY

Response by

**Tatiana Falcão and Bob Michel, IBFD Research Staff<sup>1</sup>**

Research and Publishing (R&P) is a not-for-profit foundation based in Luxembourg, with subsidiary offices in Singapore, New York (USA) and Mumbai (India). R&P began operations as a centre for specialized legal information and documentation, its greatest asset being its documentation centre which amalgamated in one place historical legal documents, publications and archives from all over the world. Having started as a research centre for access and consultation of physical documents also responsible for the publication of many books, articles and journals of a legal nature, the scope and nature of its services has expanded to include many activities which are currently deemed to be included within the field of digital economy.

R&P thus currently offers a number of international legal services to customers located all over the world, which are only viable due to the current technological development and that are thus susceptible to the taxing challenges posed by the digital economy. Amongst those services are:

- (i) A legal documentation database (LDD) with contents driven both from in-house researchers and from external contributors. The LDD contains journals, academic publications, international legal news, individual countries' juridical analyses, analyses of specific topical issues, international treaty analyses and documentation centre, case law and online books, which may be accessed by the subscribers 24 hours a day, seven days a week, from all over the world, according to the scope and extent of the client's subscription.
- (ii) A range of online courses in international law, which may be streamed from the R&P's main headquarters in Luxembourg to its clients from all over the world via the internet;
- (iii) An International Law Academy with a tailored research and training service team that provides private clients with customized courses and legal research services on the application of arbitration and international law adjusted to their needs. They are also responsible for the legal courses held in "hub", locations around the world; and
- (iv) Research services: R&P offers tailored research services on national and international legal issues for clients worldwide. The clients include governments, companies, advisory firms, non-governmental organizations and individuals; and
- (v) Policy Advisory Services, providing legal advice and supporting governments from around the world in complying with international standards and aiding in the development of policy, legislative and administrative issues particular to their domestic legislations.

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<sup>1</sup> Please note that this document has been written in the authors' personal capacity and does not reflect official views and practices of the IBFD as such. The authors can be contacted at [t.falcao@ibfd.org](mailto:t.falcao@ibfd.org) and [b.michel@ibfd.org](mailto:b.michel@ibfd.org).

It is to be highlighted that these functions are only the core activities that R&P is deemed to provide in a remote capacity as a service provider. The institution also engages in traditional publishing activities containing a physical substrate to the outputted product.

In the context of providing those services, R&P employs and/or enters into contracts with a number of researchers, country specialists and correspondents, which may be requested to be physically present in its Luxembourg office (under a full time employment capacity), or could be working remotely from their own home jurisdictions and producing content to be fed into R&P's LDD database, aid the development of new online courses or develop new legal products. The maintenance of a particular database or the provision of a determined tailored or non-tailored service might thus rely on individuals from several different nationalities, residing in multiple jurisdictions, both for the services rendered online and for the courses ministered in a personal capacity. Although payment for the courses is generally operated via the Luxembourg head office, the teaching staff might not necessarily be resident in Luxembourg or even be permanent employees of R&P. A substantial portion of the teaching and technical staff does not provide services exclusively to R&P.

R&P does not make use of any agents in the countries to which it broadcasts its web-based content. The marketing and sale of the database is carried through by sales teams located in the R&P's headquarters and satellite subsidiaries. No independent agency activity is attributed to dependent or independent agents in other countries. All of the regional representation is concentrated in R&P's own offices (except for the courses ministered in "hub" locations, therefore outside R&P's head office and subsidiaries, as will be discussed under item 1(b)).

All of the services described above are only made possible due to the current state of affairs in dealing with information technology, which allows for information to be produced from a laptop and streamlined or fed into a database that may be broadcasted to legal practitioners (clients) from all over the world. It is an international law dissemination service that would not have been possible ten to twenty years ago. This model does not tend to create any taxing opportunities in the countries to which the content is broadcasted; an issue that could potentially give rise to taxing conflicts with the jurisdictions in which those services are being rendered.

The next session thus aims to analyze the impact of these activities under each of the issues addressed under Action 1 of the BEPS Project, addressing the tax challenges of the digital economy. The issues will be analyzed under the following activity headings: (a) Legal documentation database and online courses; (b) Courses in "hubs" requiring minor, temporary physical presence; and (c) tailored client research and policy advisory services.

#### **ISSUES UNDER ACTION 1:**

- 1. The ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to lack of nexus under the current international rules.**

- a. Legal Documentation Database and online courses:**

As previously asserted the content of both the documentation database and the online courses are created in Luxembourg and broadcasted to all of the database signatories located across the globe. The issue would thus be whether the presence of a database in a host country would be enough to constitute a permanent establishment under the terms of the OECD Model, and hence create an opportunity for the source country to tax the information service provided via the database.

Under the case at hand, the supply of legal information would constitute one of the core functions of R&P's business activity and would hence not be qualified as a preparatory or auxiliary activity under article 5(4) of the OECD Model (see paragraph 42.8 of the commentaries to article 5 of the OECD Model).

The issue of whether the presence of a database (LDD) in a host country would be enough to qualify for a PE status would also be answered with a negative answer, as R&P does not possess any *in situs* computer equipment from which it broadcasts its database and online course contents (paragraph 42.6 of the Commentaries to article 5), thus not having a fixed place of business. R&P does not own a server at any of the particular locations to which it broadcasts. R&P merely operates a web site, which under OECD understanding does not itself constitute tangible property and thus may not constitute a "place of business" (as per paragraph 42.2 of the commentaries to article 5).

This means that R&P does not hold any physical presence in the countries to which it provides its web services via online courses or the documentation database. Under the OECD Model Convention it will thus not pass the substantial presence test and will not give rise to a taxing opportunity at the source country (via direct taxation). This will be true under current international taxing rules regardless of the number of people subscribing to R&P's Legal Documentation Database from any one given country. Because the test is one based on material factors (assets and functions assumed in the country), R&P's web streamed content will never be enough to generate a taxing opportunity in the country of source. For all purposes, it is exclusively up to the country of residence (Luxembourg) to tax the profits deriving from those activities. Indirect taxing opportunities may arise, as will be discussed under issue 4 of the present analysis.

A different discussion is whether the Legal Documentation Database and the online courses could constitute a transfer of computer software, in which case the remuneration paid by the subscribers might be characterized as royalty payments and sourcing rights could be conferred, under some DTCs to the country of source. These authors are of the opinion that the permission to access the online courses and the Legal Documentation Database would not be characterized as a transfer of software. R&P does not sell a portion of the software rights, it merely makes the intellectual content (digital archives and documents) available to the subscriber. The subscription to the contents of the database would thus not be characterized as royalties, but as payments in remuneration for a right to access technical information. The payment is thus one for the acquisition of data transmitted in the form of digital signal and thus would not constitute royalties, falling under article 7 as per paragraph 17.3 of the OECD Model Convention Commentary on article 12.

b. Courses in "hubs" requiring minor, temporary physical presence

The same phenomenon happens with the courses ministered by R&P at the different "hubs" around the world. R&P has the practice of conferring courses in international law on a regular basis in a series of different countries which are representative of the following regions: Central America, Europe, the Middle East, the African continent, East Asia and Russia. The courses conferred in Luxembourg, Singapore, New York and Mumbai could be subject to tax at the country where the course is ministered (i.e. Luxembourg, Malaysia, India, and the USA), because R&P has a fixed place of business at those locations.

However the remaining locations tend to only receive courses on a very temporary basis (3 to 5 days, two to three times a year), thus not meeting the threshold for the substantial presence test. Under R&P's understanding, activities taking place in those countries do not tend to rely on a local dependent

agent or any agent with the authority to regularly conclude contracts on behalf of R&P, thus not constituting a PE in those countries.

Under some instances, R&P tends to simply rent a room where the courses are to take place. All of the arrangements with the participants take place online, via R&P's webpage (registration and payment for the course). The only connection with the country of *situs* of the course is the brief period in which the course is effectively ministered and for this reason, there is not opportunity for taxation in those "hubs."

The instructors of the course, the administrative staff and the organizational staff are likewise flown in to help organize the course. Local unrelated third parties are hired for catering purposes. Therefore only minimum locally-sourced infrastructure is used and those utilized are clearly third unrelated parties. All of R&P's based resources (the instructors and the course content and materials) are flown in especially for the occasion, and then flown out after the course is over. The technical knowledge and the know-how are generated in Luxembourg or elsewhere via R&P's own staff or foreign correspondents. No intellectual knowledge is aggregated to the "hub" country.

Therefore, although the information granted via these courses is not transferred digitally, the effect of having the intellectual property built in the residence country and just physically transmitting it in a source country with minimum physical presence (R&P does not own any assets or equipment in any of those locations) produces the same result as providing it digitally, thus not configuring a PE in the host country.

However under other instances, R&P does hire third parties to both register, collect fees and repass revenues from the course on to the main headquarters after deducting a fee for their own personal administrative and financial support. Although R&P maintains fixed relations with these third parties and concede the opportunity for the representative to conclude contracts on behalf of R&P (by signing up course participants, for instance), R&P does not consider them to be dependent agents. That interpretation follows from the fact that the courses only occur 2 to 3 times a year, for short periods of time and would thus not provide enough substance to say that the third party enterprise would be "habitually" exercising an authority to conclude contracts under the terms of article 5(5) of the OECD Model Convention and paragraph 33.1 of the commentaries.

Moreover, R&P understands that the authority conferred to the third party to conclude contracts with course participants does not provide the third party with enough relation to the business proper of the enterprise. The course administration is just one of the functions of R&P and the registration part does not guard a direct correlation with the intelligence services provided by R&P. Thus, even if a third independent party has the ability to conclude contracts on behalf of R&P, that function is only an administrative one, for efficiency purposes and would not be enough to constitute a dependent agent PE in the host country (as per paragraph 33 of the Commentaries to article 5 of the OECD Model Convention).

