Digital Economy Taxation Think Tank

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DET3 INPUT TO PUBLIC CONSULTATION DOCUMENT ON THE "UNIFIED APPROACH" UNDER PILLAR ONE" SECRETARIAT PROPOSAL

Dear acting Chair and members of the OECD TFDE

We hereby present our coordinated observations about the questions posed for public comments in the consultation document recently released by the Secreateriat.

We understand that the objective it is finding an aggregable solution that is not over complicated to implement and administer while providing certainty and avoiding double taxation, and we understand that due to the international context the stakes are very high.

Our aim has been to be concise but clear in our response or point out the relevant question marks generated by some points of the proposal.

We remain at your disposal for any further conversation or clarification.

Sincerely,
Ignacio Longarte
Chairman – In representation of DET3 board

DET3 Founders: BBVA Telefónica amadeus IBERDROLA PRISA

EXECUTIVE SUMMARY OF DET3 KEY COMMENTS:

- Strong need to clarify concepts & definitions, specifically regarding:
    - Excluded industries
    - Level of the market of activities in scope (B2C / or B2C + B2B)
    - Remote interaction
    - Activities behind the portion of the residual profit allocated through A

- Highly regulated industries such as financial services, utilities or telecom, or regulated activities fulfilling certain criteria should be left out of scope

- Revenue alone should not be sufficient to trigger the New Nexus rights; Consider introducing complementary qualitative KPIs supporting the "sustained and significant remote involvement" in the market country.

  If confirmed that A amount covers sales & marketing intangibles residual profit allocation to the markets, the NTR should spot when there is meaningful remote commercial interaction with a consumers base from abroad, likely with strong assistance of digital technology.

  The NTR should not in our view be triggered when the majority of revenue obtained in the market is derived by a local entrepreneurial customer facing entity with appropriate substance that pay arm's length taxes locally

- When NTR applies, a minimum segmentation for activities or Business Lines may become necessary, although it will generate significant workload as the process itself will bring a high level of complexity.

  Flexibility is needed for MNEs to define their level of activities aggregation. Homogeneous approach in information sources will be required

- A consistent methodology should be used to determine the profits affecting A, B & C amounts in a way that can be traced and reconciled. To avoid double/multiple taxation, but also to facilitate review and administration of the new system under the Unified Approach

- Examples of the interactions between the NTR rules and current profit allocation rules will be appreciated

ACTIVITIES IN SCOPE:

Challenges and oportunities do you see in defining and identifying the businesses in scope, with respect to:

their interaction with consumers/users;

First, <u>market level definition</u> should be clear, precision is please needed:

- Consumer facing business, i.e. products & services of consumer based companies (B2C) only as the main focus of the New Taxing Right (NTR), or digital user also included in definition and comprehending businesses facing both corporation and individual type of users?.

In terms of the required "<u>remote interaction"</u> with the market, define it in a clear manner.

- The case where there is no local presence at all but just one central entity selling in several markets is straight to understand, but difficulties arise for established MNEs with strong central headquarters, regional headquarters and relevant local presence in many markets.

  The mere fact of getting sales revenue from a market does not always mean remote interaction with that market. See the comments in the New Nexus section about the need for qualitative indicators of this remote interaction.

<u>Relevant questions in respect to the interaction with consumers / users topic:</u>

- Is the Unified Approach (UA) applicable if revenue is channeled centrally to the markets for ease of administration but no remote commercial interaction at all happens from foreign entities.

  In the illustrative example provided in the consultation it seems that all marketing and distribution functions are resident in Q Co (country 2), and it is Q Co the entity billing to all the markets, but P Co (the parent company in country 1) is the one suggested to be taxed in country 2 for Amount A.

While it seems no remote commercial interaction at all from country 1, the NTR is attributed to it because of being the owners of "all the intangible assets", including the brand.

Please explain the logic behind it, as the main significant people contributions of P Co are likely the corporate functions, platform engineering / R&D, and content acquisition or production it is difficult to imagine remote commercial interaction out from that country with the market where the revenue is obtained.

Even in the case of existence of a central website of the group owned by P Co it would be difficult to consider it as the "*use of digital technology to develop remotely a consumer base*".

- Is it about remote interaction from all levels of value chain with user / consumer, or just commercial, marketing and sales related interaction??

