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10 April 2014

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BUSINESSEUROPE Comments on the OECD Public Discussion Draft entitled "BEPS Action 1: Address the Tax Challenges of the Digital Economy" 24 March 2014 – 14 April 2014

BUSINESSEUROPE represents through its members 20 million European small, medium and large companies. Active in European affairs since 1958, BUSINESSEUROPE's members are 41 leading industrial and employers' federations from 35 European countries, working together to achieve growth and competitiveness in Europe.

BUSINESSEUROPE is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled "BEPS Action 1: Address the Tax Challenges of the Digital Economy, 24 March 2014 – 14 April 2014" (hereinafter referred to as the Draft).

General Comments

Before going into any specifics, BUSINESSEUROPE would like to emphasise the importance of distinguishing between income tax and consumption taxes (VAT, GST, etc.). In the OECD framework and as a global standard, income tax is based on residence and source. Consumption taxes on the other hand aim at taxing consumption. Levied on the supply of goods and services, VAT/GST are taxes that are self-declared and business serves to collect these taxes for the government. As clearly stated in the BEPS Action Plan, it is not the purpose of the BEPS project to change existing international standards on the allocation of taxing rights on cross-border income. Consequently, the place of consumption is not and should not be a factor when allocating income for income tax purposes. Instead, the place of consumption is relevant for consumption tax purposes such as VAT or GST.

The combination of origin based income tax and destination based consumption tax allows for a reasonable allocation of taxation rights between the country of origin and the country of destination. This way, the income tax and the consumption taxes complement each other. This of course is not always the case since there are countries that do not have a consumption tax. That however is not an issue that requires action on a global level. Rather, this is a national issue to be solved in the countries in question.

That being said, BUSINESSEUROPE believes that the Ottawa taxation framework principles (*neutrality, efficiency, certainty, simplicity, effectiveness, fairness and flexibility) constitute* an appropriate framework when analysing the tax challenges. While it is clear that technology has rapidly evolved since 1998, the Ottawa taxation principles for electronic commerce outlined above, and developed under the leadership of the OECD CFA in 1998, remain relevant and valid.

We share the view presented in the Draft that it is not possible to ring-fence the digital economy. However, the Draft also tries to identify features that distinguish the digital economy. In our opinion, the features identified in the Draft are neither accurate nor limited to the digital economy. They may be relevant for some businesses in the digital economy, but they are not likely to be limited to the digital economy or to cover all aspects of the digitisation of the economy. Considering the complexity of this topic and the speed with which business models evolve, the features identified are likely to become obsolete in the near future. Consequently, we believe that the OECD should not develop any new guidelines, recommendations or amendments to the OECD Model Convention based on the Draft. Indirect tax issues referenced in the BEPS Draft are already being reviewed by the OECD through its existing WP 9 efforts related to B2C, and are also being discussed in OECD work on international VAT/GST guidelines. Business is fully engaged in that process.

In fact, it is our firm opinion that no specific rules are required for the digital economy as a “sector”. Considering that it is not possible to ring-fence the digital economy, we believe that it would be highly inappropriate to develop separate principles or rules for taxation of the digital economy from those applied to businesses engaged in the “conventional” economy.

Specific Comments

Nexus

The Draft points out that it is possible to be heavily involved in the economic life of another country without having a fixed place of business or dependent agent. In most cases, neither tax treaties (OECD Model Tax Convention Articles 5 and 7) nor domestic laws allow a country to tax income from a non-resident if there is not sufficient nexus. Sales to customers located in that jurisdiction would not constitute a sufficient nexus.

It is also stated in the Draft that the digital technology has had a significant impact on how activities are carried out, by enhancing the ability to carry out activities remotely, increasing the speed at which information can be processed, analysed and utilised, and, because distance forms less of a barrier to trade, expanding the number of potential customers that can be targeted and reached. According to the Draft, this increases the flexibility of businesses to choose where substantial business activities take place, or to move existing functions to a new location, even if those locations may be removed from both the ultimate market jurisdiction and from the jurisdictions in which other related business functions may take place.