Income received for the onsite and online course is submitted to tax in the source country jurisdiction which generally tends to be a low income tax jurisdiction. VAT is also paid at the country where the course is effectively administered under those instances of "local representation."

### c. Tailored research and policy advisory services

The case for tailored research is slightly different from case (b) provided above because it could involve the following one or both circumstances:



- (i) There is a request for advice from a client. R&P thus studies the client's case using its network of in-house staff and correspondents and sends the result of its research to the client. This is a true consultancy service. There is no need for R&P to meet with the client in its country of source, although a meeting could occur;
- (ii) R&P is requested to send experts to the client's headquarters to either (a) communicate the result of its research; or (ii) teach client's staff specific issues related to international law.

None of the above options would give rise to the characterization of a PE in the country of source. Even if R&P has recurring clients in the country of source, there would still not be enough activities for there to be a substantial presence in the country of source (provided the country of source is not one where R&P has subsidiaries).

The result of the research would be digitally sent to the client and the corresponding income taxed in Luxembourg. A visit to the client's offices or a request to teach for a number of days would not be enough to characterize a fixed place of business in the country of source.

## **2. The attribution of value created from the generation of marketable location-relevant data through the use of digital products and services.**

### **a. Legal Documentation Database and online courses:**

A second issue arising from the legal Documentation Database and online courses content is the place where value was generated. That is so because although R&P routinely hires full time staff to work in the development of the contents of both the online courses and the website (country specialists), much of the information fed into the website derives from "correspondence" services with other specialists scattered all over the world. This structure is needed because otherwise R&P, a foundation, would have to have on site specialists (in Luxembourg) covering all of the countries in the world, which is practically not feasible. The in-house country specialists are thus representatives of the respective regions from which they originate, but are not necessarily experts in all the countries they represent. They use the information provided by the correspondents to update the database in a timely manner.

As a consequence, a Brazilian specialist with a R&P correspondent contract, residing in Brazil (and thus taxable in Brazil) could be providing website content (or value) to a R&P full-time employee on a regular basis and receiving remuneration from R&P based on a correspondence contract. The specialized legal information provided by the Brazilian correspondent could (i) merely be fed into the website by the full-time R&P employee in Luxembourg; or (ii) could be reviewed and edited by the R&P full-time employee to be then fed into the website. This information could then be made available to a Brazilian database signatory or any other signatory from anywhere in the world. Brazil in this case could be substituted for any other country covered by R&P.

The point being that both the content of the information and its consequent use could be located in one same country (in the above example, in Brazil) without there being any consequent allocation of taxing rights to the country of consumption (in this example, Brazil). Because the action connecting the information to the database (from which the profitable activity derives) is in Luxembourg, which happens to be the country of corporate seat (residence) of R&P. R&P would be exclusively taxed in Luxembourg, without there being any consequent allocation of taxing rights to Brazil. That is explained by the fact that there would be no database without the underlying information, and the database itself is what generates marketable value, even if the value was created through resources from the country to which the product is sold.

The fact that certain portion of the database content was created (value was added) in the same country of consumption (to which the database is sold) is lost by the fact that a lot of other information (also contained in the database and not related to Brazil) was also made available to that signatory and distinguishing all the sources deriving the content vehicle via that database is impracticable if not impossible.

Brazil would only be entitled to tax the revenues deriving from the correspondent contract signed by the Brazilian law specialist, which is the only portion of this transaction where a direct connection is made to the source country.

b. Courses in "hubs" requiring minor, temporary physical presence

No value is created from the courses granted in any of the remote "hubs." Some location-savings might derive from the physical location of these "hubs" as they tend to be strategically picked according to their proximity to different target markets. Therefore, although R&P might benefit from being able to better reach its target audience (i.e. by ministering courses in Asia, the Middle-East, Central America and Europe), no value is effectively aggregated to R&P's activities just by picking those locations. The same result (non-PE configuration and no source taxation) would probably be achieved by picking any other country within the same regional vicinity.

c. Tailored client research and policy advisory services

Since there would be no actual presence in the country of source, no value would be generated from marketable location-relevant data.

**3. The characterization of income derived from new business models and the application of related source rules**

a. Legal documentation database and online courses:

There is nothing to say that the way in which R&P structures itself in order to provide a remote specialized information service is a novel approach to the way other competing companies would provide the same service, or a new business model. In fact, R&P's business model is shared by many other publishing and news companies providing content that is only of an intellectual nature. The fact that no taxing rights derive in the source country is probably not an intended result, although it is so desired. Were R&P obligated to be assessed on a source basis in all the countries to which it provides its web based content, it would probably not be able to operate on a profitable margin.

That does not mean that source countries are totally unable to confer some taxing rights over any portion of the transaction. Many countries tax services hired from abroad (and delivered in the country), and therefore a source country could attempt to tax the price paid by the (database or course) signatory, who is a resident in the source country. Likewise, the source country may exert taxing rights over the payor if it maintains stringent Central Bank foreign currency controls, or if it imposes taxes on the resident person's foreign financial transactions.

These are all possibilities whereby a source country could tax a portion of the transactional price paid by the client (the payor) to R&P. The burden of the tax would thus be with the payor. Under no circumstance would the source country's tax administration be able to reach the profits (or income) attributable to R&P under the current state of affairs in international taxing rules, due to the lack of elements connecting R&P to the country where the payment originates from.

b. Courses in “hubs” requiring minor, temporary physical presence

The way in which the R&P organizes its foreign international law courses is again shared by other companies providing similar services in the legal market.

Considering R&P is responsible for organizing a teaching event which will require physical presence in the country, there is some opportunity for the country of source to demand indirect taxes on the physical goods sold during the time the event takes place (it is assumed that most countries will require some kind of special purpose visa to organize a temporary event in their countries). It seems difficult for there to be the demand of source taxes on the fees charged for the courses, if those are required to be paid beforehand, via an online payment system. The lack of a fixed long-lasting presence in the country would forestall the country of source from assessing any taxes over the course remuneration, since the income does not necessarily circulate through the jurisdiction where the course takes place.

Likewise, any contracts concluded with course attendees to sign up for any of the online services provided by R&P, would be excluded from tax in the source country if the payment is made remotely and the contract is signed directly with the headquarters in Luxembourg (because after all, R&P does not hold a fixed place of business in the country where the course takes place). The fact that no financial transaction effectively occurs via the country of source makes it difficult for the country to assess or even apportion some of that income to the source jurisdiction.

An opportunity for profit shifting might arise if the international contracts concluded by R&P outside of Luxembourg are signed up directly with the Singaporean office, or with the Mumbai Office, if these jurisdictions offer lower effective tax rates than Luxembourg would under similar circumstances. As a practice, R&P tries to centralize all of its transactions at the Luxembourgish office though.

In some instances where R&P provides a substantial amount of services or trades significant amounts of products, it has been made to register in the country for VAT purposes.

c. Tailored client research and policy advisory services

Sourcing rules might be applicable on the service contractor (the client). No sourcing rules would apply towards direct (income) taxes levied on R&P's income. The Luxembourgish tax authorities would have exclusive taxing rights over the income attributed to R&P.

**4. How to ensure the effective collection of VAT/GST with respect to cross-border supply of digital goods and services.**

a. Legal documentation database and online courses:

There are currently no uniform rules on the imposition of VAT/GST on cross-border supply of goods and services. For most countries, an actual presence in the country (or formal registration in the country's corporate business registry) is required in order for the company to be liable for VAT/GST in the country to which the good is sold or the service is provided. If the person acquiring R&P's online course or legal documentation database is a corporate person, the tax administration might be susceptible to demand the VAT/GST levied on the service provided (remotely) abroad, and whose results were verified in the country. In this case, the source country resident will be liable for the tax and not R&P, since the latter does not have a place of effective management (or even physical presence) in the country (see issue 3).

As previously mentioned, in some countries, such as South Africa, the configuration of substantial presence, via physical trade or the provision of services is enough to require a non-resident company to

register for VAT in the country of source. In those circumstances where registration is required, VAT obligations have to be complied with both in the country of source and the country of residence. There is no opportunity for double taxation provided the residence country acknowledges (i) an export operation and hence exempts the VAT that would be levied on the residence country based transactions; or (ii) acknowledges the payment of VAT in the source country and provides for some form of relief. R&P strives to maintain a good communication channel with the tax administrations in order to achieve a desirable result.

The result is still the same even when physical merchandise (such as books), purchased online, are sold to third (non-EU) member countries directly from the publisher, which is located in Spain, without going through the Luxembourgish office. The EU based operations are complied with according to the administrative requirements contained under the EU VAT Directive.

The cross-border supply of digital goods is of particular interest in the case of R&P, because many of the products made available by R&P via its legal documentation database could also be sold in physical form. That is the case for the R&P specialized journals and the online books, which may be sold by R&P in physical print, or online, together or independently from the rest of the content of the legal documentation database.

The issue then would be how a country would be apt to provide for a uniform VAT/GST treatment between the products physically sold to residents in the country (and undergoing customs control, hence making it easy to assess the VAT/GST upon crossing of the border), and those products sold (or better, made available) in a lump sum together with other digital services, on a continuous basis to a foreign company without a physical presence in the country.

Were the lump sum payment for the right to access the database to be treated as a service, then a tax on services or some kind of indirect tax might be assessed on the payor (who would have no opportunity to transfer the burden of tax to R&P). The individualization of the products acquired via the database and attribution of value to each individual product would be a very difficult exercise, and the most likely result would be an unequal handling of taxes on physical products once compared to digital products.

b. Courses in "hubs" requiring minor, temporary physical presence

VAT/GST or a tax on services (if these are distinguished under the jurisdiction of source) might be demanded by the local tax administration if the country requires R&P to register itself as a temporary taxpayer upon requiring permission (at times, a special visa) for the organization of the course.

