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## PUBLIC CONSULTATION ON ADDRESSSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY

Dear acting Chair and members of the OECD TFDE

We very much appreciate the public consultation period open about this topic as we think this is a fundamental issue in today's modern economy that needs to be approached and resolved on a coordinated basis.

Significant effort hast been invested in framing the key issues underlying the relationship between the international tax system and the modern way of doing cross-border business and creating value in a digitalized economy and now we all need to contribute to the development of solutions that can be commonly agreed to ensure growth, sustainability, and a level playing field for businesses of all kind in this context.

Having a "timely solutions-oriented mode" it is from our perspective key for all the intervening parties in this exercise; we appreciate the tone of the consultation paper in that sense.

We hereby present our coordinated feedback, comments and observations, following the order of your questions, remaining at your disposal for any further conversation.

Sincerely,
Ignacio Longarte
Chairman – In representation of DET3 board

DET3 Founders: BBVA Telefonica AMADEUS IBERDROLA PRISA

## Key notes of our overall view:

- We validate and endorse the OECD described policy rational and objectives

- None of the proposed solution provides an integral solution, but that is expected.

- Consistency & standardized global metrics as core unavoidable first brick to any model

- Seamless interaction needed:

  Implementation issues expected for MNEs with established local presence & traditional / digital operational models co-existing; defining clear interplay rules and process and providing ways to gain legal certainty on it is fundamental.

- Early certainty mechanisms are necessary to motivate and assist MNEs in pivoting to the following state of international taxation in the digital maturity era

- If agreement is reached on a selected option, it has to bring with it compromise to derogate not only unilateral digital taxes of any kind and with any name and those related to corporate taxation measures not aligned with the new standard, like the ones existing or in consideration in some LATAM countries. Any VAT/GST measure should also be aligned to the OECD / EU established principles to ensure a holistic approach for the next phase and facilitate global trade

- SEP concept, if built with clearly defined limits and inter-play rules, seems to be the option with higher balance between effort to achieve it, simplicity, results and transition to the future tax system path

# Request for input topics:

## ON PILAR 1: REVISED PROFIT ALLOCATION AND NEXUS RULES

### 1. What is your general view on those proposals? In answering this question please consider the objectives, policy rationale, and economic and behavioural implications.

In terms of **policy rationale**, we understand that the situation is extremely complex nowadays, with a real risk of an increased proliferation of unilateral country measures targeted to ring fence some digital parts of the economy in the short term if no agreement is reached on a global longer-term solution.

In this context, a wide consensus-based policy solution whose principles are generally accepted and applied should be a strong and necessary building block for reaching a tax level playing field in an increasingly digitalized economy.

We understand that the **aim** of this exercise is to agree on a common solution by December 2020, that we shall generically define as the "selected option"; so, when analyzing potential implementation impact, we assume that all the 125-member countries of the OECD BEPS inclusive framework would have agreed on it.

We accept that the current system was not fit to record some of the features of modern way of doing business in a highly digitalized economy but note that the options proposed are mainly targeting cross-border remote business carried through/with strong digital elements by organizations with no or limited legal presence in the foreign territory of their clients/users.

Every one of the solutions proposed is incorporating elements that clearly depart from some of the traditional international tax principles and would move the framework to a hybrid one where the solution proposed would have to co-exist with the profit allocation of the part of the business that is delivered on a more traditional way (seamless inter-action required).

Attention to implementation for groups that have not the "targeted" remote operations structure:

A key message from our side is that the delineation of the proposals will have to carefully define in which cases the selected option applies and consider how the implementation of the selected option would be for established multinationals that have relevant legal presence in most of the foreign territories where they operate and consistently paid taxes there. We are talking of MNEs where digital is in the process of transforming the core, or technology companies delivering B2B software or technology solutions but that are not the ecommerce market places, social media or search engines where users play a highly prominent role.

The selected option should have enough merits in itself to constitute a "de facto" gradual transition from the current international system to a future one that can be much more fit for what the economy will be in 15-20 years from now, as it will be difficult then to find any international business model that is not fully connected and heavily depending on a seamless real-time use of technology across its whole value chain, and in the relationships with its key stakeholders.

We have observed that every proposed option comes with potential simplification steps / measures. We welcome any option that extracts relevant complexity from the system while approximating sound enough results for all the parties.

