By email to: TFDE@oecd.org

13 October 2017

Request for input on work regarding the tax challenges of the digitalised economy

1. Introductory Comments

1.1. PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's *Request for input on work regarding the tax challenges of the digitalised economy* ("the Request for Input").

1.2. As a matter of process, we are concerned at the pace at which the OECD (and consequently stakeholders, through this consultation) are being requested to deliver quality output that could influence significant changes in the international tax system. The BEPS Action 1 report identified broader tax challenges arising from the digitalisation of the economy, and set out a timeline to monitor the impact of the BEPS recommendations and other changes to the economy. We do not believe it is possible to undertake the detailed analysis required to deliver by April 2018, and a three week consultation period has not been sufficient for a broad range of stakeholders to sufficiently consider the issues involved, nor the potential impact of proposed solutions which had already been ruled out by the OECD. We urge the OECD and other stakeholders to commit to more detailed thought and analysis, over a longer time period, with a view to having a better informed, productive, pro-growth global conversation around the issues identified.

1.3. Global profits of multinational companies are generated through many activities by many legal entities in many countries. Synergy-related profits are also realised. Allocating profits, based on functions, assets, and risks, in the various countries, has become an extremely complicated matter. Transfer pricing rules are increasing exponentially in number and complexity, and have resulted in high compliance and enforcement costs and increased risk of double taxation.

1.4. Digitalisation (both through a host of new products/services, and through impact on more traditional functions) is further altering value chains within multinational companies and leads to questions about where value is generated. How these new value chains will run through different legal entities and countries will change the tax analysis.

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1.5. In short, business models and value chains are changing fundamentally and value creation is becoming increasingly independent of (physical) activities and physical presence in a market. Naturally, even 30 years ago, it was possible for French wine growers to send boxes of wine to Dutch customers without being physically present in the Netherlands. This type of trade is not normally classed as permanent establishment. The great speed with which information and communication technology is developing means the same French winegrower can upscale his activities in the Dutch market without being physically present in the Netherlands (and may even allow him to engage more easily with consumers, rather than intermediaries). However, all marketing, sales, distribution and after-sales activities may still take place in France; in that sense, the location of where the value has been created has not changed, and digitalisation has merely opened up new markets and reduced barriers to growth. It is hard to understand why the French wine grower's digital access to the Dutch customer should be considered to yield a different tax result than the result with the customer access of decades past.

1.6. It is worth reiterating that Action 1 of the final BEPS report of October 2015 concluded that the 'perceived challenge' to be addressed is the digitisation of businesses of all types and sectors rather than some idea of a digital economy that one can clearly identify and tax separately. Avoiding unilateral action would require a longer term global solution and we recommend below a framework (from a business and tax perspective) for further dialogue, while stressing the need to avoid unilateral and reflex actions, some of which were described in the Request for Input and have been called for by some countries. We include descriptions of some of the key features of modern business that should help clarify the nature of the underlying tax base, with a view to informing the discussion over the appropriate tax base.

1.7. Policymakers can and should view digitalisation as an overall accelerator for growth, with taxation as a potential and significant restraint if it is not done appropriately - withholding taxes and equalisation levies would inhibit growth with significant potential for double taxation. Countries will benefit from a bigger pot even if the tax share is smaller (not to mention the additional non-financial benefits to consumers and societies that increased digitalisation can bring).

1.8. In summary:

- the digital economy is not a sector that can or should be identified clearly and taxed separately;
- digitalisation is an accelerator for growth, and taxation should not inhibit that more than it does with traditional business;
- there is a need to understand how value is created in digitalised business models and whether this is different from traditional businesses;
- unilateral actions and potential solutions will have a negative impact overall (including particularly on growth); and
- time should be taken to consider the perceived problems, the real challenges, their impact, and potential solutions that could attract multilateral consensus.

2. *Features of modern business models*

2.1. Before any changes are made to the tax system, our recommendation is to develop and obtain consensus on a framework to evaluate "value creation" within the digitalising economy with the purpose of first evaluating the adequacy and appropriateness of existing rules before considering options that might change how and where this "value" should be taxed and where.

2.2. This framework could include the following inputs:

- understanding the unique features of the digital economy which lead to the creation of digital business models;
- deep understanding of how digital business models function and how revenue is earned and costs are minimized;
- how profitability may be affected; and
- what is value creation and how do any new assets or value drivers interact with existing assets and impact people functions, capital and the analysis of risks.