In our opinion, this is true for all businesses and not only limited to the digital economy. Globalisation and the reduction of cross border obstacles allow businesses of all kinds to locate various functions in the most appropriate locations. Access to natural resources, cost of labour, capital costs, political stability, business climate, taxes etc. are all factors that are taken into account in such decisions. This is however not a matter of base erosion or profit shifting. This is sound business management aimed at enhancing economic efficiency and value. The only reason for countries to prevent this global aspect of modern business would be for protective reasons, which is contrary to the purpose of the OECD. Taxes must not be used to prevent trade and investment.

We do not consider the fact that a business can provide customers in a jurisdiction with goods and services, without a physical presence in that jurisdiction, to be an issue of great concern. Income taxes are not and should not be based on the location of customers. In our view this could potentially be an issue in a formulary apportionment situation but not as a BEPS concern. Given the fact that the Draft does not seem to clearly make this distinction, we would like to make some comments with respect to the fundamental income tax principles.

As previously stated, income tax is based on residence and source. Clearly, the traditional division of income based on factors such as functions of R&D, production and marketing is relevant also for the digital economy. Customers and markets are obviously necessary for any business, irrespective of whether a product is sold over the counter, by mail order through a catalogue or by digital means. A market is a condition of doing business but does not constitute functions, assets, risks or income by itself. Markets with many customers having disposable income may provide a business opportunity, but that is all it is: an opportunity. In order to turn those opportunities into income, companies must develop products that customers want to buy, find their customers, and deliver their products. Companies that cannot perform these functions will not earn income. The income that companies do earn is attributable to the performance of those functions, not the mere existence of the market. If the only thing that happens in the market jurisdiction is customer activity, it is difficult to see how, under traditional notions of income taxation, any income (as opposed to other bases of taxation) can be attributable to the market jurisdiction. This is true both for the digital economy and for the conventional economy.

Thus, the fact that a company provides goods or services to customers in a country does not by itself constitute a jurisdiction to levy income tax. If there is no need for a physical footprint, then the infrastructure of that country is not utilised and, consequently, that country should not have a jurisdiction to tax that income. The country where consumption takes place may, however, levy a consumption tax.

We understand that it is not the purpose of the BEPS project to alter fundamental principles of international taxation. Some of the options tabled in the Draft imply reallocation of income taxation to where the consumption occurs, even though there is no nexus. This would mean that the jurisdictions claiming the right to tax under current principles (based on function, assets and risks) will have to give up all or part of that right. These are most likely to be small economies with substantial exports and small markets of their own. Should those countries choose not to give up that right, double taxation would inevitably be the result. The negative revenue implications for a large number of countries could be substantial. In fact, many countries with small domestic markets could experience a considerable erosion of their national tax base as a consequence of actions taken by the largest economies represented in G20, taking actions in the name of the BEPS project.

Furthermore, we believe that the Draft contradicts other actions of the BEPS project. Several of the action points in the BEPS project require more substance in order to grant taxpayers the allocation of income to a jurisdiction or to grant treaty benefits. However, in the Draft the OECD seems to search for ways to allocate income to a jurisdiction where the taxpayers have no or very little substance (assets, function or employees). This is a contradiction in objectives that should be spelled out and explained. The risk of extra-territorial taxation should also be addressed and its consequences analysed. This has unfortunately not been done in the Draft.

We would furthermore like to make some specific comments with respect to the options in Chapter VII of the Draft related to nexus issues.