  For instance, if remote data is gathered from the wind turbines an electricity company has scattered across different continents / market countries and monitored centrally or regionally, would that situation fall in the definition?

  Part of the electricity generated by those turbines could end up being sold to a local downstream user / consumer, but through a 100% commercial local interaction. This "remote operational interaction" does not seem to be the one targeted here.

- For the interaction itself, is it a Digital Platform needed for it to happen or any other medium (i.e. phone / video communication through a separate service) would just be enough for these purposes?. How would the interaction be objectivized?

- About the interplay of NTR and traditional PE rules when talking specifically about commercial interaction.

  In the supposed case of a commercial relationship mainly develop and maintained by the local entity but with incidental remote contact of the global or regional commercial team with the local customer, it seems that the UA would apply if the country sales thresholds are reached?.

How would UA be applied with a potential PE analysis if those foreign regional sales directors do also incidental or not that incidental trips to the country that could be interpreted as a significant people functions delivered there?

Would in this case Amount A of the NTR cover the whole compensation for the marketing and sales residual profit and limit the application of any separate PE profit attribution analysis for this type of functions?

Defining the MNE group;

We understand this question as related to the perimeter of analysis and potential business lines segmentation.

- The trade-off here is gaining simplification versus Residual Profit subsidies-transfers between lines of activity and/or regions. A full company approach without a minimum segmentation of business lines or activity lines seems a too far step at this stage.

- Nonetheless, we expect heavy workload/difficulties in executing any sort of business line or activity segmentation for these NTR purposes

- It will likely be difficult to use the IFRS 8 segments reporting as we appreciate a very heterogeneous IFRS operating segments reporting between different MNEs and even in same industry. If a pattern is to be drawn in IFRS segment reporting is geographic segmentation which is not enough for these purposes.

- Flexibility in deciding the level of activity and regional segmentation to contribute will therefore be welcome and needed but homogeneous information sources would be required first within a group and then across industries.

- A clear red line here would be never to consider management books for these purposes.

In terms of consolidated Accounting standards & potential Tax adjustments:

For Amount A determination, adjusting the consolidated accounting profit in the tax adjustments related to equity participation impairments or to equity disposal/acquisitions could be an initial logical step due to the potential materiality of those. Extraordinary / non-recurring items generating accounting to tax material differences could also be considered.

Going further than that adjusting other concepts to the consolidated accounting result will likely introduce complexity.

Another option could be adjusting the A residual profit amount after it has been allocated to the market, using in this case local tax adjustments, which also seems initially difficult.

Perhaps simplification measures or proxies per industry are to be considered.

Relevant to mention that for companies listed in EU and the US, the Accounting differences between US GAAP and IFRS for the determination of the net consolidated profit are in some cases very material, and very industry dependent.

To finish with this "accounting to tax" reconciliation piece, it is important to remark that consistency in profit determination rules affecting A, B & C amounts should be a strong inspiring principle.

Specific measures to maximize the possibility of rational reconciliation and interplay between tax profit amounts A, B & C are important to both avoid a chaotic application of the new system in practice and reduce the likelihood of double-multiple taxation.
Specific examples providing guidance about how the calculation and interplay of amounts A, B & C could be executed in practice would be very appreciated.

Covering different business models (including multi-sided business models) and sales to intermediaries;

Differentiating by business models and market level seems a difficult line to trace at first glance.

This discussion is connected to the "remote commercial interaction" definition in general for any activity and how and if digital elements are included there.

The size of the MNE group, account of fairness, administration and compliance cost;

Initial CBCR and alike thresholds mentioned are suggesting relevant materiality is required before the application of the Unified Approach to any group which seems a rational starting point, but about the thresholds determination several questions require due consideration or analysis:

- Is it necessary to consider setting the group threshold at an even higher level or rather establishing it by business line / reporting segment?

- Or is it an option to consider instead the size of the revenue generated by the remote interaction with strong digital elements, by business line and not the whole group generic revenue?

  How would this be interpreted if there is a given business lines segmentation and one of the business lines is having no remote commercial interaction at all with foreign markets while contributing in relative proportion most of the sales revenue in the markets? Would this situation justify the allocation of Amount A to the market jurisdictions if group sales are above the thresholds?

Last, the sensibility to set country nexus threshold levels will be very relevant and the same analysis between generic or remotely generated revenues apply.

Carve outs that might be formulated (e.g., for commodities)?