In terms of **economic rational**, before any "common solution" can be implemented, a first unavoidable step is to have standardized globally defined concepts for Classification of activities and one Accounting GAAP to use.

Any global solution, and any simplification step in the profit allocations calculations will require first a common global language for activities classification, that is updated to current reality, and second a single set of accounting GAAP to measure elements and value creation consistently and from where one total system profit can be inferred that is not revisable or questionable by each country.

In terms of **behavioural implications**, it is traditionally considered that only a WW taxation system (unitary taxation) would greatly help to avoid distorted business decisions and investment behavior because of the absence of income deferral. In that sense, although the options proposed are still territorial taxation based, as they all increase weight to the market country, and would apply in the post BEPS, post US tax reform and post Digital BEPs complementary rules world, we think that a careful design of the selected option (i.e. a sound weight of allocation keys in the SEP concept) in that context will deliver a more neutral behavioral influence impact, fostering more natural business and location investment decisions.

**2. To what extent do you think that businesses are able, as a result of the digitalisation of the economy, to have an active presence or participation in that jurisdiction that is not recognised by the current profit allocation and nexus rules?**

To an extent that is enough to require a review and adjustment to the current profit allocation and nexus rules to accommodate the new reality. Some businesses still require relevant personal interaction and local presence for some face to face activities, but there are situations where fully automated contracting of products and exponential frequency of digital transactions are reaching huge revenue volumes with zero or very limited local presence.

This trend is only expected to grow as A.I. matures, and machine-driven natural language processed conversations and not APPS start to play a dominant role in customer relationships through digital interfaces.
It is also true that for other types of digital business solutions that reach material size will still require local presence and local interaction with customers. Also, in many cases, pure-play digital companies might have millions of connected objects and not only individual consumers / users in a given Country and need to do some operations and services related to them. With current rules, it is not clear if a remotely operated energy-metering device, smart watch, smart car, or similar, would constitute a Permanent Establishment, but the capacity and potential of those elements to generate income/profits for the MNE is clearly there.

**i. To what types of businesses do you think this is applicable, and how might that assessment change over time?**

In the long run, it will be applicable to businesses in any industry as they put digital at the core of what they do, investing in connecting with clients, educating their talent on digital skills, optimizing their operations and transforming their products.

Although the trend is very clear, not all MNEs are at the same level/maturity in the digitalization of their current value propositions.

In our perspective the "selected option" should affect mainly the part of the MNE activities that are running on a very automated basis, contracted electronically and not by traditional means and delivered through platform based remote/cross-border digital solutions with high use/impact of technology.

As stated before, more and more MNEs are evolving their traditional business, automating some of their local products and services and delivering them through internet. But until this happens on a cross border basis for a group, and that digitalized business reaches a minimum given materiality level, and the used technology is in fact a proportionally bigger part of the overall product/solution, any profit attribution should be governed by current rules.

Regardless the industry, or activity group, having to manage the complexity of the "hybrid situation" should only happen when objective facts happens & KPIs are met.

### ii. What are the merits of using a residual profit split method, a fractional apportionment method, or other method to allocate income in respect of such activities?

The possibilities for MNEs extending foreign and local digital business operations that are seamlessly integrated into a unitary global company where synergies and talent are maximized are real and probed nowadays.

Cloud exponential growth, connectivity democratization, the capacity to automate processes and deploy cross border solutions, the employees capacity to generate value from everywhere in an always on omni-present business model, the customer participation in the creation of products through regular digital iteration and feedback, have maximized the advantages of the creation of synergies from combining economic activity on a large scale, in different locations, and through different digital platforms. Data is flowing in and out across the different stages of the company scattered value chain and countries on a constant basis, and this will only grow. Even regulated businesses are embracing cloud adoption.

For these digitally powered activities and business perimeter there are not many other options than to use methods that enable pooling a whole integrated and inter-related business activity, like the profit split or any formulary or fractional apportionment option, as long as some limits are observed.

### 3. What would be the most important design considerations in developing new profit allocation and nexus rules consistent with the proposals described above, including with respect to scope, thresholds, the treatment of losses, and the factors to be used in connection with profit allocation methods?