It does not seem to be unreasonable for the tax administration to request VAT/GST upon the provision of services from the source country. The main issue a tax administration would be faced with would be in verifying and assessing the information provided by R&P, as to the price of the service rendered. That is considering the course is paid for remotely, directly to the headquarters or one of its subsidiaries, because there would be no financial substrate in the country of source.

The tax administration of the country of source could thus request R&P to inform the price of the service to the local revenues office, as a pre-requisite to the granting of authorization (or visa) for the course or seminar to take place in the country. This is not a practice that has been verified on many instances by R&P though. In most cases where R&P has to register due to VAT/GST compliance issues, it is on account of the transactional volume it operates in the country.

Physical books and journals sold during the course might likewise be reached by local taxes and VAT/GST. However, digital signatures to online resources such as R&P's legal documentation database, online books and online journal signatures might not ever be reached by the country of source, because there would be no effective connection between the country of source (where the course is ministered) and the good sold (i.e. if the course attendant is a foreign person paying from a foreign bank account to a bank account in Luxembourg), there would be no attributable sourcing right to the place where the contract was concluded.

The only hypothesis which might give rise to taxation is if the person concluding the contract with R&P is a resident of the country where the course takes place. In this case, the country of source might be able to request the payment of indirect taxes upon payment of the subscription to R&P's online services. The county of source would have to have a specific provision in its domestic tax legislation to be able to demand such taxes to the local resident. These taxes would most likely never be netted out from R&P's own remuneration, which would only submit its remuneration to the Luxembourgish VAT.

It is important to highlight however that on certain circumstances where R&P administers courses in low tax jurisdiction hubs, it hires local third party service suppliers to provide for the administrative arrangements in the hub (catering, renting out of the teaching space, reception of the course attendees, etc), but also to register and receive payments from the course attendees on behalf of R&P. The service provider then deducts a profit margin from the total income received from the course attendees and repasses the course money to R&P (for the provision of services).

Under those cases, if the third party service provider is qualified to act as R&P's agent, or if it regularly acts on account of R&P, it would be required to collect VAT/GST on the income received from the course attendees. It is very likely that the third party will be taxed for the service rendered. The third party qualification (according to international taxing rules and to the contract bonding the parties) will suit to merely determine whether the local VAT/GST is to be borne by R&P's headquarters or by the third party service provider. It was seen from part 1(b) that R&P does not consider those independent parties to be qualified under the dependent agent provision.

#### c. Tailored client research and policy advisory services

Since R&P would fail the substantial presence test in the country of source nor would it have a fixed place of business, it would be very difficult for the source country to impose VAT/GST on the price of the service provided by R&P to a local business. That would require an international joint effort between the tax administrations of Luxembourg and the source country. It is very likely for R&P to only be taxed VAT in Luxembourg.

Other indirect taxes might be imposed on the service contractor (the client), if they are so determined as a result of a domestic legal disposition.

It would be extremely difficult for the source country's tax administration to impose any type of indirect taxes on tailor-made services (classes or seminars) provided directly to the client. This situation is distinguished from the one stated in option (b) because in this case, R&P does not even require a special permission (or visa) to host an event. A working visa would be enough for it to enter the country and provide the consultancy service. Therefore it is unlikely that the tax administration would even know the nature of the activities performed by R&P in the country. Only if the client is the government, would the nature of the activity be known. In this case, R&P might be exempted for providing training in specialized knowledge to government officials.

If the training is tailor-made and provided totally or partially via online resources to a specific business client, the training could arguably be characterized as transfer of know-how, which would lead to the characterization of the remuneration as a royalty payment classified under article 12 (thus attributing the source country taxing rights under some DTC instances).

However, since the payment is not one made for information concerning industrial, commercial or scientific experience, acquire by R&P due to its own personal experience and deriving an economic benefit to the enterprise to which it is granted, it is highly unlikely that it would be characterized as know-how (and as a consequence, classified as royalty payment, as per paragraph 11 of the commentaries to article 12). The information provided by R&P resembles more closely an opinion given by an advocate (i.e. new information resulting from R&P's own research activity) which would not be characterized as know-how under the Commentaries (as per paragraph 11.4 of the commentaries to article 12).

### **Transfer Pricing Issues**

Transfer Pricing issues arise on the transactions occurring between R&P's main headquarters and its foreign subsidiaries. However, different solutions tend to be encountered on a case by case basis, considering both Singapore and India are jurisdictions which do not subscribe to the OECD model and thus follow their own methods for the determination of an arms length price. Transfer pricing does not present a particularly relevant problem to R&P's every day operations, because R&P strives to centralize all sales and financial operations in Luxembourg. However there are instances where R&P is made to discuss with tax authorities the right procedure to comply with transfer pricing obligations at both residence and source countries involved in a related party transaction.

### **Conclusion**

From the above description it seems clear that R&P organizes its business in order to have taxation concentrated entirely in its country of residence, Luxembourg. R&P does not position itself aggressively with the intention of saving taxes, although it has an abundance of opportunities to do so.

Although R&P's official tax position is fair and square in line with the OECD's Model main position, it is to be considered if, due to the nature of the services provided by R&P, there would not be a chance to consider that R&P would have a PE in some of the jurisdictions it provides service for, even though one would otherwise not exist under the scope of article 5(1). The issue is thus whether the alternative provision, which provides for an extension of the PE concept (paragraph 42.23 of the Commentaries to article 5) would not be the fairest option for digital economy related transactions.

Under the case at hand, the extension of the PE concept would not modify the taxing outcome for R&P because the enterprise does not meet the 183 days temporal limit which would qualify one for the alternative provision (as per paragraphs 42.25 and 42.26 of the OECD Model Commentaries to article 5).

The general question which the authors would like the OECD to debate is the following:

are the current treaty rules on the PE concept (both the standard rule as laid down in article 5(1) and the alternative provision suggested in paragraphs 42.25 and 42.26) appropriate for e-commerce, as practiced by R&P?
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The threshold of activity that triggers the existence of a PE within the OECD Model has traditionally been based on physical presence of the economic actor. Where no predetermined level of physical presence

is found, the taxing rights of business income is solely allocated to the state of residence of the economic actor. R&P's business model reveals that, as a consequence of the digitalization of the economy, a business can serve customers and provide services across the globe without setting a foot outside its country of residence. The authors question therefore, whether the OECD's emphasis on the physical presence criterion can be upheld in the global partition of business income taxation rights.

Specifically, the authors invite the OECD to discuss the following specific issues:

1. The need for physical presence in order to constitute a PE as per commentaries provided above;
2. The need for a substantial time presence in the country of source and how to measure time-permanence under the specific features of the digital economy (where physical presence is not required);
3. Would there be a way of providing for an international standard for the configuration of VAT/GST rights in the source countries where data and goods are traded in a current (yet digital) manner?
4. How to treat services that are partially physically provided and partially digitally provided, as is the case of the "hub" courses provided by R&P. Is there an occasion to qualify a 50/50 (digital/physical) service as just digital, or just physical according to the predominant character of the service?
5. What would the OECD consider to be "substantial electronic commerce" in order to qualify as a taxpayer for VAT/GST purposes?

These were the comments we had for the moment. Please do not hesitate to contact us should you require any further information and/or commentaries on this or any other issue related to this case study.

Tatiana Falcão and Bob Michel, IBFD Research Staff

December 2013

8 January 2014

OECD  
BEPS Project  
via e-mail: [CTP.BEPS@oecd.org](mailto:CTP.BEPS@oecd.org)

Dear Sirs,

## Tax Challenges of the Digital Economy

Informa plc welcomes the OECD's request for input on the tax challenges of the Digital Economy which was issued on 22 November 2013.

We are pleased to provide input as follows:

### *A. Nature of work/activities undertaken by your organisation*

#### **A.1. Please describe the background of your organisation, including the nature of the work or activities performed.**

Informa plc is a broad based, resilient business to business media group. We operate in three main areas; Events, which incorporates a range of face to face media businesses, including exhibitions, conferences and awards; Professional and Commercial Information (PCI), which delivers high value proprietary content to a number of industries including healthcare, pharmaceuticals, financial services, maritime, commodities, telecoms and insurance and the legal profession; and Academic information, which produces books and journals for the academic market, including university libraries.

We have over 6,000 employees in over 100 offices in 25 countries; we also run events and sell digital products in many more countries.

We pride ourselves on our digital expertise, which runs across all our businesses. The vast majority of our publishing products have now transitioned to digital platforms and, in 2012, 74% of publishing revenues were from digital product. In the Events business, we have seen social media becoming a powerful marketing tool, and have invested in technology used "within events".

**We see our mission as Bringing Knowledge to Life:** Businesses, professionals and academics worldwide turn to Informa for unparalleled knowledge, up-to-the minute information and highly specialist skills and services. Our ability to deliver high quality knowledge and services through multiple media channels, in dynamic and rapidly changing environments, makes our offer unique and extremely valuable to individuals and organisations.



Our 2012 revenues were £1.23bn of which over £500m were attributable to electronic product and a significant amount more was attributable in part to digital marketing, or supported by digital technology.

## ***B. Impact of information and communication technology on the activities of the organisation***

**B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.**

In our business, the fundamental business relationship between the provider of valuable information and the purchaser of such information is unchanged.

We still produce valuable content for our customers; what has principally changed is how it is delivered. Instead of a printed journal, book or bespoke report, all can be delivered electronically. In addition, customers can access more specific and more tailored content through sophisticated database interfaces. Access to such databases can be linked to a digital journal subscription or an e-book purchase, or can be obtained independently. However, the fundamental relationship is still between a content provider and a customer purchasing that content.