On this point we consider that highly regulated industries such as utilities or telecom, should be left out of the Unified Approach scope.

A number of indicative factors are to be highlighted when analyzing this carving-out topic:

- Highly regulated industries with special onerous tax rules and additional taxation levels
- Relevant substance in the market
- Very specific industry regulations that restrict or impact open market pricing affecting margins
- Non reliance on foreign large user-based activity nor on remote sales/marketing/distribution structures
- Different capital or Accounting standards for important business production factors

For more specific guidance on this point we refer to the potential specific position paper that each of our members industry associations might contribute to inform this debate.

NEW NEXUS RULES

Challenges and opportunities with respect to:

defining and applying country specific sales thresholds; and
calibration to ensure that jurisdictions with smaller economies can also benefit?

Two DET3 key observations from an NTR nexus quality perspective:

The consultation document states that "*The new nexus rule would address this issue*" of conducting business from a remote location *"by being applicable in all cases where a business has a <u>sustained and significant involvement in the economy of a market jurisdiction</u>, such as through consumer interaction and engagement, irrespective of its level of physical presence in that jurisdiction*".

In that sense:

- Regardless of who is the billing entity to a market, **revenue alone should not be sufficient to trigger the New Nexus Rights**, as it is not always indicative of a “sustained and significant remote involvement“ in such market country.

  Consideration should be given to add qualitative elements also in combination to the revenue factor: i.e., number of remote contracts or KPIs probing remote interaction it is really of some significance (#digital users, communications established, platform/app access …..).

- In our perspective, **the NTR should not be triggered when no consumer base has been generated remotely** in a case when:

  - Most of the business in a country is generated by the local subsidiary commercial & marketing team interactions
  - Majority of that revenue is channeled to the market through the local entity acting in an entrepreneurial commercial role
  - No relevant commercial interaction with country consumers from abroad performed with strong assistance of digital elements
  - There is appropriate substance in the subsidiary, its economic results are arm’s length and taxes are paid locally
  - The parent company provides parental support for horizontal / central services also at arm’s length

  This new “non-physical nexus” should only spot when a consumer base has been generated remotely, likely with strong assistance of digital technology

- Proportionality required; industry perspective relevant

- This debate is connected to the business line / segment reporting discussion and to the B2C – B2B activity in scope required clarification for purposes of quantifying thresholds

- For the local nexus threshold determination: Is the revenue obtained in one country cause of the activities of digital users in another country to be shifted to the user's activity country sales computation pooling, reducing this way the other paying country "revenue to" figure?

NEW PROFIT ALLOCATION RULE - BEYOND ARM'S LENGTH PRINCIPLE:

- **AMOUNT A: Allocate a portion of the deemed residual profits to Market: what challenges and opportunities arise from this approach?**

  The definition of the portion of residual profit to be captured and allocated to the market by the NTR has to be clear. This is a pyramidal point as it will strongly affect the consistency of any dispute resolution / negotiation that might happen in respect to Amount C.

  Clearly please confirm if Amount A residual is the one belonging to the whole group marketing, distribution & sales activity as the interpretation of the paper suggest.

  Consultation document suggestion that C amount could also be rewarding the above base line local sales & marketing functions could pose a recurrent double taxation pattern and a consistency issue with the A portion allocation that happens previously in the process.

  In this case of potential additional compensation for local non routine marketing and sales functions with C amount, to ensure that A & C profits are not duplicated in market jurisdiction, we suggest analyzing it depending on the risk profile of the distributor / local entity.

  Is there a transition period needed for past relevant Marketing Intangible creation investments before starting to effectively allocate A amount to a Market?

  Please confirm that the Unified Approach would not apply in case of positive profit but no overall "abnormal profit" at group level?.

Extremely challenging doing the A amount segmentation by business line / reporting segment, but not doing so would increase complexity in reconciling results with the part of the system working under traditional arm's length principles.

- **Which specific challenges and opportunities do you see in:**

  - **identifying relevant taxpayer(s) entitled to relief;**

    Legal entities controlling the remote interaction with market and where the HQ or Regional marketing / sales DEMPE functions are

  - **building on existing mechanisms of double tax relief, such as tax base corrections, tax exemptions or tax credits;**

    The document (43.) indicates that relief from double taxation would be provided once the A amount taxpayer claims a foreign tax credit or an exemption in market country.