We answer this question in the following paragraphs on a case by case basis for each proposal, summarizing our overall considerations in the below heatmap table first:

| ANALYSIS OF PUBLIC CONSULTATION DOCUMENT PROPOSALS | | | |
|---|---|---|---|
| MERITS FOR FURTHER DEEPER CONSIDERATION | | | |
| MARKETING INTANGIBLE PROPOSAL | UNIFIED APPROACH | USER PARTICIPATION PROPOSAL | SEP PROPOSAL |
| • Very high complexity in execution<br>• Distortion/unbalance for central/reg marketing & sales structures<br>• Difficult to match with remaining part of Value Chain | • Little less demanding than M.I. proposal in theory, but very similar implementation in practice | • Ring fencing?<br>• Partial solution<br>• Residual profit assumption going far?<br>• Complex unless pre-agreed % option | • Higher balance between effort to achieve, coverage of solution, simplicity & results<br>• But only possible if carefully crafted with well defined boundaries & inter-play rules |

Key general observation: as any of the solutions will necessarily have to co-exist and "interact" with the remaining part of the business, defining clear interplay rules and processes & providing ways to gain early legal certainty on it is fundamental.

## On User Participation Proposal:

- The way it is described, can be seen as ring-fencing targeted digital business models. Over time, most MNEs will have strong interaction with their clients &/or users through digital platforms, regardless their industry / activity.
- It requires a difficult and complex process to separate the residual part of the value created by users from the residual part of the rest of the value creation drivers / elements along the whole MNE value chain that should be Arm's length valued.

  A pre-agreed straight % should then be a practical approach, but there are limited references to define approximate market value of it per industry or business model.
- Hypothesizing active user base as a separate entity it is already an advanced step, but assuming it directly participates on the residual is a too far reaching step.

  Some users are not clients, and some more active than others; contribution to revenue and profitability is not always the same. Raw data of the user can be processed centrally, and sometimes at the edge (in the market), but for the targeted business models most of the times is centrally processed on an automated basis and centrally analyzed.

  User can generate revenue in several sides of a platform through direct & indirect data exploitation. Same user can generate data related to local & global products and in digital products that are controlled by a subsidiary and are not remote.

  But it would be too complex in our opinion to segment the user's data based in different levels relative to their value contribution, or raw versus processed status, so the recommendation would be using a prudent/conservative value to fix this part of the residual profit if this option is selected.
- User participation it does not reflect all the digital value creation elements, partial solution only.
- If we talk just about data, on top of users related data, other types of externally produced data can be captured in the jurisdiction. The profit related to that part would belong to the other side of the residual profit; this would seem a partial approach.
- The required measurement of the user geographic origin should not generate any personal data privacy issue to the tax-payer, that should not report any personal data to Tax Administration to comply.
- In case of being the "selected option", and the user participation being fairly valued through the "pre-agreed %" alternative, it is true that this proposal is relatively easier to be implemented than the other solutions.

  In this case, if targeted business models are the ones suggested, likely a single pragmatic user base residual profit determination to set user related residual profit would suffice, but if proposal were to be extended to other industries digital business models, then the attributed user's residual value should consider the industry / activity type.

## On Marketing Intangibles proposal:

- Based on the post BEPS Action 8 Marketing Intangibles definition, we can say that in fact the whole sales/distribution/marketing part of the overall MNE profit is to be allocated. Name of proposal misleading.
- In step 3 it is not clear if the whole Marketing Intangible (M.I.) residual has to be separated or it is the Digitalized Business part of the M.I. only. We understand based on the introduction that the idea is separating the whole M.I. of the group.
- Once that the M.I. has been segmented, in the following step, due to the driver proposed, mechanic seems to allocate in practice ALL the M.I. residual to market countries, leaving central/regional/strategic/decision making functions potentially under-remunerated.

  There are global Business Units in MNEs where the marketing & sales strategy, product pricing & discounts are centrally develop/decided/approved in its majority; products are not adapted, & local subsidiaries are just executing / communicating. Proposal creates unbalance and distortions in this case.
- Execution brings complexity in both M.I. approaches. The "Marketing Intangible Adjustment" approach not as easy as it also requires the difficult prior isolation of M.I. residual profit from other IP/Value creation elements residual profit.