The customer will access the content through a variety of electronic devices; personal computers, tablets and smart-phones. Customers for our content product will typically not interact with each other.

Within PCI, the transition to digital is virtually complete, whilst within Academic Information print still sits alongside digital as an important medium.

We have identified a change in the relationship with customers within our Academic Information division in particular. When text books and academic journals were purely a printed medium, our relationship with customers essentially ended at the point of sale. However, when customers purchase a digital text book or journal, they expect to be able to download a replacement copy, should their version become corrupted or lost when they change their computer and "update" services are also often expected or required. So the relationship is not broken at point of sale, and the supplier has to continue to incur cost after sale; e-books and journals are effectively sold "in perpetuity". This has required the creation of systems to meet the on-going requirements and "dark archives" in which digital copies of books and journals can be stored for the long term, and retrieved for customers even if the original publisher has gone out of business.

Within the events business in particular we have seen the application of digital technology in the marketing of events through more sophisticated customer relationship systems being able to identify potential event attendees and sponsors, and we have been able to extend this to parts of our publishing business. We have also seen the development of interactive

and “networking” events where communications technology is used by delegates to interact both with speakers and each other.

## **B.2. How do these models leverage new technology to change organisational structures and supply chains?**

In our publishing businesses we have shortened and simplified the supply chain by cutting out the “physical” delivery of product. To take one of our oldest products, Lloyds List, this is now delivered to a laptop or tablet and no longer delivered by mail or purchased from a news vendor. Digital delivery also allows the inter-linkage of journals with database type product.

As noted above, whilst the shortening of the supply chain can eliminate some costs, the move to digital delivery can also add costs in the development of digital platforms, including meeting expectations of additional on-line functionality and the creation of “dark archives”. Digital delivery is not necessarily cheaper than print, and may be more expensive in some cases

The structure of our organisation is little changed, although technology allows more home and remote working in the assemblage of content. We have increased our recruitment of eMedia experts and technologists to support the development of digital delivery and marketing.

## **B.3. In each of the business models identified, what assets and activities contribute to the generation of value?**

The prime generators of value in publishing are the creation of content, and the improvement of delivery systems. Our customers will simply not purchase sub-standard content. The more relevant the content to their work, the more likely they are to purchase, and the more they will be prepared to pay. The development of easier and quicker delivery mechanisms, such as reliable and user-friendly “apps” for tablet devices will also encourage a purchase decision.

In events the improved analysis of data through more sophisticated customer relationship management can be a driver of value – the system of managing data rather than the data itself being critical. “In-event” networking and inter-active software can enhance the experience of event attendees, and in some cases can be the prime attraction of the event.

In summary, the assets and activities contributing to value are content and innovation in delivery.

Once the product is at the point of delivery, in our view value creation is largely complete, although the customer may place value on “after-sales service” provided by us, such as the ability to update a publication.

#### **B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?**

There has been little fundamental change; as noted above, it is easier for content to be created in several places. Equally, the development of technology to improve delivery can be more widely dispersed.

Historically, there could be some (low) value attributable to the physical delivery of product. However, as physical delivery disappears from the supply chain, this element disappears.

#### **B.5. How have changes in underlying business models impacted the way in which business is organized as a legal or tax matter?**

There has been little change, as the fundamental relationships have not changed. However, as noted there is a reduced requirement for organisation and entities at the delivery stage. A greater variety of sources for content and innovation will require greater focus on organisation and legal structure at that earlier point of the supply chain.

#### **B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?**

From a corporate tax point of view, challenges will arise in determining profit allocation to potential dispersed sources of content and innovation. From a VAT perspective, whilst there are split VAT rates and differing treatments for digital and non-digital versions of the same product, challenges in getting invoicing correct will continue.

#### **B.7. How do you see business models and supply chains evolving in the future due to advances in information technology?**

That is very difficult to answer, as both developments in hardware and software and our customer industries have to be considered. It is possible more and more data will be collected, but data itself is of little value – it is the processing and interpretation of such data which is important. Much data may be irrelevant, some data can simply be wrong. Internal and “closed” networks may become important drivers of innovation as companies seek to manage dispersed workforces and suppliers. Data flow is also likely to become more two way; for example, our business and academic customers can now request download/usage data on products from us, and are thus able to make more informed purchase decisions. This trend is likely to continue.

In the business to business market it makes sense to have a single point of delivery between content producer and content user. We can envisage selling a variety of content to a business in a single package and that business then dispersing the data within its organisation. However, such central procurement is not a new activity specific to the digital world, and certain industries such as pharmaceuticals are fragmenting into more specialised units which results in customers who are only interested in a narrow range of products.

## *C. Other comments*

**C.1. Please provide any other comment you may have regarding Action 1, including any additional information that you would consider useful in identifying the challenges that the digital economy poses for the application of existing international tax rules.**

We have addressed the questions from our specific point of view, and recognise that there are other parts of the “digital economy”, including, for example, on-line shopping for physical products and on-line services. However, in most cases it would appear that the digital economy is shortening or modifying a supply chain rather than fundamentally changing the value creation process; the customer ultimately values the product or service, not the supply chain process involved.

A particular issue for digital publishers supplying to consumers who cannot recover VAT is that there is a perception that “the internet is free”. Hence digital consumers expect lower prices, not higher, for digital products when compared to printed matter. As noted, it is not a given that digital production is cheaper than print; given the development of ever more complex delivery platforms, and the requirements for “dark archives”, digital costs may even be higher. Where the supplier has to absorb the VAT cost on digital product, profit margins will be squeezed, and investment in digital technology will suffer.

We trust you find our input to be helpful

Yours faithfully,

**GLYN FULLELOVE**

Group Tax Director, Informa plc

cc: Zoe Leung-Hubbard, UK Government HM Treasury – [zoe.leung-hubbard@hmtreasury.gsi.gov.uk](mailto:zoe.leung-hubbard@hmtreasury.gsi.gov.uk)

OECD –

Request for Input Regarding Work on Tax Challenges of the Digital Economy

November 2013

<b>A. Nature of work/activities undertaken by your organization</b>
A.1. Please describe the background of your organisation, including the nature of the work or activities performed.
Our company group (“the Group”) has development, manufacturing, sales and services activities in the field of office system, imaging system and industrial machineries, etc.
<b>B. Impact of information and communication technology on the activities of the organization</b>
B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.
The Group mainly deals with hardware products and the volume of our business in the field of digital economy at present is not significant. However, due to the digital technology today, information for many of our products is shared through a network. As a result, we have observed an increase in demand for hardware products that serve as platforms for software and digital contents. For example, image information contained in a digital camera is transferred to a personal computer, printer and copier or a server in Cloud by using a network and you can process that information or output it as it is. This image information can be shared across borders over the network. Using the process described above, there is a business model where fees are charged for services of outputting the image information uploaded to our server by users from their digital cameras as high-quality print results.
B.2. How do these models leverage new technology to change organisational structures and supply chains?
Along with the development of network environment, it is now possible to install software in our product without a data storage device (i.e. magnetic tape, medium disk and memory). Such development may lead to improving the efficiency by reducing the hierarchy of a physical supply chain from manufacturing to sales.
B.3. In each of the business models identified, what assets and activities contribute to the generation of value?
Assets such as software, digital contents, network utilization activities, which directly contribute

to value creation, together with competitive hardware equipment, which are the foundation of network, create intangible assets with a main focus on intellectual properties such as patents.

B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?

In order to improve customer satisfaction, services are expected to be carried out in a location close to the customers and the services should be designed to meet the diverse needs around the world. The development of new digital technologies may have an influence on providing more improved solutions for these services.

B.5. How have changes in underlying business models impacted the way in which business is organized as a legal or tax matter?

As answered in B.1., our Group mainly deals with hardware products and the volumes of the business in the field of digital economy are not significant at present. Accordingly, it has not yet reached the stage where the fundamental business model would transform significantly nor have the tax and legal implications on the fundamental business practice changed. However, corresponding to the shift in the weight of business from hardware to software, digital content and solutions, and services, the current business practice is expected to change from centralized controlling to local federal controlling and accordingly the tax and legal implications may change as well.

B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?

Sales of our products (hardware and software) and provision of our services to customers and users are conducted by our Group companies located in each country. Since we do not do cross-borders sales activities for our digital content, we have not faced the tax issues as those covered in this BEPS.

B.7. How do you see business models and supply chains evolving in the future due to advances in information technology?

As answered in the above B.2., along with the development of network environment, it is now possible to install software in our product without a data storage device (i.e. magnetic tape, medium disk and memory). Such development may lead to improving the efficiency by reducing the hierarchy of a physical supply chain from manufacturing to sales.

As answered in the above B.5., corresponding to the shift in the weight of business from hardware to software, digital content and solutions and services, the current business practice is

expected to change from centralized controlling to local federal controlling and accordingly, the tax and legal implications may change as well.

### **C. Other comments**

C.1. Please provide any other comment you may have regarding Action 1, including any additional information that you would consider useful in identifying the challenges that the digital economy poses for the application of existing international tax rules.

Under the current tax administration systems, if the tax authorities thoroughly monitor the declaration and payment status of value-added tax and corporate income tax through conducting tax audits, it is possible to prevent tax erosion issues in a B to B transactions without customs clearance, even for businesses delivering digital content through a network.

The problem lies in B to C transactions and how to capture the transactions where individual consumers download digital content from a supplier server overseas and settle the payment with a credit card. Basically, we think that the most feasible way to prevent the tax erosion is to require cross-border suppliers to register as taxpayers with the tax authorities in the countries where the suppliers provide digital contents and value-added tax should be imposed at the entry points of cross-border transactions.