2.3. We will briefly introduce the framework on an illustrative basis to provide some direction and explanation of how the digital economy and business models are truly disruptive and different, with a view to informing the debate on the tax challenges they pose. There is more detail in the Report on our 2016 Global Industry 4.0 Survey[1], the biggest worldwide survey of its kind, with over 2,000 participants from nine major industrial sectors and 26 countries.

2.3.1. Digital business models originated from a need to serve customers better and at a lower cost and digital technologies could make this possible. Social media, mobile phones, and platforms allowed for a greater understanding of customer needs and the ability to build a stronger relationship with customers to continue to improve the customer experience. Serving customers with the best products or services at the best price has always been the objective of business. Now with greater customer insights and technology capabilities, digital business models are meeting that objective differently than traditional business models. But customers are not the only value driver.

2.3.2. Our key observations about the business models of "digital" businesses (and the impact of digitalisation on existing business models) are that:

- they overlap and may be combined, as discussed in BEPS Action 1;
- they will continue to evolve as emerging technologies such as Artificial Intelligence, Blockchain and Internet of Things (IOT) advance and new ecosystems emerge;
- they include new ways to maximize revenues and reduce cost; and
- they are able to leverage data, technology platforms, and customer relationships, etc in innovative ways.

[1] https://www.pwc.com/gx/en/industries/industries-4.0/landing-page/industry-4.0-building-your-digital-enterprise-april-2016.pdf

2.3.3. There are no universally accepted definitions of digital business models but several broad types have emerged. BEPS Action 1 describes most of these models in detail so we will identify them only briefly. There are four broad categories of digital business models are defined mainly by how they generate revenues and engage customers/users:

(A) e-Commerce/ Online retailer model

- trading through online platforms of "bricks and mortar" businesses ;
- trading through "digital only" offerings; and
- consumers trading with each other.

(B) Platform models -

- multi sided e-commerce platforms that allow two or more customers or groups to connect with each other through an online platform;
- cloud platforms that could take the form of Platform as a service or Software as a service model; and
- IOT platforms, whether connecting industrial equipment and machinery or cars or even people; and
- payment platforms and use of mobile wallets by consumers and mobiles in point of sale by merchants.

(C) Social media/Online advertising model

- location based;
- behaviour based; and
- other ways of differentiating users.

(D) On demand/ Subscription model - in particular

- the subscription model locks in a customer by taking a product or service that is traditionally purchased on an ad hoc basis and charges a subscription fee for continued access to the product/service; and
- the "freemium" model lets users sample the service for free and then charges to upgrade to the full offer.

2.3.4. Mapping a company's business model maturity will be important to understanding its profitability and how that's impacted by two factors:

- the investment required to reach a level of maturity that is viable, profitable and sustainable; and
- when commoditisation begins to occur with a product or service such that margins begin to drop – a late comer to an innovation will not reap the same benefits and profitability as a company at the forefront of innovation.

2.3.5. Digital technologies have changed the way an organization may be able to create value:

- new value could be increasingly captured by data, platforms and customer experiences;

- the combination of these value drivers will differ in each business model and may give rise to new intangible assets/IP; and
- disruption is not new, but never before has disruption affected all industries or happened so fast and it continues to pick up speed so that businesses have to re-think and sometimes re-invent their business models to survive.

2.3.6. Data may become valuable through the business outcomes it makes possible. Data comes in many different forms and from many different sources. It could be structured or unstructured, public or private. Companies can create proprietary data sets. These type of factors need to be considered to assess the value of data before any data analytics or transformation of the data occurs to add value.

2.3.7. By investing in data analytics capabilities, companies can uncover insights whether it is to identify new products or services, serve customers better, make operations more efficient or improve employee engagement and retention. More specifically, it may be necessary to consider whether value may be extracted through data analytics to produce these actionable business insights or further develop into algorithms and apps. Some algorithms or apps may be publicly available so it cannot be automatically assumed that all algorithms or apps are valued the same.

2.3.8. Platforms provide connectivity and provide the ability to scale quickly. Convenient access to platforms in the cloud has replaced the need for significant capital expenditures in hardware and software. It may be possible for value to be created by:

- opening communication channels and initiating transactions between various consumers and producers so that platform owners can observe and incorporate its users' behaviours and preferences to drive changes to its value chains, products and services, and
- the ability to scale quickly to enable companies to attract users to reach a level of adoption that sustains the business model and realize the network effects.