<u>PE Exemptions in para. 4 of Article 5 of the OECD Model Convention</u>

BUSINESSEUROPE strongly opposes any amendment of para 4 of Article 5 of the OECD Model Convention. Para 4 provides certainty with respect to the activities listed therein. Should the paragraph be amended or should the paragraph or parts of it be deleted, countries may consider all activities that currently fall under its scope as constituting a permanent establishment. The impact on conventional businesses would be severe. Businesses would have to re-evaluate all such activities and assess whether they would constitute a permanent establishment. This would result in either cost intensive restructuring or in a significant increase in the number of permanent establishments.

We strongly question whether such an extension of the permanent establishment concept would be feasible. If this would be the case, every enterprise would be required to file a tax return in every country where that enterprise has sales. In practice, this would prove to be very difficult, if not impossible, especially for SMEs. We worry that further BEPS concerns would emerge as a result of the difficulties to attribute cost deductions, losses etc. to all the countries where an enterprise is considered to have a permanent establishment.

Furthermore, if this option was adopted, the increase in the number of permanent establishments would most likely require businesses to register for VAT purposes in every country where they would be deemed to have a permanent establishment. Tax administrations tend to require a VAT registration where a permanent establishment for income tax purposes exists, even though there is no link between the two. This would further add to the administrative burden for businesses.

Significant Digital Presence Nexus

We firmly oppose the option to establish an alternative nexus for businesses to address situations in which businesses are conducted wholly digitally. This is, in our opinion, contrary to the conclusion in the Draft that the digital economy cannot be ring-fenced and would create great uncertainty on practise. Furthermore, an action that would differentiate wholly digital activities from other activities would be contrary to the neutrality principle in the Ottawa Framework.

Virtual PE

As previously mentioned, there is in our opinion no jurisdiction for a country to tax income where there is no physical nexus in that country. A virtual permanent establishment concept is a matter of formulary apportionment or splitting the cake rather than a BEPS concern. It would be very difficult to find sound and acceptable rules for allocating profits to a virtual PE.

The concerns in relation to para 4 of Article 5 above are applicable to the virtual permanent establishment concept as well. A virtual permanent establishment would also lower the threshold significantly and, as a result, lead to a significant increase in the administrative burden for businesses and an increase in double taxation cases worldwide.

VAT Collection

CFA have requested WP9 to develop guidelines for applying the destination principle to cross-border supplies of services and intangibles to final consumers. BUSINESSEUROPE endorses the OECD’s work on VAT Guidelines, and would like to stress that this is the venue for further work on the topic at the global (OECD) level.

We would recommend that governments take a closer look at the international VAT/GST guidelines.

As previously stated, BUSINESSEUROPE believes that the appropriate means of taxing consumption is with consumption taxes rather than income taxes. VAT and other consumption taxes do not require allocation of revenue, costs, losses, etc. This difference from income tax makes consumption taxes more suitable in this respect.

The Draft identifies two main challenges with respect to VAT collection, namely the exemptions for import of low valued goods and the remote digital supplies to consumers.

With respect to the first mentioned challenge, we question whether this is an issue that warrants attention from the OECD. As stated in the Draft, a low value threshold exists because the administrative cost associated with collecting the VAT likely outweighs the potential VAT revenue. The risk of abuse should be taken into account by countries when calculating the appropriate threshold. If countries find such a threshold in their domestic VAT systems problematic, they are free to adjust or remove the threshold in question. It should also be mentioned that the need for a threshold is reduced with the reduction of the compliance and administrative costs of collecting the tax. This being the case, we believe that the best way forward here is for governments and the OECD to aim at reducing the compliance and administrative burden for businesses.

With respect to the challenge regarding remote digital supplies to consumers, we understand the concern expressed in the Draft. We believe that the appropriate means of addressing this issue is by enhanced administrative cooperation between tax administrations. Enhanced administrative cooperation would help the consumer countries tax administration to enforce and collect the VAT due. However, it should be noted that the framework with respect to distance selling requires a certain level of legal certainty and a feasible registration process. Whilst this may be the case for EU countries, the OECD should take into account that not all the OECD member countries have well developed VAT or similar systems. It is thus of utmost importance that the OECD keeps encouraging countries to simplify registration regimes and administrative and compliance burdens in general.