We think that the corporate taxation does not necessarily need to be changed if corporate taxes are generally imposed in the suppliers' country of residence or depending on the presence or absence of PE and if double taxation is eliminated by applying foreign tax credits.

OECD –

Request for Input Regarding Work on Tax Challenges of the Digital Economy

November 2013

<b>A. Nature of work/activities undertaken by your organisation</b>
A.1. Please describe the background of your organisation, including the nature of the work or activities performed.
<b>B. Impact of information and communication technology on the activities of the organization</b>
B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.
B.2. How do these models leverage new technology to change organisational structures and supply chains?
B.3. In each of the business models identified, what assets and activities contribute to the generation of value?
B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?
B.5. How have changes in underlying business models impacted the way in which business is organized as a legal or tax matter?
B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?
B.7. How do you see business models and supply chains evolving in the future due to advances in information technology?
<b>C. Other comments</b>
C.1. Please provide Any other comment you may have regarding Action 1, including any additional information that you would consider useful in identifying the challenges that the digital



economy poses for the application of existing international tax rules.

1. The OECD needs to define the “ Digital Economy ” . Digital Economy can be the sale of physical goods over the internet, the sale of pure digital goods/services where there is no physical product, or a hybrid of both. We have all three types of transactions. To the extent we are talking about the sale of physical goods over the internet, we see the internet as being just a different means of selling the same goods to a consumer and believe that existing rules are broad enough to cover these transactions. If the governments decide to change the rules in this area, they must ensure that in doing so that they do not create a distortion between sales of physical goods over the internet and sales of physical goods through physical retail stores.
2. To the extent the governments determine that existing rules do not adequately address the sale of digital goods and services (where there is no physical product), we would advocate that any new rules be clear, consistent and proportionate to these often high volume but low price transactions. Rules should be globally consistent in both interpretation and application and should be administrable so that taxpayers can easily comply. This is particularly important in the case of indirect taxes, such as VAT, where the companies are collectors of the tax but are hit with huge penalties when they fail to properly comply. Collection of VAT requires detailed systems for proper implementation and, therefore, treatment and outcomes must be clearly understood at the outset in order to build the proper systems. And the amount of reporting required and registration thresholds should reflect the economics of these transactions. Transaction by transaction reporting for such high volume, low price transactions may be highly inefficient and therefore summary reporting or minimum thresholds may be needed to be practical.
3. Consistency around the world is highly recommended. If countries begin to implement changes unilaterally, the rules will quickly become extremely complex and make it difficult and every expensive for taxpayers to comply.

OECD –

Request for Input Regarding Work on Tax Challenges of the Digital Economy

November 2013

<b>A. Nature of work/activities undertaken by your organisation</b>
A.1. Please describe the background of your organisation, including the nature of the work or activities performed.
Internet advertising business, e-Commerce business, members services business, and other businesses.
<b>B. Impact of information and communication technology on the activities of the organisation</b>
B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.
Internet advertising business : There is a variety of Internet advertising, like Keyword targeted advertising, Display advertising, or Video and Rich Media advertising. Clients pay to advertising medium based on the number of clicks or page views. There are cases where direct contractual relationship between clients and advertising medium exists, and on the other hand, advertising agencies, sometimes called media representatives, stand between clients and media. Compared to TV advertising, internet ad can be started with less expenses, and is accessible to smaller businesses.
B.2. How do these models leverage new technology to change organisational structures and supply chains?
Through Internet, and without passing through customs, online advertising of similar quality can be provided from home and abroad. Accordingly, global advertising medium, which has advanced ad technology, expand their business to domestic market.
B.3. In each of the business models identified, what assets and activities contribute to the generation of value?
Internet advertising technology is ever evolving and changing; for example, a technique called behavioral targeting, by enabling advertisers to target audiences based on their recent online activity, create new demand for online advertising.
B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?
As described above, online advertising services of similar quality can be provided from home and abroad, and this allows advertising services providers to expand their business from places favorable in terms of governmental policy, regulation, and taxation and/or to

move their legal or physical entity to such areas.
B.5. How have changes in underlying business models impacted the way in which business is organized as a legal or tax matter?
Same as above B.4.
B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?
In Japan, consumption tax is not imposed on Internet services provided from abroad, and domestic advertising companies is put in disadvantageous position compared to the their overseas rivals in terms of price competition. For internet services is in nature can be provided from wherever the place of operation, domestic service providers is beginning to consider transferring their legal or physical entity abroad as an practical option, and thus there are growing concerns about erosion of tax base and/or decline of employment.
B.7. How do you see business models and supply chains evolving in the future due to advances in information technology?
Generally speaking, it takes longer time to amend taxation rules, as compared to fast-paced changes in the Internet (so-called dog year), and tax in quality can be an irreparable disadvantage. There is a concern that global internet service entities may expand market share in a country where taxation rules and other regulations has not yet kept up with the technological advances.
<b>C. Other comments</b>
C.1. Please provide Any other comment you may have regarding Action 1, including any additional information that you would consider useful in identifying the challenges that the digital economy poses for the application of existing international tax rules.
In the age of digital economy, tax system, which is not industry-neutral, can generate competitiveness disparity between domestic and foreign entities. We hope that not only tax revenue but also viewpoint of industrial policy would be taken note of and emphasised in the discussion process under Action Plan 1.

*Cette note a pour objet de présenter les réponses de Solocal Group au questionnaire de l'OCDE suite à notre participation et à notre audition dans le cadre du Groupe de travail sur les enjeux de la fiscalité du numérique.*

## **A. Nature of work/activities undertaken by your organisation**

### **A.1. Please describe the background of your organisation, including the nature of the work or activities performed.**

Solocal Group est un des leaders de l'économie des contenus et des services numériques français et le n°1 de la communication locale digitale en France. Son activité repose sur la mise en relation locale entre les professionnels et les consommateurs.

En 2012 Solocal Group a généré un chiffre d'affaires de plus de 1 Md€, dont 95% en France, grâce au maillage géographique de ses 19 agences réparties sur tout le territoire et à ses 17 marques complémentaires (PagesJaunes, Mappy, 123people, Chronoresto etc...).

Solocal Group fédère près de 5 000 collaborateurs - dont plus de 2 300 conseillers en communication locale en France, en Espagne, en Autriche et au Royaume-Uni.

Solocal Group se classe au 5<sup>ème</sup> rang des plateformes les plus consultées en France et permet donc à ses 600 000 clients d'avoir une visibilité directe extrêmement forte. De surcroît, grâce à ses partenaires (Yahoo, Bing, Google, ebay), Solocal Group offre à ses clients une visibilité accrue via un référencement sur les principaux carrefours d'audience du web et des réseaux sociaux.

## **B. Impact of information and communication technology on the activities of the organisation**

### **B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.**

Historiquement, le groupe est un annuaire dont le business modèle reposait sur la vente d'espace de communication à des professionnels (commerçants, artisans, etc...). Le modèle est la gratuité pour les lecteurs des annuaires et le paiement des encarts publicitaires par les clients (annonceurs). La publicité dans les annuaires a connu depuis 1946 un développement continu grâce à la croissance de la consommation et du marché de la publicité en France, ainsi qu'à l'augmentation de la diffusion et de l'audience des annuaires, liée à l'augmentation du nombre d'abonnés au téléphone.

A partir de 1997 et de l'arrivée d'Internet, le modèle d'affaire du groupe reste inchangé dans son principe mais s'adapte au secteur digital. A partir de ces années, le groupe s'est profondément transformé pour s'adapter aux mutations technologiques et sociétales :

- 1996, premiers pas du groupe dans internet : les premiers sites Internet sont proposés aux clients
- 1997 : naissance de « pagesjaunes.fr »

- 2000 : première application de pagesjaunes.fr sur application mobile.

Le volume d'activité sur le segment digital n'a cessé d'augmenter pendant que celui de l'activité papier s'est progressivement réduit. En 2013, Solocal Group devrait réaliser près de 65% de son chiffre d'affaires sur Internet (avec une ambition à 75% à horizon 2015).

Avec le développement du digital, le business model repose sur le cercle vertueux d'une forte audience sur les sites du groupe, monétisée ensuite auprès des clients qui se voient proposer des solutions pour rendre leurs services et leurs produits les plus visibles possibles. Le groupe propose ainsi à ses clients des solutions de communication qui couvrent toute la chaîne de valeur en matière de visibilité digitale : sites, référencement, display, élaboration de contenus, web-to-store,...

### **B.2. How do these models leverage new technology to change organisational structures and supply chains?**

-

### **B.3. In each of the business models identified, what assets and activities contribute to the generation of value?**

La stratégie création de valeur et de croissance de Solocal Group repose sur 3 axes prioritaires :

- La croissance continue des audiences avec des supports complémentaires : Internet fixe, mobile et imprimé, pour accompagner la croissance des usages et des besoins (recherche d'informations et de coordonnées, recherche par la carte, de proximité, recherche par univers thématique, recherche de personnes...);
- L'enrichissement des contenus locaux, qui passe à la fois par le lancement de nouveaux produits et services pour les clients : création de sites Internet fixes (135 000 sites créés par Solocal Group) et mobiles, garantie de visibilité sur les moteurs de recherche, agrégateur de bons Plans, partenariats avec des acteurs de référence dans leurs domaines, dépôt d'avis...

### **B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?**

L'évolution technologique a impacté notre business model dans la mesure où le digital multiplie les solutions et les moyens de visibilité qu'il est possible d'offrir à nos clients (des sites en propre, du référencement sur toutes les plateformes, des avis...), par rapport à « l'avant Internet » où les solutions offertes par les annuaires étaient plus restreintes.