  Steps 1 to 3 of approach 2 still needed and those should put the entire value chain in context.

  Most LRD based structures were in practice remunerating the less complex function, so residual part of MI was not computed before.
- Splitting the MI part of the total residual based on a Fixed contribution % is a practical solution, but with high chances of generating unbalances with the economic valuation of the remaining part of the value chain. Rules for non-profitable situations should be defined.
- Not all Brand value drivers are generated by sales/marketing functions. Segmenting the M.I part in B2B MNEs becoming challenging due to their open innovation strategies.
- How to manage cases with Full Fledge Distributors? or well-established subsidiaries when they control the local market and take a good number of decisions? Would same rules apply?.

## On Marketing Intangibles & User Base unified Approach:

- Although mechanic saves steps due to the "proxy", the connection with the profit allocation of the remaining part of value chain still requires effort.
- Segmentation level: Business line vs group approach. Business line level would be more accurate in the short term, but we anticipate very high complexity in segmenting information. As time evolves mot MNEs will be having higher & higher interaction with B2B / B2C users through digital interfaces; synergies and resource sharing between them will grow and this business line segmentation will have to be more assumption based, so we suggest using the <u>group level approach</u>, but <u>setting materiality thresholds</u> at a higher enough level for this option to apply.

- The materiality thresholds related to cost should be tied to cost centers that are not routine and have strong correlation with the residual profit that is to be measured (Marketing, Sales, User experience…).

  We anticipate relevant difficulties in these computations as the growing in size information technology & cloud expenses that are needed to deploy the customer / user interaction can be booked in different cost centers / departments in every MNE.

- Industry sector exclusions?: Because of the expected increased digital iterations, it does not seem advisable in principle.

- Clearly defined prioritization & compatibility rules needed.

## On Significant Economic Presence Proposal:

General comments & design considerations:

- This seems to be the option with higher balance between effort to achieve it and practical results.

- Requires regulating the combination of sustained digital interaction factors and revenue-based factors very strictly and precisely so only really significant digital activity is captured in this new Tax SEP concept.

- But once an MNE falls "in the SEP" concept in a Jurisdiction, co-existence with the other type of PEs and local subsidiaries anticipated to be exponentially problematic and chances of multiple/double taxation & controversy high.

  This issue is especially important for established digital or being digitalized MNEs like DET3 members that already have relevant sustained legal presence in foreign jurisdictions and have being consistently paying taxes. In the case of being captured by the SEP concept they would have to manage profit attribution for the different legal entities / "tax regulation created figures".

  It would really be a much more cumbersome exercise than for the pure play Digital companies with remote business go to market in different countries.

- Fractional apportionment avoids the need to identify and price IC transactions / internal dealings, saving considerable effort, resources and costs.

- Fractional apportionment avoids indeed multiple allocation iterations between Non-Resident entity and SEP countries, but the selection of the allocation keys and the weighting has to ensure a rational relationship between "market attributed value" and the "value attributed to the location of the other elements / building blocks creating value" in the SEP business perimeter, including relevance of people functions & governance. Creating a process to obtain a reasonably consistent result of the total group profit determination when adding up the SEP profit and the rest of legal entities profit will be needed.

- In respect to the **profit allocation drivers** and weighting keys, two initial general considerations:
  - Set the main focus here along next months, as this is core to the discussion and very likely to generate differences between OECD member countries.
  - It will be difficult to move from current system to a SEP that features a very limited / minimalist number of allocation factors to maximize simplicity.

    Accept that a transition to the next step will require a careful application of a number of factors that with further experience and time can be refined, reduced or simplified.

For the allocation drivers design and weight, we suggest the following principles:

- They should reflect a good balance between movable and less movable factors.
- Balance geographical distribution of sales under a destination-based principle + local users with other factors weighting governance, value creation functions, and assets.
- Include elements of intangible assets and data in the calculation.