Finally, there is one very important point to highlight when it comes to supplier registration as a collection mechanism for VAT/GST purposes. As mentioned in the OECD VAT/GST guidelines, a registration for VAT purposes by itself does not constitute a permanent establishment. It is the experience of more and more businesses that, by acting as VAT/GST collectors for governments, foreign VAT registrations are misused by governments and are being re-qualified as permanent establishment for corporate tax purposes. This forces businesses to pay corporate tax in jurisdictions where, based on international direct tax principles, no corporate tax should be due. In the long term, and if this continues to happen on a larger scale, such developments could undermine the efficient collection of VAT/GST by dissuading businesses from registering for VAT/GST purposes.

Withholding taxes

Another option suggested in the Draft is to impose a withholding tax on certain payments made by residents of a country for digital goods or services provided by foreign e-commerce providers.

It is not further specified in the Draft how such a withholding tax would be designed other than that the financial institutions involved with those payments could be the ones to bear the compliance burden.

In theory, levying a withholding tax may sound appealing since it would not require net income filing and allocations of revenue and costs. However, this option is also in contradiction with the conclusion that the digital economy cannot be ring-fenced. In addition, it does not stand up to the Ottawa taxation framework conditions. Furthermore, we question whether it is appropriate for the OECD to suggest taxes that would be imposed on <u>foreign providers</u> and limited to the <u>digital economy</u>. The risk of extra-territorial taxation must be addressed and analysed.

The digital economy, or the digitisation of the global economy, continues to evolve. Generally, there is no special legislative regime preventing small enterprises with innovative ideas from emerging and becoming successful. In our view, these small and innovative enterprises are essential in the modern economy. This being the case, it is neither desirable, nor appropriate to increase the threshold for starting a digital business. A withholding tax on digital goods and services would discourage rather than promote cross border trade, investment and economic growth. A broad-based consumption tax, which does not make any difference between foreign and domestic providers and between digital goods and services and conventional goods and services, would in our opinion be preferable compared to a withholding tax.

Concluding remarks

Considering the complexity of this topic and the speed with which business models evolve today, a specific set of rules for the digital economy does not seem warranted or achievable. Taxes must not be used as barriers to trade and investment, to the detriment of the welfare of citizens. The digital economy is an area where a more in-depth policy debate on the merits of direct/indirect tax solutions is needed. It is also essential to analyse the risk of extra-territorial tax situations. Furthermore, making consumption the basis for income taxation would have significant revenue implications for a large number of countries, in particular for small countries with a limited domestic market.

The BEPS Action Plan states that actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income. However, several of the action points calls for greater reliance on where economic activity takes place and in Action 1 the importance of actual sales for taxable profits is emphasised.

The argument that income can be taxed on the basis of the location of sales and irrespective of substance and presence of assets, functions and employees, is in sharp contrast to the BEPS approach, requiring and calling for more substance in order for companies to allocate income to low tax jurisdictions. Although markets are essential to businesses, they provide by themselves nothing more than a business opportunity to be explored. They do not constitute a basis for income taxation. However, sales and consumption are justifiably important sources of revenue for countries relying on consumption taxes like the VAT, GST or other consumption based taxes.

BUSINESSEUROPE is concerned that the nexus options in the Draft would lead to additional administrative and compliance burdens for businesses and substantially increase the risk of double taxation. To widen the scope of the permanent establishment concept would result in a completely new system for allocating international taxation rights across countries. It would also result in the reallocation of taxation rights between countries, which would diminish tax revenues for small open economies. It is essential that the larger economies in the G20 include small economies in Europe, Africa and elsewhere if a completely new framework for allocation of international taxation rights are to be developed.

On behalf of the BUSINESSEUROPE Tax Policy Group

Yours sincerely,

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