Par ailleurs, ces nouvelles technologies donnent aux consommateurs un accès à des informations instantanées partout ils se trouvent. Il était donc indispensable que le groupe développe ses services sur tous les outils digitaux : fixe et mobile (tablettes, Smart phones) pour répondre aux besoins grandissants, d'utilisateurs très mobiles.

### **B.5. How have changes in underlying business models impacted the way in which business is organized as a legal or tax matter?**

L'exploitation des données personnelles, rendue possible par le développement des technologies, a soulevé la question juridique de l'utilisation et de la protection des données personnelles.

### **B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT perspective?**

Le principal challenge international auquel doit faire face un groupe national comme Solocal, dont le chiffre d'affaires est réalisé à 95% en France, est l'optimisation fiscale des géants mondiaux de l'internet.

Comme l'OCDE le souligne dans son rapport BEPS, les questions de l'érosion de l'assiette de l'impôt sur les sociétés et du transfert des bénéfices figurent en bonne place parmi les priorités politiques des pays de l'OCDE.

Néanmoins nous tenons à rappeler **que les conséquences de telles pratiques sont dévastatrices en terme d'activité, d'innovation et d'emploi pour les acteurs nationaux qui ne pratiquent pas l'optimisation et « jouent le jeu » de la fiscalité nationale.** Ces acteurs nationaux finissent par payer une proportion d'IS national bien supérieure à leur poids réel dans l'économie pour compenser le manque à gagner de ces comportements d'optimisation.

*Ainsi avec plus de 8 Mds€ de revenus estimés en France, GAFAM (Google, Amazon, Facebook, Apple et Microsoft) acquitteraient au total moins de 40 M€ d'IS en France ; Solocal, avec un CA d'1Md€, en paye 3 fois plus et se classe au 23ème rang des contributeurs à l'IS national.*

Au point de vue national, les acteurs nationaux du numérique souffrent aussi de dispositifs fiscaux qui ne sont pas adaptés au secteur :

- **Le Crédit Impôt Recherche (CIR)** : le CIR est très conséquent au niveau national (10% de l'IS français soit près 5 Md€) mais totalement inadapté à l'économie numérique ; **il ignore l'innovation au profit de la recherche fondamentale.** C'est ainsi que les industries manufacturières (11% du PIB français) ont bénéficié de près de 69% du CIR distribué en 2010 contre seulement **1,2% pour le secteur des technologies de l'information et de la communication** => *Ainsi, seules 13% des dépenses de R&D de Solocal sont éligibles au CIR contre un ratio de 34% en moyenne pour le Top 5 des entreprises bénéficiant du CIR (Sanofi, Thales, Renault, Safran, Alcatel) ; sur 40 M€ de dépenses réalisées par Solocal, seuls 5M€ sont éligibles au CIR.*
- **Le Crédit d'Impôt Compétitivité Emploi (CICE)** ; censé réduire le coût du travail pour les salaires allant jusqu'à 2,5 fois le SMIC, ce **dispositif exclut largement le secteur numérique qui est le 1<sup>er</sup> créateur d'emplois à forte valeur ajoutée en France et qui représente le ¼ de la croissance économique** => *Chez Solocal, le montant attendu par le CICE est estimé à 2 M€, ce qui représente moins de 2% de l'IS du groupe (112 M€), alors qu'au niveau national il atteindrait 20% de l'IS payé par les entreprises en 2014; par ailleurs le CICE ne réduirait le coût de la masse salariale de Solocal que de -0,6% contre -2% attendus pour l'ensemble de l'économie en 2014.*

### **B.7. How do you see business models and supply chains evolving in the future due to advances in information technology?**

-

### ***C. Other comments***

C.1. Please provide ***Any other comment*** you may have regarding Action 1, including any additional information ***that you would consider useful*** in identifying ***the challenges that the digital economy poses for the application of existing international tax rules.***

Les travaux de l'OCDE sur l'érosion de la base fiscale et le transfert des bénéfices donnent au numérique un place particulière avec notamment la constitution du « groupe de travail sur les enjeux de la fiscalité du numérique ».

Certains pays pourraient toutefois ne pas souhaiter que des solutions spécifiques au secteur numérique soient appliquées, mettant en avant l'idée selon laquelle :

- L'érosion de la base fiscale concerne tous les secteurs d'activité et que l'outil numérique n'est qu'un facilitateur/accélérateur de ce mouvement global d'érosion
- Le secteur numérique n'est lui-même pas plus touché que les autres

**Pourtant le secteur numérique a des spécificités propres qui rendent l'optimisation fiscale des géants mondiaux, sur ce secteur particulier, incomparablement plus massive et facile:**

- Le poids considérable des actifs immatériels
- Un marché quasi immédiatement mondial
- Le découplage systématique, opéré par les géants mondiaux du net, du lieu d'établissement du lieu de consommation
- La collecte et l'exploitation des données sur un territoire sans pour autant y payer une contrepartie fiscale
- Le « Travail gratuit » de l'utilisateur au bénéfice des groupes internet

L'ensemble de ces caractéristiques fait que **les comportements d'optimisation ne sont pas comparables à ce qui existe dans les autres secteurs traditionnels (agriculture, industrie automobile, chimique, BTP ...)** dont les actifs physiques restent indispensables et difficilement délocalisables.

Fort de ce constat il est **fondamental** que les travaux de l'OCDE prennent en compte cette singularité dans l'élaboration des prochaines conventions fiscales multilatérales.

## Action 1 Digital Economy

### **A Name of work/activities undertaken by your organisation**

Financial Services Provider (Banking, Wealth Advisor, Broker/Dealer, Insurance)

### **B Impact of information and communication technology on the activities of the organisation**

The impact of the digital economy in the financial services industry can be segregated on a high level into two sectors: internal operation and client offering. Whereas, in the area of operations the digital economy did support to a large extent the outsourcing of classic operation services and maintenance activities into centralised special units that are no longer geographically dependent from the service offering, service offering is still related to the relationship with the clients and the classic distribution channels. Operation and maintenance are mainly cost related. Income is generated through the service offering. However, the financial services sector is among the highest regulated areas in the world. Anti-abuse rules are a common standard in a highly regulated area. They apply as principles and cover also the digital economy.

Today, due to global regulatory constraints, it is not possible to open a business relationship or an account without physical contact and identification procedures. Electronic commerce only starts after an account is opened (in the old fashion).

#### **B.1 Please provide a detailed description of the business models that have emerged in the context of the digital economy due to the advances in information and communications technology. Please describe also the technology deployed.**

The financial services industry is confronted with the challenges of a continuous development of modern communication technology. The impact of the digital economy on financial services is primarily related to extremely fast changes in communication tools and the behaviour of some segments of clients using these tools whereas the traditional service models and products have not changed.

Currently financial services providers use the modern technology in different areas:

- Communication, secure mails
- Remote account access (view only)
- Financial consulting
- Payment services
- Substitution of cash and debit/credit cards
- Trading activities (remote access)
- Brokerage



When everything started in the financial services with real time remote access to account information and portfolio information, the next step went into secure direct payments and stock exchange trading i.e. brokerage via real time remote access. We see nowadays a growing demand from our clients for integrated wealth advisory over secure channels directly via smart phone or tablet applications (Apps).

Currently we face a growing trend using smart phone applications as substitute for cash, ATM's and credits.

## **B.2 How do these models leverage new technology to change organisational structures and supply chains?**

In principle the supply chain did not change. Old communication channels via personal visits, telephone calls or fax messages have been substituted by secure messaging and smart phone/tablet applications. However, due to a more efficient operation of services via modern applications, costs of staff have been reduced. This generated also a quite substantial pressure on the traditional margin business. This was mainly driven by pure electronic service providers, in particular by internet brokers (virtual broking firms) who operate with only minimal maintenance staff. These effects had or still have a negative impact on the income side of financial services providers. In principle lower margin income has not yet been compensated by lower costs as a result of a reduction of staff. Traditional financial services providers are required to continue offering a dual layer of services: traditional offering via personal contacts and electronic offering via applications.

## **B.3 In each of the business models identified, what assets and activities contribute to the generation of value?**

Infrastructure costs for the offering of financial services and products have shifted from staff related costs to IT related costs. Regulatory capital allocation for regulated activities remains key for a sound risk management and business development in the financial services sector. Personal relationship with clients cannot be substituted by information technology but only enhanced.

## **B.4 How has new technology impacted the way and the location in which value is created or monetised under these business models?**

As mentioned above modern technology has to a large extent substituted the traditional communication channels. Value creation remains identical at the level of a booking centre (location where the account is booked) or at the place from where the services are provided from. The provision of operational services and IT is to a large extent centralised within specialised units operating as part of the financial service group or independently as a third party provider (based on an outsourcing contract). Although staff cost could be reduced, costs of infrastructure have increased substantially.

## **B.5 How have changes in underlying business models impacted the way in which business is organised as a legal or tax matter?**

The financial services sector is among the highest regulated areas in the world. The legal implications for cross border offering remain the same. There are increased regulatory constraints concerning solicited vs. non-solicited business, which have an impact on the distribution of products via electronic platforms. They are and will be addressed by financial services regulators. Anti-abuse rules are a common standard in a highly regulated sector.

Financial services in Switzerland and in the EU are exempt from VAT therefore the fiscal impact the new electronic channels pose can be neglected.

## **B.6 What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?**

See above B.5

## **B.7 How do you see business models and supply chains evolving in the future due to the advances in information technology?**

Modern communication technology will continue to have an impact on new communication technology and thereby also on the various channels for product distribution and service offering. Payments and credits (micro credits) might continue to shift from traditional into digital offering. The attractiveness of credit and debit cards will decrease and be substituted by smart applications.

Real-time portfolio valuation, integrated modelling for new investments combined with a real-time risk management will open new opportunities for integrated wealth advisory. Capturing the risk appetite of clients, their needs related to the "life cycle" together with their individual investment behaviour will allow financial service providers to improve the selection of products and cross selling of cross sector products (investments, credits and insurance).

