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Task Force on the Digital Economy
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Subject: Addressing the Tax Challenges of the Digitalisation of the Economy

1 Introduction

Grant Thornton International Ltd (GTI or we) appreciate the work undertaken by the Organisation of Economic Corporation and Development's (OECD) Task Force on the Digital Economy (TFDE) so far. The outcome of this work will have a significant impact on international taxation as we know it today. In our experience, the OECD has proven to be successful at devising innovative and effective proposals while creating global support among its members and non-members.

In this regard, GTI supports the OECD's initiative and encourages all involved parties to actively participate in these discussions so that consensus can be reached on this fundamental matter. The ability to identify and grant taxing rights on a consistent basis is a key element of a stable global economy. Unilateral initiatives unnecessarily add complexity and uncertainty to an already complex and uncertain tax environment for multinational enterprises (MNEs) and jurisdictions alike. We are also concerned that increased levels of complexity and uncertainty may make it even more difficult for start-ups or future MNEs to successfully navigate the digital tax landscape and may even impede their ability to compete on a level playing field.

In our view there is also an assumption implicit in the draft that there will be profits, or super-profits. Further consideration of cases during the investment phase, or where losses or non-super-profits arise, may be helpful in analysing the approaches and in determining a way forward.

2 Revised Profit Allocation and Nexus Rules

2.1 Determining Nexus Rules

When analysing the user participation and marketing intangibles proposals, the TFDE has focused on the profit allocation methods in line with Article 7 of the OECD Model Tax Convention on Income and on Capital 2017 (MTC 2017). The framework to determine whether there is, in fact, a taxable 'digital' presence appears to be subordinate to the amount of profit that can be allocated to it.

From an international tax law perspective, it's challenging for MNEs to comprehend that a nation may tax digital profits within its jurisdiction (tax object), without having a clear sense of when it actually became a taxable presence (tax subject). Article 5 of the MTC 2017 may not represent the best test of when an economic activity surpasses a certain threshold within a market jurisdiction. However, it does provide a clear and transparent framework for MNEs to move within. Only after a taxable presence has

been established will that market jurisdiction have the right to tax that particular tax subject. We acknowledge that it is challenging to find a practical and reasonable approach to allocate profits generated by the digital economy. However, to guarantee certainty and proportionality for all MNEs, we encourage the TFDE to maintain a two-step approach; classifying a digital taxable base and then allocating profits or losses to it.

In terms of this two-step approach, we believe that the TFDE needs to provide greater detail regarding how to determine the underlying value that is created within the taxable base and how to identify who effectively creates the value, i.e. the MNE or the users, and how the underlying value is actually monetised by the MNE in practice. Such guidance would help MNEs delineate how its profits or losses were created and by whom, which would then lead to appropriate profit allocation. The current explanations in the OECD draft are too vague and, as noted above, do not fully answer the question of how and why the profit should be allocated to a jurisdiction, making it difficult for MNEs and tax authorities alike to know how much profit is appropriate for a given jurisdiction.

We also question whether the digital economy is really a paradigm shift or simply an adjustment of existing business realities with stronger focus on certain factors. Our impression is that the OECD's guidance relies on certain rare but well-known cases in which the user base / user participation creates a certain 'lighthouse effect' in which the platform strength and/or network effects from user participation extends into adjacent markets, thereby creating value-add with a taxable base. We believe that certain examples are not necessarily representative of the whole market; in most cases, even in digital markets, it is still the case that local instances of the website or platform are developed by local sales and marketing efforts (i.e., by local people on the ground that create a taxable base). However, we also see that profit allocation between a headquarter entity and the local entities may be misaligned in an established market in some cases due to very high returns. The OECD needs to provide greater clarity on this. We would also note that the general principle of a lighthouse effect can also be applied to non-digital businesses as well.

2.2 The Profit Allocation Proposals

The User Participation Proposal

The user participation proposal is a combination of the number of users participating in a digital service or platform and the created user data. The residual profit split is then applied to allocate global profits to jurisdictions where users are based.