2.3.9. Where product and price differentiation is no longer sustainable, focusing on delivering superior customer experiences is key. Multiple channels and devices mean that companies have more ways to reach customers, but customers also expect to use their preferred methods at each stage, and on their own time.

3. The post-BEPS tax environment

3.1. The OECD has committed to reviewing the implementation phase of BEPS in 2020 and at that point it will be necessary to determine whether sufficient time has passed to identify a clear picture of the impact of these changes. When sufficient time has been provided for implementation of the direct tax measures and any indirect tax (VAT/GST) measures have been reviewed and introduced it will then be possible to determine what other measures (if any) are necessary to tackle the challenges of the new economy.

3.2. Direct Taxes

3.2.1. The delivery of the BEPS reports in October 2015 has given countries a number of recommendations to consider and implement. The implementation phase proposed by the OECD was from the date of release in October 2015 until 2020, and given the level of technical legislative change required this is a tight time frame. Aided by the multilateral instrument and EU Directives, significant progress has been made in addressing BEPS issues, and continues to be made. However, it is likely that the full impact will not be felt until 2020 and beyond.

3.2.2. As such, we believe that it would be unwise to overlay new measures onto the recommendations currently being adopted which, to a large extent, may address many of the concerns relating to the digital economy. We have outlined here the progress and impact of some of the actions expected to address BEPS issues and broader challenges raised by the digital economy (or the new digitising economy as a whole).

3.2.3. Action 7 - Permanent Establishment

3.2.3.1. Two significant changes brought forward by Action 7 centred around the dependent agent test and the specific activity exceptions. The reduced threshold for a dependent agent means that it is significantly more difficult for a company to avoid recognising a PE in instances where that company habitually has people in a jurisdiction who play the principal role leading to the conclusion of contracts. Hence it will no longer be possible for the sales of goods or services by digital companies to not be subject to tax in locations where they have related parties playing a principal role leading to the conclusion of those sales. This is a potentially significant shift from the pre-BEPS landscape.

3.2.3.2. Similarly, one of the recommendations relating to the specific activity exemptions is that they should only apply where the activities themselves are preparatory and auxiliary in nature. This, for example, would mean that the storage of goods for delivery may constitute a PE for an online company whose logistics operations are not merely preparatory and auxiliary to the rest of the business. The anti-fragmentation rules mean that it will not be possible to separate activities to avail of these exemptions.

3.2.3.3. The PE rules can be adopted by countries through the MLI. Some countries have indicated that they will not adopt these rules in their treaties due to either the factor not being a risk for their jurisdiction due to domestic legislation, or due to the lack of clarity on the profit that must be attributed to PEs. This is a continuing area of debate and we acknowledge that public consultations have been undertaken in 2016 and 2017. We await the outcomes of this work stream. It is likely that further guidance and clarity on profit attribution would lead to more jurisdictions gaining comfort on adopting these new standards.

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3.2.4. Actions 8 - 10 - Transfer Pricing

3.2.4.1. The revised OECD Transfer Pricing Guidelines ("the 2017 OECD TPG", which have been recently released) draw a clear distinction between the return due to the mere legal ownership of an intangible and the return due for the DEMPE functions that contribute to the value of the intangible. Alignment of profit with the functions which create value is a cornerstone of the BEPS project and the outcomes of this action should be appraised in advance of any other measures being introduced. Furthermore the introduction, or modification, of CFC rules (as proposed by Action 3) will act as a backstop to these transfer pricing initiatives in tackling the mobility risk commonly associated with the digital economy.

3.2.4.2. The increased and standardised documentation that has also been included in the 2017 OECD TPG as a result of the recommendations from BEPS Action 13 will also mean that tax administrations will have a much greater understanding of the functions being undertaken in their jurisdictions by companies (including digitalised functions digital businesses) along with how they fit into broader value chains through detailed Master Files and Local Files. Tax administrations will also benefit from country by country reports, which give them the information they need to perform high level risk assessment and focus their resources.

3.2.5. Action 5 - Preferential regimes

BEPS Action 5 examined preferential regimes, and reinforces the work undertaken as part of the transfer pricing actions. Setting rules relating to IP regimes and the instances in which preferential regimes are not deemed to be harmful has resulted in a wind down of certain structures and will, in conjunction with the TP actions above, result in a better alignment of profit with value creation.

3.3. Indirect Taxes

3.3.1. Business experiences

3.3.1.1. Following the 2015 BEPS Action 1 report, a growing number of countries have either already implemented new VAT/GST rules to tax the import of digital services into their territory, or they have announced plans to do so in the near future.