To  
OECD

Date 20.12.2013 –  
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Subject Request for Input on Tax Challenges of the Digital Economy

Dear all,

WTS is pleased to provide you with comments regarding the requested input regarding the tax challenges of the digital economy. With our comments we will focus on the transfer pricing issues concerning the digital economy. Any potential income, VAT or WHT issues related to the digital economy will not be addressed in our memo. We appreciate the effort of the OECD to provide guidance for companies within the digital economy and hope our comments are helpful in that regard.

## **Transfer Pricing for the digital economy**

### **1. Introduction**

The relevance of the digital economy in regards to transfer pricing is a hot topic and is gaining more and more importance of course. As a general rule for the OECD member states, transfer prices should be based on the OECD transfer pricing guidelines for multinational enterprises and tax administrations as updated in July 2010. Therefore, an appropriate analysis of the allocation of functions and risks as well as comprehensive analysis of the overall value chain is indispensable to determine appropriate transfer prices.

In the following we would like to briefly summarize the transfer pricing issues which should be considered as specific for the digital economy according to our understanding:

- 2) The differences between classic industrial value chains and virtual value chains of the digital economy.
- 3) Different kinds of IP with the biggest impact on companies within the digital economy.
- 4) The allocation of the IP and the correlation to the development of value to IP.
- 5) The applicability of accepted transfer pricing methods for the de-

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termination of transfer prices within the digital economy.

## 2. Regular industrial value chains versus IP focused value chains

Companies within the digital economy differ from regular industrial companies particularly concerning the value chain. The most valuable assets for companies within the digital economy is their intellectual property (hereinafter referred to as "IP"), while regular industrial companies are more diversified in terms of the value chain including purchasing, logistics, manufacturing, stock keeping and distribution. Companies within the digital economy focus more on research & development, maintenance of IT systems and further growth of the specific IP. Value chains of traditional industrial companies contain IP which is mostly integrated in the manufacturing or distribution process. The focus of industrial companies regarding the value chain is on the product itself, the production of that product or the actual relationships to customers.<sup>1</sup> The Federation of German Industry (BDI) splits a typical value chain of industrial companies in four parts<sup>2</sup>:

- Primary focus on activities regarding raw materials and materials
- Upstream services and the delivery of components (e.g. customer advisory services)
- The actual production process
- Downstream services (e.g. maintenance services)

However, companies within the digital economy create their value chain around their IP and focus on its success. Usually these companies perform functions regarding innovation, research & development, design of a product, product and brand management, supply chain strategy as well as marketing. The actual manufacturing process is not contributing that much to the value chain as well as the distribution of the product and is therefore mostly sourced out to contract manufacturers and distribution companies. In several cases the companies are not even producing tangible assets at all.

This shows the importance of the IP regarding companies within the digital economy. In the following some of the most common used intangible assets regarding the digital economy are getting described.

## 3. Different IP used within the digital economy

As shown above the digital economy has its focus on IP. Regarding the IP the value chain differs a lot depending on each business model. The following sorts of IP have a big importance for many companies within the digital economy:

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<sup>1</sup> Cf. Institut der deutschen Wirtschaft Köln Consult GmbH, Cologne, 2013 ([http://www.bdi.eu/download\\_content/BS\\_5\\_Wertschoepfungsketten.pdf](http://www.bdi.eu/download_content/BS_5_Wertschoepfungsketten.pdf)) (last access 20.12.2013)

<sup>2</sup> Cf. Bundesverband der Deutschen Industrie e.V. (<http://www.bdi.eu/Industrielle-Wertschoepfungsketten.htm>) (last access 20.12.2013)

a) Brands<sup>34</sup>

Brands of multinational companies are often the distinctive mark for a potential customer regarding the decision to buy. Potential customers associate special characteristics with a specific brand. A brand needs to emphasize the features and should inspire the community. Considering an outer perception each brand has different characteristics. While Coca Cola stands for tradition, Apple became a cult brand and regarding the Google Incorporation, the community even created a synonym (to google) for looking something up on the internet. Therefore a brand needs a lot of marketing to grow and to create value for the company. Common examples for successful brand strategies in the digital industry are Apple, Facebook or Google. Those brands are well known all around the world. Apple, Facebook and Google invest a lot of effort in marketing and design of the brand (and products) to maintain or even raise the level of awareness on the market and to differ from competitors.

b) Logistic concepts<sup>5</sup>

High-tech companies with high value logistic concepts (e.g. Amazon) are focused on the distribution of products. Especially within the E-commerce business a successful logistic concept seems to be inevitable. Therefore, the actual value chain of those functions can be divided in three divisions; the procurement, the warehousing and the distribution. The manufacturing is not taken into account regarding the value chain. The logistic concepts form a link between the warehousing and the distribution. Amazon for example has a few huge logistic centers in key locations to be as efficient as possible regarding the distribution process. The actual value increase is located in the cost and time saving.

c) Software<sup>6</sup>

High-tech software companies have their focus clearly on R&D and therefore the creation of IP. The development of new software products as well as the upgrade of already existing ones is the value driver. These functions generate the most value for the companies. Therefore companies like Microsoft or Oracle research and develop permanently and document the results. It is necessary depending on the target group of the specific software to awaken interest and to demonstrate advantages of the software for the potential customers. Individual solutions as well as a reliable customer support gain additional value. The distribution, the training courses and the maintenance are not contributing much value. Therefore these functions are often out sourced to service companies.

<sup>3</sup> Cf. Roland Berger Strategy Consultants, 2008 ([http://www.rolandberger.de/media/pdf/rb\\_press/Roland\\_Berger\\_thinkact\\_content\\_13\\_D\\_20081001.pdf](http://www.rolandberger.de/media/pdf/rb_press/Roland_Berger_thinkact_content_13_D_20081001.pdf)) (last access 20.12.2013)

<sup>4</sup> Cf. OECD, Revised discussion draft on transfer pricing aspects of intangibles, Chapter VI, A.4, No. 55, Paris, 2013  
<sup>5</sup> Cf. Krcmar, Prof. Dr. H., Munich ([http://www.krcmar.in.tum.de/lehre%5Cwb\\_material\\_archiv.nsf/intern01/FC019CB194011FBDC1256C45004757DB/\\$FILE/LE03.pdf](http://www.krcmar.in.tum.de/lehre%5Cwb_material_archiv.nsf/intern01/FC019CB194011FBDC1256C45004757DB/$FILE/LE03.pdf)) (last access 20.12.2013)

<sup>6</sup> Cf. Wolf, C./Benlian, A./Hess, T., Industrialisierung von Softwareunternehmen durch Arbeitsteilung: Einzelfall oder Trend?, Munich, 2010 ([http://webdoc.sub.gwdg.de/univverlag/2010/mkwi/01\\_management\\_und\\_methoden/software-industrie/03\\_industrialisierung\\_von\\_softwareunternehmen\\_durch\\_arbeitsteilung\\_einzelfall\\_oder\\_trend.pdf](http://webdoc.sub.gwdg.de/univverlag/2010/mkwi/01_management_und_methoden/software-industrie/03_industrialisierung_von_softwareunternehmen_durch_arbeitsteilung_einzelfall_oder_trend.pdf)) (last access 20.12.2013)

d) Used-based Networks

Social networks like Twitter or Facebook are companies within the digital economy as well. The growth of these companies has been enormous in the recent past. Regarding the determination of a value chain two approaches might be reasonable. The determination can be either done in consideration of the location of the marketing department attracting the user base or of the research and development of the software. The customer/user base is the most valuable asset for networks and has to be treated carefully. The more users join those networks, the higher is the gained value for each user. Therefore every new user contributes value to the whole network. A determination of the value chain by using the software approach would also be imaginable as the research and development as well as the update of future focused implementations is crucial to satisfy the users' needs. As shown it can be discussed whether the IP of these companies lies within their software or local marketing. However the network companies provide access to a huge platform of potential customers for advertising companies through their IP.

Additionally the OECD splits IP in two categories. Trade intangibles on the one hand include software, patents and technical know-how and marketing intangibles on the other hand contain brands, logistic concepts and agreements.<sup>7</sup> Networks can be classified as trade intangibles due to their above described characteristics. After the display of some important sorts of IP within the digital economy and its contribution to the value chain, it becomes clear that IP is a main factor regarding the business model of companies within the digital economy. Prior to the determination of the right transfer prices it is necessary to clarify existence and allocation of the IP of each multinational group of companies. In the following we discuss the influence of the development of the IP on the allocation of the same.

#### 4. Allocation and development of IP

The allocation of IP to entities is a hot topic. This statement is based on the fact, that IP enables companies to gain higher profits in contrast to e.g. companies performing routine services that only gain routine profits.<sup>8</sup> The ownership question is essential to determine the appropriate remuneration as only the economical owner is entitled to receive the reimbursement for the IP.

It is necessary to differentiate between the legal, the economical and the functional owner. While the legal ownership is only relevant in terms of protected IP (e.g. trademarks, patents, etc.), the economical and functional ownership are inseparable since the performance of functions and the bearing of risks determine the transfer pricing system and therefore the economical attribution.<sup>9</sup> Therefore, for transfer pricing purposes it is important to determine the economical and functional owner of the IP.