    Should the possibility of straight Transfer Pricing adjustments to eliminate any potential A amount double taxation be considered as it is suggested for B amount (44.)?

  - **ensuring that existing mechanisms for eliminating double taxation continue to operate effectively and as intended.**

    A key challenge to approach is having the overall homogeneous perspective & measurement of what is taxed where to avoid distortions and chaos. Objective to achieve certainty is very much dependent on this aspect.

- **AMOUNT B: Given the number of disputes related to distribution functions, Amount B explore the possibility of using fixed remunerations on an assumed baseline activity.**

  What challenges and opportunities does this approach offer in terms of simplification and prevention of disputes?

  According to current proposal, on top of A amount allocation to the market to cover what seems to be the marketing intangibles residual sales proportional part, and the B base line compensation amount, a country could still claim extra sales and marketing residual profits in C for the same functions and also an additional article 7 PE profit attribution.

  Would that not create additional complexity?

  Shouldn't be a possibility just leaving C to cover the non-sales & marketing remaining value chain functions compensation and to cover double taxation conflicts plus the overall new system consistency issues?

  In other words, if when NTR applies A + B were to be determined now in consensus as the final compensation for the marketing, commercial and sales part of the value chain wouldn't the chances for disputes on double taxation and complexity remit?.

  Could a two or three levels mark-up on cost mechanism be considered in B amount computation to avoid having to declare additional profits in the C amount belonging to those functions? This would likely reduce conflicts and simplify the Audit of C amount.

Any design aspects and existing country practices that could inform the design of Amount B, including:

- **the need for a clear definition of the activities that qualify for the fixed return;**

  There is a need yes. Based in the proposal please confirm if these activities are the local functions developing the marketing & sales functions and contributing to the elements described as marketing intangibles in the OECD TP Guidelines?.

  A potential function that can be difficult to allocate as part of B is the technical / product expert local functions that are in between R&D and Sales/Pre-Sales in some companies.

- **a determination of the quantum of the return (e.g., single fixed %; a fixed % that varied by industry and/or region; or some other Method).**

  With the traditional TP principles, in general, complexity of the product/solution to be sold, versus the Product IP should inform the potential fixed margin determination; industry aspect could also be a factor to define the return percentage.

  If both B2B and B2C activities are in scope, market level could also play a factor into this fixed return.

  If different fixed margin levels % were to be established depending on the risk profile / control of risks of the sales & marketing functions, could this strategy relieve tension & disputes at C level as mentioned before??

- **AMOUNT C & TAX CERTANTY:**

  In the context of Amount C of the "Unified Approach", what opportunities do existing and possible new approaches to dispute prevention offer to reduce disputes and resolve double taxation?

  What are your experiences with existing mechanisms such as:

  - **APAs;**
    Slow process that is disconnected of current economy pace, coupled with uncertainty about if a final agreement is to be reached in bilateral APAs.

  - **ICAP;**
    The procedimental principles & timeframes governing the ICAP can be really useful in this context, but result has to be binding and that is a challenge considering the number of potential intervening administrations.

    Would a risk-based prioritization ICAP type of exercise where just the top revenue generation countries for the group are involved at first stage be a practical / efficient approach?

  - **Mandatory binding MAP arbitration**
    Positive experiences when timeframes respected, or process expedited.

Interactions between the new taxing right under Amount A and current profit allocation rules

A fundamental element of this conversation is homogenizing the measurement of the consolidated profit that is distributed through the UA and the profit and the one that is allocated through the legacy transactional based TP systems for the rest of the value chain.

That is why the mentioned level of consistency in the A+B+C profits measurement or having tools to reconcile it are important.

Ensuring that the net tax profit when exists and when there is also a residual is taxed once should be an inspiring objective for the UA.

Treatment of losses under Amount A (e.g. claw-back or "earn out" mechanism)

The losses treatment hast to be clear in the new system with sound economic principles around a business determined or simplified proxy life cycle to be considered.

This document is the result of the objective and consensual analysis of the questionnaire by DET3 members. Our purpose, objectives and values are expressed in the different sections of our www.det3.eu website, explaining how we want to collectively contribute to this relevant social debate. This does not however preclude that each individual member might hold its own position on any aspect affecting them based in their specific needs, situation or industry peculiarities and/or regulations.
For industry specific elements of this analysis we refer to the relevant industry associations position papers, if any.