We provide a suggestion below with allocation keys tied to 4 general value drivers that are designed to balance contributions, avoid duplications and ensure consistency with remaining part of the value chain. Multiple options exist here, so take please this table as an illustrative suggestion:

| ALLOCATION KEYS OPTIONS & WEIGHT FOR SEP APPROACH | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **VALUE DRIVER** | **HUMAN RESOURCES & GOVERNANCE PRINCIPLES** | Weight | **PRODUCTIVE ASSETS** | Weight | **EXTERNAL RELATIONSHIPS & MARKET** | Weight | **DATA** | Weight | **TOTAL ALLOC** |
| **UNIT** | # HC / FTEs | | Group Head Office currency | | Group Head Office currency | | Terabytes / similar | | |
| **SOURCE** | Annual Audit report + Company | | Common group GAAP books | | Common group GAAP books | | IT dept | | |
| **Factor 1** | HC / FTE of key decision makers | % | Amortization/Depreciation of tangible assets | % | External revenue collected in non-resident country in B2B or B2C | % | Annual data collected from / in jurisdiction vs Total Group collected year | % | |
| **Factor 2** | HC / FTE rest of human resources | % | Pay per use - OPEX of productive assets | % | # of non client users | % | | | |
| **Factor 3** | | | Development costs of IP: Sftw-agor / Patents / KH / Data rights / Strategic Alliances / inc amortization | % | | | | | |
| **Total Factor weight:** | | **%** | | **%** | | **%** | | **%** | **100%** |
| | | | | | | | | | |
| **Geog. driver** | Country of HC/FTE Tax residence during year | | Tax ID of the B/S & P/L where they are recorded | | Tax residency of billed client based on its tax id number | | IP address | | |
| | | | | | IP Address for non-paying users | | | | |

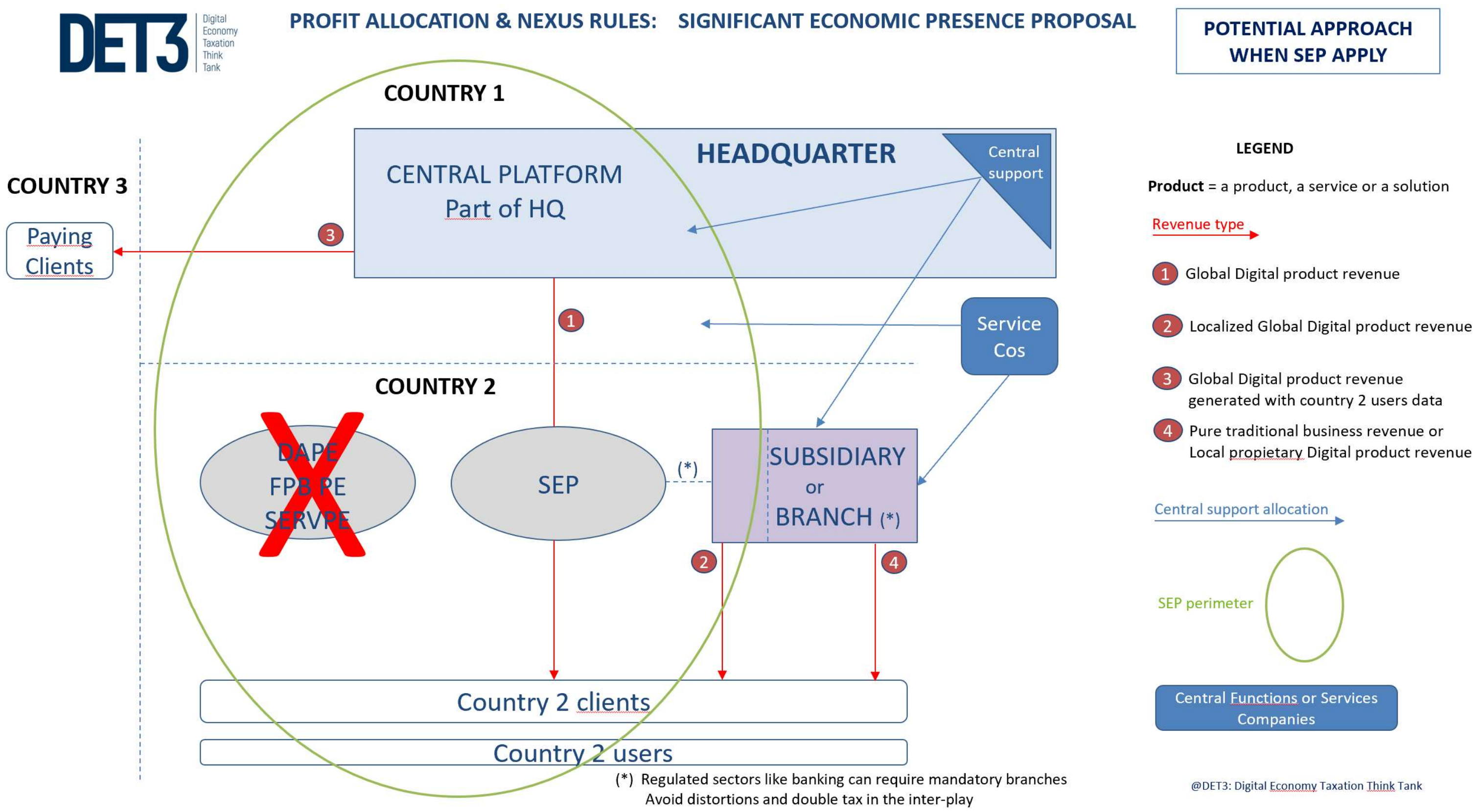
- On top of any allocation-driver (like above illustrative suggestions) the system should have different weights by industry / activity classification (to be defined). Establish a rule to decide activity classification and compute allocation drivers for hybrid business activities.
- Define rules for a dynamic update of the allocation-drivers weight per activity type.