<sup>7</sup> Cf. OECD, Revised discussion draft on transfer pricing aspects of intangibles, Chapter VI, A.3, No. 50, Paris, 2013

<sup>8</sup> Cf. Rouenhoff, A., Zurechnung der durch immaterielle Wirtschaftsgüter erzielten Wertschöpfungsbeiträge unter rechtlichen, wirtschaftlichen und funktionalen Gesichtspunkten, IStR, 22, 2012

<sup>9</sup> Cf. Rouenhoff, A., Zurechnung der durch immaterielle Wirtschaftsgüter erzielten Wertschöpfungsbeiträge unter rechtlichen, wirtschaftlichen und funktionalen Gesichtspunkten, IStR, 22, 2012

Regarding the allocation of IP there are many different approaches in practice. IP is getting allocated and moved to different companies within multinational groups (e.g. the parent enterprise of a group, a separate IP entity or offshore companies). Nevertheless this influences only the legal allocation of the IP but the functional/economical allocation might differ from the legal one.

Taking into account the OECD approach of an appropriate allocation of functions and risks as well as an analysis of the value chain the development of the IP and the performed functions and risks automatically result in an allocation of the IP to a specific company.<sup>10</sup> Therefore the development of the IP and the performed functions and risks connected to the IP have to be considered in detail regarding each unique business model. In the following we want to try to determine where the different types of IP should be allocated regarding the development and performed functions and risks:

a) Brands

The development of brands is generally located within the marketing departments of companies. Not reminding the community of the brand by advertising would have a negative impact on the value of the brand. This would lead to a loss of value and over time the brand could disappear. Following the functional allocation approach brands should be economically owned by the entity which is responsible for the brand marketing and development. This entity should therefore be remunerated for the brand from a transfer pricing aspect.

b) Logistic concepts

Logistic concepts are developed through research and development. Therefore the IP of a logistic concept should be economically allocated to the entity which is performing the R&D function.

c) Software

Development and updates of the software are very important for the success of software companies. Similar to logistic concepts the development of software is R&D driven and therefore the IP should be economically allocated within the entity which performs the R&D.

d) User-based Networks

As discussed earlier the allocation of IP that can be regarded as a user-based network is complicated. The allocation depends why the users joined the network. One reason could be that a free application offers unique possibilities. In these cases the IP should be economically allocated to the R&D entity. Another possibility could be that the users joined the network due to its marketing strategy. Then, the IP should be economically allocated to the entity providing the marketing.

To avoid a loss of value regarding the IP, maintenance is needed.<sup>11</sup> If IP is relocated to other entities then the ones that perform the maintenance in regard to the IP, the economical value of the IP should be diminishing in most cases.

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<sup>10</sup> Cf. OECD, Revised discussion draft on transfer pricing aspects of intangibles, Chapter VI, No. 38, Paris, 2013

<sup>11</sup> Cf. Wübbelsmann, S., Gedanken zur Diversifikation der Abschreibung einer Domain – Oder: Nachts sind alle Katzen grau, DStR, 1659, 2005

From an economic perspective the know-how regarding the maintenance of the IP and the IP itself seem very hard to separate if that is at all possible.

Based on the problems regarding the allocation of the IP the companies of the digital economy face the challenge to determine appropriate transfer prices. In a first step they need to determine the appropriate transfer pricing methods for the transactions within their business model. Therefore, within the next section we want to discuss the applicability of the methods provided by the OECD.

## 5. Application of transfer pricing methods in the digital economy

The OECD pursues the most appropriate method approach and prefers the application of one of five transfer pricing methods. Thereof three methods are the so-called standard methods. These three transfer pricing methods are the comparable uncontrolled price method (CUP), the resale price method (RPM) and the cost plus method (CPM). Beside those standard transfer pricing methods the OECD allows the application of two transactional profit methods. Those transactional profit methods are the transactional net margin method (TNMM) and the transactional profit split method (Profit split method).<sup>12</sup>

The application of the transactional profit methods is more complicated than the application of the standard methods. Therefore, most multinational groups prefer to use the standard methods for their intercompany transactions if they can be applied. Transactions that include IP can mostly not be remunerated through using one of the standard methods. The application of the CUP method requires comparable transactions involving third parties. As IP is mostly unique comparable transactions involving third parties do not exist in most cases. The resale price method is mostly applied for the remuneration of distribution functions. As the distribution functions within the digital economy are not comparable to distribution functions in other industries it is seldom possible to compare the margins earned. Furthermore a cost based remuneration methodology via the application of the Cost Plus Method cannot be applied for transactions involving IP in most cases as a cost based approach does not account for the profit potential of the IP.<sup>13</sup>

Therefore, companies in the digital economy need to apply one of the transactional profit methods for transactions involving their IP. The TNMM examines the net profit relative to an appropriate cost/sales/asset base that the taxpayer generated from a controlled transaction. As with the standard methods this method also requires data from comparable companies that have a comparable profile of functions and risks so that the adequacy of the transfer prices can be documented.<sup>14</sup> As a result the Profit Split Method seems to be the most appropriate transfer pricing method for transactions involving complicated value chains and a severe portion of IP. The application of the Profit Split Method requires a thorough analysis of the functions and risks performed by the parties, the involved assets and the IP. Taxpayers with business models

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<sup>12</sup> Cf. OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter II, Paris, 2010

<sup>13</sup> Cf. OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter VI, Part 6.27, Paris, 2010

<sup>14</sup> Cf. OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter II, Part 2.65, Paris, 2010



that are placed in the digital economy are therefore in need of structured transfer pricing systems that take into account the economic allocation of their IP and the value chain of their business model. Based on this information the transfer pricing system should be built. But even if the companies built their transfer pricing system in that manner, tax auditors in many countries will be questioning the companies as those transactions differ a lot from those that can be witnessed with companies that are active in other industries.

As a result transfer pricing for companies within the digital economy is linked to many uncertainties and risks of corrections by tax auditors as the transfer pricing systems are different of those used by multinational groups in other industries. Value chains and the used IP differ and therefore the OECD Transfer Pricing Guidelines offer only little support as most examples relate to other industries. If possible the OECD should offer support to companies within the digital economy regarding the structure of transfer pricing systems involving complicated value chains and high portions of IP.

Kind regards,

WTS Steuerberatungsgesellschaft mbH

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# **Request for Input Regarding Work on Tax Challenges of the Digital Economy**

**November 2013**

## **REQUEST FOR INPUT REGARDING WORK ON TAX CHALLENGES OF THE DIGITAL ECONOMY**

### **1. Background**

1. At the request of G20 Finance Ministers, in July 2013 the Action Plan on Base Erosion and Profit Shifting was launched. The G20 leaders at their meeting in St. Petersburg on 5-6 September 2013 fully endorsed the Action Plan and welcomed the establishment of the OECD/G20 BEPS project in which all non-OECD G20 countries participate on an equal footing with OECD Countries.

2. The Action Plan sets forth 15 actions to tackle BEPS in a comprehensive and coordinated way. The development of the 15 actions in the Action Plan will result in significant changes to the rules for the taxation of cross-border profits. The aim is to ensure that profits are taxed where the economic activities that generate them are carried and where value is created. The digital economy provides a good illustration of the types of challenges facing the international tax system.

3. According to the Action Plan:

*The spread of the digital economy also poses challenges for international taxation. The digital economy is characterised by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes. At the same time, the fact that new ways of doing business may result in a relocation of core business functions and, consequently, a different distribution of taxing rights which may lead to low taxation is not per se an indicator of defects in the existing system. It is important to examine closely how enterprises of the digital 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 in order to take into account the specific features of that industry and to prevent BEPS.*

4. Against this background, the BEPS Action Plan includes the following description of the work to be undertaken in relation to the digital economy:

#### *ACTION 1 – Address the Tax Challenges of the Digital Economy*

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

5. The Action Plan also provides that “[t]he OECD’s work on the different items of the Action Plan will continue to include a transparent and inclusive consultation process” and that all stakeholders such as business (in particular BIAC), non-governmental organisations, think tanks, and academia would be consulted.

6. A Task Force on the Digital Economy has been established to identify the issues raised by the digital economy and possible actions to address them. A report is expected to be finalised by September 2014. Examining the tax challenges of the digital economy requires a thorough analysis of the various relevant business models involved. In particular, it is of utmost importance for the work of the Task Force to be based on a full understanding of how digital economy businesses create value and make their profits, and also to analyse how the overall digitalisation of the economy has impacted business models and supply chains in traditionally non-digital industries.

7. As an initial matter, therefore, the Task Force on the Digital Economy is seeking **general comments on Action 1 regarding the appropriate approach to addressing the tax challenges of the digital economy**. In addition, the Task Force is seeking specific input on the questions below related to business models employed in the digital economy. This input will be relied upon in producing a discussion draft of the Task Force’s required report on the Digital Economy, which is expected to be released for comments in March 2014.

## **2. Request for specific input**

### **A. *Nature of work/activities undertaken by your organisation***

A.1. Please describe the background of your organisation, including the nature of the work or activities performed.

### **B. *Impact of information and communication technology on the activities of the organisation***

B.1. Please provide a detailed description of the business models that have emerged in the context of the digital economy due to advances in information and communications technology. Please also describe briefly the technology deployed.

B.2. How do these models leverage new technology to change organisational structures and supply chains?

B.3. In each of the business models identified, what assets and activities contribute to the generation of value?

B.4. How has new technology impacted the way and the location in which value is created or monetised under these business models?

B.5. How have changes in underlying business models impacted the way in which business is organized as a legal or tax matter?

B.6. What challenges do digital economy players face in determining their tax liability from a corporate income tax and VAT/GST perspective?

B.7. How do you see business models and supply chains evolving in the future due to advances in information technology?

**C. Other comments**

C.1. Please provide *Any other comment* you may have regarding Action 1, including any additional information *that you would consider useful* in identifying *the challenges that the digital economy poses for the application of existing international tax rules*.

8. Responses to this invitation should be sent electronically (in Word format) by email to CTP.BEPS@oecd.org by 22 December 2013 at the latest. Unless otherwise requested at the time of submission, responses to this invitation will be posted on the OECD website.