The fact that the TFDE already indicates that this approach would also need to be combined with a strong dispute resolution component to minimize additional controversy and double taxation, implies that the user participation proposal may not be the most appropriate method to create certainty going forward. In particular:

- We wonder whether the OECD really wants to recommend that profit allocation based on user participation cannot be achieved via an application of the arm's length principle in general or that traditional methods (especially the comparable uncontrolled price method) cannot be used? From a practitioner's perspective, we see no indication that third parties would not pay for access to or transfer of an established user base. Further, one could interpret the remarks made by the OECD as an implicit statement that the residual profit split method does not adhere to the arm's length principle. We assume that this was not the intention of the OECD and ask that it considers changing the wording accordingly.
- To corroborate the validity of the arm's length principle even in the digital economy, in practice we do indeed see transactions involving the sale of or access to an active participating user base (e.g., sale of traffic/ lead generation, mergers to combine user bases in multi-sided markets). What someone would pay for the user base of a third party is not a purely theoretical question. In practice, it is usually solved by using standard valuation methods.
- Also from a fundamental business perspective, it could be argued that the annual global profit of an MNE was not achieved by the number of users within a market jurisdiction, but by the amount of data and the application of the data created within it. By allocating global profit using a user allocation metric, countries with large populations will be entitled to larger tax income.

This is in effect a market feature, which has always historically been excluded from profit allocation approaches by the OECD.¹

- Furthermore, the development of an active user base for a digital platform is the result of digital platform and marketing strategies, and services tailored to local markets. This approach only focuses on the allocation of net profit. However, costs incurred to meet certain requirements to enter a specific jurisdiction should also be allocated to that jurisdiction as they were incurred with the intention of enlarging the local active user base. Global profitability does not imply that all jurisdictions are profitable from a business perspective. This in itself creates a problem because the costs incurred to develop digital platforms/local markets typically precede the generation of revenues in a particular jurisdiction. Furthermore, if the relevant costs in a developed market should only be current/running costs, we see another potential problem in that marginal costs tend to quickly converge towards zero (scalability without mass), which also yields an additional allocation problem.
- Marketing intangibles are developed through marketing services the cost of which can be identified. Does this proposal assume that a marketing intangible can contribute to the global profit without the involvement of the human factor relating to these services? To assess the viability of the possible application of this approach, it must be clear to what degree various marketing intangibles contribute to global profits or losses.

The TFDE also describes the need for greater dispute resolution procedures related to this proposal. Based on our experience, wider adoption of multilateral APAs will likely be ineffective as too many countries would need to be involved and even if an APA could be agreed, given how quickly the market changes, any conditions agreed for the APA may very quickly no longer hold, making the APA invalid. Simply referring to ex-post dispute resolution and effectively having tax authorities decide upon the individual taxation between themselves after the fact, also cannot be the goal of taxation rules, but is a predictable outcome where the justification of profit allocation and practical measures are not clearly defined.

Lastly, we see the need to clearly define what highly digitalised companies are and describe how they are different from other MNEs for which, according to this proposal, different regulations would apply. Furthermore, we see a potential abuse where there are vague definitions in place and wonder how it is intended to stop companies avoiding this categorisation, e.g., how to differentiate an 'online retailer' from a 'normal' distributor with websites?

Marketing Intangibles Proposal

This approach seeks to allocate profits that have an intrinsic functional link between a market jurisdiction and the marketing intangibles developed within. The intrinsic functional link can be supported by developing marketing intangibles such as:

- Trade names or brands; developing a positive attitude in the minds of 'potential' customers, and
- Customer lists, data and relationships; which are the result of activities of an MNE in the market jurisdiction.

We appreciate this is based on the existing Transfer Pricing Guidelines but, generally, we are of the opinion that the definition of 'marketing intangibles' is too nebulous and unspecific; the examples provided in footnote 4 may not delineate it sufficiently. Further, the term 'marketing intangibles' may not really be appropriate as we are of the opinion that something else is meant instead (e.g., customer base, brand/ tradenames are clearly defined and well established marketing intangibles but we are of the opinion that the 'marketing intangibles' in a digital economy mean the hard to measure synergies that are generated by the feedback process of an active user base of digital economy MNEs that also happen to have strong marketing intangibles). We see a problem differentiating between 'marketing' intangibles and other (e.g., market-based) intangibles and the value to be allocated between them (e.g., brand and algorithm and user base). For this reason, we consider the use of 'marketing intangibles' as a rather unfitting proxy term and definition.

¹ OECD Transfer Pricing Guidelines 2017 – 1.144 onwards.

The TFDE has attempted to split local marketing intangibles that have been developed from non-local trade intangibles. By doing so, it seeks to carve out this type of IP to apply alternative profit allocation principles whilst maintaining the consensus relating to the existing transfer pricing guidance as much as possible. When conceptually applying the marketing intangibles proposal to non-highly digitalised businesses, it can be concluded that the current transfer pricing principles already provide effective and clear guidance from a transfer pricing perspective. Due to its increasingly pervasive nature, the TFDE acknowledges that it would be difficult to 'ring-fence' the digital economy. However, clear and effective guidance must not make way for a less practical one-size-fits all approach that may lead to more controversy.