3.3.1.2. Many of the new collection models follow, at least at a high level, the general principles of taxation set out in the OECD's VAT/GST International Guidelines. However, the speed and scale at which changes are being announced around the world has produced a wide variety of challenges for businesses operating in the global marketplace due to inconsistent implementation at an international level,

even where governments have tried to keep compliance obligations for foreign vendors as simple as possible (e.g., by adopting simplified registration procedures).

3.3.1.3. The result, even if overall the broad aims of the rules are similar, is a great array of legal and administrative practices established by different countries. Our experience is that even simple and flexible rules can still result in significant complexity if there is limited co-ordination between different countries in addressing what are effectively global issues. Therefore, in our view, where countries have VAT/GST regimes, more consistency is required between them to ensure that there is greater efficiency and cost effectiveness whilst safeguarding tax revenues.

3.3.1.4. The OECD work being undertaken on the implementation package ('Design and operation of efficient foreign vendor VAT/GST collection mechanisms') will be a vital resource for the consistent implementation of the framework set out in OECD VAT/GST International Guidelines both in terms of introducing legal and administrative best practices to those countries working towards new digital taxation regimes and also for those countries that have already adopted digital taxation regimes and are looking for ways to improve their current arrangements. Benchmarking against the OECD implementation guidance would help drive an even greater level of consistency.

3.3.2. Platforms

The role of digital platforms and intermediaries in the VAT/GST collection process is a hotly debated topic. Some governments have already taken steps to implement measures in this area, while others are in the process of considering whether and how best to take action. The commercial reality is that there is a wide variety of constantly evolving business models and as a result no one-size-fits-all solutions. It will be important to develop solutions that are effective from a tax collection perspective without negatively impacting the growth in this rapidly expanding market.

4. Key principles in tax policy design

4.1. OECD identified principles

4.1.1. The OECD's Final Report on BEPS Action 1 (chapter 9) identified tax principles (based in part on the Ottawa Principles) of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, flexibility and sustainability, and proportionality. We endorse these principles and consider that as proposals are developed they are assessed against them.

4.2. Broader principles

4.2.1. Given the breadth of the impact that digitalisation is having on the economy (and on business models), it is clear that changes to the taxation system may not have their intended impact if they do not consider:

- the potential for digitalisation to even further change business models in ways that have not been anticipated;
- the potential impact of competition on tax rates as a result of BEPS implementation and greater mobility in functions as outlined above;
- whether corporate taxation gives the whole picture of the benefits (including taxes collected) arising from a digitalised economy; and ultimately
- whether changes that may arise in the incidence of tax as a result of either changes to the economy, or the changes to the tax system[2] are as intended and desirable.

4.2.2. Tax on company profits is, from an economic perspective, one of the most disruptive forms of taxation and has a negative impact on decision-making. Alternative forms of corporate tax have been considered, mainly in academic studies. Each is designed to target the yield from different contributions (e.g. total capital, labour, economic rent). The actual impact of fundamental changes to this system would be substantial, and should not be entered into without clear and agreed global objectives regarding the incidence of taxation, and a realistic and globally agreed understanding of the best way in which to realise those objectives.

4.3. Growth

4.3.1. Perhaps most importantly, we believe that the expectation of the G20 Finance Ministers was that their request to "examine the implications of digitalisation" for taxation was part of a paragraph on pro-growth tax policies, inclusive growth, and tax certainty.

4.3.2. Tax rules should align taxation rights with value creation, but pro-growth tax policies cannot be achieved without consideration of the impact on the broader economy, including detailed rigorous economic work, global cooperation, and compromise for the greater good. We encourage the OECD to remind stakeholders of this point.

5. Review of OECD considered options

5.1. General comments

[2] It is widely understood that the incidence of tax falls on individuals, or, (as is the case for all taxes paid by on-natural persons), ultimate groups of individuals. Taxes paid by businesses are ultimately borne by shareholders, employees, creditors, suppliers or customers. The allocation between these groups clearly depends on the underlying structure of the tax system, and the openness of the economies involved (in general, a larger relative burden falls on immobile factors in smaller countries).

5.1.1. The international tax framework proposed in the BEPS package seeks to align profit taxation rights with the economic activities where the corresponding value is created.

5.1.2. Advances in digital technology have not changed the fundamental nature of the core activities that businesses carry out as part of a business model to generate profits. To generate income, businesses still need to source and acquire inputs, create or add value, and sell to customers. Value creation is also critical to the digital economy and current rules amended in the BEPS Actions 8-10 recommendations provide the framework to identify value and align taxation with its creation.