Potential approach recommendation when SEP applies:

- To avoid some of the tough issues identified before, and assuming the triggering factors and the allocation drivers & weight are carefully designed as indicated, we additionally suggest the following approach when a SEP concept applies:
  - Use one common set of accounting GAAPs to allocate profits that will end up in SEP or local entities corporate tax return. Ultimate headquarter GAAP can be the reference.

    For the allocation drivers, use a combination of Accounting consistent information and other data points from trusted sources.
  - Set particular attention to the Business Line level and Products type level, as an additional factor to define SEP perimeter as part of a cohesive digital significant presence.

    Product = a product, a service, or a solution in which digital technology usage, automated means and user interaction is significant.
  - Void application of the other Permanent Establishment treaty concepts and AOA in the SEP jurisdiction for the defined SEP business activities perimeter.
  - When computing the non-SEP perimeter transfer pricing have consensus on relying on HQ GAAP books of the subsidiary (i.e. not considering timing/permanent differences with local accounting gaap, for these tax purposes).
  - Use same currently accepted Arm´s Length principles to allocate Central HQ / Regional functions and pure services companies to both local subsidiaries and the SEP perimeter, when needed.
  - Include local digital products revenue and local cost of the global digital products in the SEP profit split perimeter when they are developed abroad and just suffer a minor adaptation for local market and being then resold in the country.
  - Avoid any unnecessary additional complication to the SEP mechanism, like free capital attribution etc.
  - Define how to treat regulated sectors MNEs in the process of digital transformation operating with local regulation imposing business requirements, minimum assets, investment conditions or local reserves.
  - Ensure unanimous global approach leveraging experience from closely related regulatory proposals like EU CCTB or from the US intra-states regs, but adapted to digitalized economy.
  - Provide early certainty mechanisms and develop agile method to resolve controversies arising from the SEP application and interaction.




To conclude on SEP, we do not consider that establishing in parallel to it a new Withholding Tax should be necessary. Leaving aside technical legal compatibility and potential discrimination issues, that would add complexity and a level of fairness for companies with sustained focus in tax governance. In case of being applied, we suggest enabling exemptions for companies included in a kind of tax-governance reputation index.

### 4. What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

A SEP concept, with relevance/size driven triggering factors, consistent globally applied definitions, sensibly crafted allocation drivers, and clear interaction boundaries/limitations, if validated by the Inclusive Framework OECD members, would constitute a meaningful frontal step in reducing complexity, and avoiding double/multiple taxation upfront.

## ON PILLAR 2: GLOBAL ANTI BEPS EROSION PROPOSAL

### Questions for public comments

Our general view comments on the two proposed measures would be ensure that legitimate business transactions that have substance / business purpose / real activity behind in both sides of the transaction are not damaged; ensure consistency with BEPS action 5 work and EU ATAD and ATAD2 Directives;

The sensitive point here is what would be the sound numeric point to trace the line in terms of Effective Tax Rate for both the "undertaxed payments" and the "subject to tax rule".