In particular, in para. 32, two tax systems for the same profit are proposed. We were wondering how this would fit together, especially the non-routine income value and allocation and how double taxation of this profit could be avoided?

One of the main challenges with this proposal is that favorable attitudes in the minds of customers cannot be quantified. Although financial metrics such as revenues or marketing costs connected to a specific market jurisdiction may provide an indication of the value of the local brand and customer relationships, MNEs need a clear indication at which point the intrinsic functional link with a market jurisdiction has been established.

As part of the BEPS project, the OECD established links between non-routine profits and value creation, DEMPE functions, and significant people functions. We do not yet see any rationale why these links should no longer be valid for highly digitalised businesses.

We are further of the opinion that this proposal needs a clear classification of entities into routine/non-routine entities to work.

According to this proposal, the most profit that can be allocated to a given jurisdiction (absent any other presence) is profit that is generated by exploiting the 'marketing intangibles'. Following other principles laid out elsewhere in the BEPS version of the Guidelines, e.g., with regards to financial transactions, without further functions or risks, the maximum profit that could be attributed to such a jurisdiction is a routine return on assets on the marketing intangibles.

Lastly, the language used by the TFDE appears very critical of 'Limited Risk Distributor (LRD) structures and implies that they are used inappropriately to minimise tax in a jurisdiction, even where the ownership, functions, risks and control of intangibles are located outside the jurisdiction. Furthermore, the comments made by the TFDE in this regard could also be applied to traditional businesses. We do not see a systemic problem with LRDs in this context. We would ask the OECD to revise the text on this point.

Significant Economic Presence Proposal

Although the significant economic presence (SEP) proposal has not been described as thoroughly as the other two approaches, it does include wording which could conceptually be interpreted as the groundwork for a digital nexus approach. In line with the current MTC 2017 and to create more certainty for MNEs, this step must be considered as a fundamental starting point when defining and allocating profit to a foreign taxable presence.

The factors described under para. 51 reflect the underlying rationale of the TFDE on the determination of a SEP in a certain jurisdiction. However, the factors described are very broad and will unintentionally pull in even those MNEs without a highly digitalised business model given the thresholds currently proposed. For this reason, we would advise you to consider focusing only on factors relevant to business models that generate digital revenue streams, which do not fall within the current permanent establishment concept.

Furthermore, we encourage the TDFE to formulate an appropriate approach which does not require rejecting virtually all international tax consensus principles and experiences that have been built up over decades by tax authorities and practitioners. For this reason, we advise you to consider linking the SEP proposal to the local 'exploitation' function of the DEMPE-concept, thereby placing the focus on the local earnings or losses generated by local activities. This avoids the use of a top-down approach, whereby the tax base is allocated between market jurisdictions. By doing so, the guidance can be considered as

an add-on to the current consensus of economic substance and taxable presence. Also, local tax authorities would then be able to define the taxable amount without requiring an extensive amount of additional data from foreign jurisdictions.

2.3 Losses

We believe that more emphasis should be placed on the allocation of losses in the various proposals going forward. Given the highly competitive nature of highly digitalised businesses, MNEs tend not to be profitable during their start-up phase as they seek to rapidly expand operations and gain sufficient market traction in local jurisdictions. As it is currently portrayed in the user participation and marketing intangible proposals, global profits are allocated as if these digitalised businesses only make profits. The examples provided in the current proposals do not describe whether and how a taxable presence can be identified in market jurisdictions during taxation years in which there are global losses. Furthermore, does this mechanism allow for a market jurisdiction to receive a share of the global profit while also suffering losses locally? From a loss deductibility perspective, the current wording is unclear as to which taxable presence would assume these losses (investments).

Para. 73 indicates that this matter has been identified by the TFDE but it would be highly appreciated if additional guidance and examples could be provided.

2.4 Closing Remarks

Our input does not include any comments on the global anti-BEPS measures but we do have concerns about the development of complex rules which vary depending on the treatment in a recipient country. (In this regard we are already seeing confusion and unintended consequences arising from the hybrids measures). International tax law is organic and subject to change in line with evolving business models. However, when formulating future tax policies, the TFDE should take into account the principles of the Ottawa Taxation Framework Conditions. According to the certainty and simplicity principle: *“the tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted”*.² Irrespective of the outcome of this process, the aim should be to enhance multilateral commerce by providing MNEs with clear legislation. Taking into account the further digitalisation of the economy, these future policies will not only apply to established digital industry leaders but also to new MNEs.

We are grateful for the opportunity to comment and would be pleased to discuss or clarify our response. Please contact the undersigned or any of the contributors listed below.

Yours faithfully,



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² OECD Report – implementation of the Ottawa Taxation Framework Conditions 2003 – p. 12.

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