5.1.3. The proposals in the Request for Input are fundamental departures from the existing international tax system that do not meet the principles identified in chapter 9 of the BEPS Report on Action 1, nor consider the broader impacts on tax incidence and growth, nor even support the BEPS objectives of aligning taxation rights with value creation.

5.1.4. At the same time, they would lead to a different treatment of the physical and digital economy. Therefore a sales based nexus or gross turnover based tax cannot be the appropriate approach for taxing enterprises that are internationally active in the digital economy.

5.1.5. Rather the taxation nexus must be based on taxation *in the jurisdiction where value is created*. This means that the approach used in calculating the taxable profits of the digital economy and determining the jurisdiction where those profits may be taxed should be based upon an analysis of where the value is effectively created. As under the physical economy, value may be created in the residence jurisdiction, in the market jurisdiction, in both jurisdictions or in a third jurisdiction. We do not consider that this question has been appropriately addressed in designing the three proposals.

5.1.6. Any approach to addressing tax challenges that arise as a result of the digitalisation of the economy should find its basis in the internationally agreed principles as agreed by the OECD / G20 BEPS project, and should discourage unilateral measures.

5.2. Turnover based approaches (withholding taxes and equalisation levies)

5.2.1. A withholding tax on certain types of digital transactions would impose an additional administrative burden on the buyer / recipient of the digital services who would become liable for part of the tax obligations of the seller / provider of the services. Such withholding tax would also miss every connection with the jurisdiction where value is created and would also come very close to a sales tax.

5.2.2. Of all of the proposals for digital taxation, we are most concerned about the economic damage that taxes on turnover could bring. For the same reason as mentioned above (taxation in the jurisdiction where value is created) the digital equalisation levy is not an option that should be pursued. Like the concept of 'significant economic presence' such levy would aim for the turnover of digitalised enterprises without a link to the value

creation in the jurisdiction where the equalisation levy is levied. Moreover such levy could not consider the economic circumstances under which the digitalised enterprises operate and would pose a barrier to economic activity, in particular in markets or activities where the profit margins are already considerably low.

5.2.3. Both withholding taxes and equalisation levies would lead to double (/ multiple taxation) and would significantly inhibit the potential of the digital economy to deliver economic growth.

5.3. Nexus of "significant economic presence"

5.3.1. The concept of a "virtual permanent establishment" is fraught with difficulty.

5.3.2. Unless arbitrary lines are drawn that encourage avoidance and break the neutrality principle, almost anything (and everything) could be a permanent establishment – live chat, an online order form, an interactive catalogue, etc. The result is that the concept of permanent establishment (which has historically required a degree of permanence, and an establishment) no longer seeks to balance the activities in one country with those in another – it simply asserts that there would always be a PE in the sales country.

5.3.3. Additionally, a move away from analysis of functions, assets and risks of the taxpayer would need new models for income attribution. In order to remain neutral, these same models would need to be applied to all businesses. It would be a significant challenge to identify such models, and it should not be desirable to do so without undertaking significant analysis on the potential impact on incidence and growth.

5.3.4. We consider that a swift move toward such a concept will not be met with universal agreement, and accordingly would expect additional complexity, uncertainty, and double taxation to arise.

6. Closing remarks

6.1. Almost all countries have a form of conventional corporation tax with an exemption for international profit, sometimes supplemented by taxing rights on worldwide profits from so-called 'passive income', and sometimes supplemented by deduction of notional interest.

6.2. We do not believe it is appropriate to abandon these principles, and consider that any changes to their operation should be designed with growth at their heart, with their impact understood, and with global agreement. It will take time to fully examine the issues and understand the full impact of proposed solutions.

6.3. We believe that the OECD's Inclusive Framework is well poised to deliver such a consensus to avoid potential unilateral actions that would have a negative impact on cross border trade and growth.

6.4. Before making fundamental changes to the tax system, engagement from a wide range of taxpayers and other stakeholders would enable a thorough investigation of the ways that value is created by digitalisation and how that value can be appropriately and efficiently taxed. PwC would welcome further opportunities to engage on this issue.

6.5. For any clarification on this response, please contact the undersigned or any of the contacts below. We look forward to discussing any questions you have on the points we raise above. We would welcome the opportunity to contribute to the discussion and to speak at the public consultation meeting to be held in November 2017.

Yours faithfully,

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