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Policy and Statistics Division
Centre for Tax Policy and Administration
OECD
Paris

By Email

Dear OECD Secretariat

Submission on the Proposed "Unified Approach" to Pillar One

Please find attached my written submission on the above Secretariat's Proposal.
As indicated in the submission I have mostly focused on the policy issues behind the proposals. The attached analysis supports the theoretical underpinning of the Secretariat's approach.

Thank you for the hard work undertaken in the last period of time and we look forward to your further progress in this endeavour. If there is anything I can do to assist please do not hesitate to contact me.

Yours faithfully

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Comments on a *Secretariat Proposal for a "Unified Approach" under Pillar One*.

Professor Craig Elliffe, University of Auckland.

Introduction

1. This is a personal submission on the Secretariat Proposal on the introduction of new, and/or reallocation of existing, taxing rights contained in the unified approach under Pillar One. I am a Professor of Taxation Law and Policy at the University of Auckland, Faculty of Law, in New Zealand, and the New Zealand Law Foundation International Research Fellow 2019.

   As part of this Fellowship I have been based at Oxford University in the United Kingdom as an academic visitor, researching and writing a book on the taxation problems emerging from the digitalisation of business for Cambridge University Press (planned for publication in 2020).

   My comments on the proposals are personal and may not represent the views of either the academic institutions referred to above or the New Zealand Law Foundation. I would, however, like to acknowledge the support of the above academic institutions and in particular the generous support of the New Zealand Law Foundation to enable me to carry out this work.

2. In the Proposal document of 9 October 2019, the OECD called for comments on the policy, technical, and administrability issues raised by the Secretariat Proposal. This submission focuses mostly on the first element of this request, namely the policy behind the Secretariat's proposal. All of these three aspects are important but the theoretical basis of, and justification for, cross-border taxation is a fundamental starting point and might be helpful prior to the examination of detailed issues in the proposed solutions.

Justification for taxing non-residents

3. When the great Klaus Vogel tackled the issue of justification for taxation he described it as "a forgotten question".[1] Most traditional, and indeed

[1] K Vogel, "The Justification for Taxation: A Forgotten Question", (1988) The American Journal of Jurisprudence, 19.

current, theories[2] for the justification of tax fall loosely into two major categories.[3] These are the *benefit theory* and the *ability to pay theory*. The conventional view is that the benefit theory is used to support source taxation, whilst the ability to pay theory supports residence taxation, but this viewpoint's validity is questioned.[4] The difference between the two theories is based upon the fundamentally different worldview of public finance (that is, the relationship between revenue and expenditure). In the benefit theory, the taxpayer and government are seen as economic actors exchanging consideration with each other. In other words, an exchange of goods and services, namely something of value (taxation) in return for something of value (public goods and services). In contrast, in the ability to pay theory, there is no connection between the benefits received and the payment of tax. Tax is therefore viewed as compulsory without any relationship to the market.

4. The line of thinking that links the justification for taxation and source taxation with the benefit theory has been present at the League of Nations and the OECD for some considerable time. In the next part of this submission, I discuss the so-called "1920s compromise".[5] The compromise of allocating taxing rights between source and residence countries is an integral part of the history of the rules which form the basis of the modern international tax system and OECD double tax model. Arising out of the 1923 Report was the concept of economic allegiance.[6] This concept of economic allegiance recognises various contributions made by the source and residence state to the production and enjoyment of income. In other words, the 1920s compromise was a solution comfortable with the concept of allocating taxing rights to the source jurisdiction on the basis that foreign-owned entities enjoyed the benefits provided by the source state (such as public services and the protection of property rights).

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[2] There are at least two other distinct theories-the sovereignty doctrine and the realistic doctrine. These are referred to in N Tadmore, "Source Taxation of Cross-Border Intellectual Supplies-Concepts, History and Evolution into the Digital Age", (2007) Bulletin for International Tax, January at 2. In some respects these theories seem to be statements of attributes rather than theories in their own right. The sovereignty doctrine observes that the jurisdiction to make tax law exists only as far as sovereignty exists. The realistic doctrine has an inverse relationship to the sovereignty doctrine. It argues that since no rules of international law exist to limit a country is taxed jurisdiction and therefore the restriction is only one of practical enforcement.

[3] Ibid, at 61. Vogel (fn 51) also makes the point that these are best expressed as two fundamental directions or groups of theories, but he also describes the distinction as to narrow because of the multiplicity of theories and their historical development.

[4] M. Devereux and J Vella, "Are We Heading Towards a Corporate Tax System Fit for the 21st Century?" (November 20, 2014). Fiscal Studies, Forthcoming; Oxford Legal Studies Research Paper No. 88/2014. Available at SSRN: https://ssrn.com/abstract=2532933, at p 2.

[5] See paragraphs 15-18.

[6] League of Nations Economic and Financial Commission (Bruins, Einaudi, Seligman and Stamp), *Report on Double Taxation*: Document E. F. S. 73. F. 19 at page 20.

5. The four economists involved in preparing the 1923 Report discussed the four elements of economic allegiance describing them as follows: [7]

    I. The production of wealth; which means all the stages involved up until the wealth comes to fruition, by which they mean "the oranges upon the trees in California are not acquired wealth until they are picked, and not even at this stage until they are packed, *and not even at that stage until they are transported to the place where demand exists and until they are put where a consumer can use them*."[8] (emphasis added).

    Under this heading, it can be seen that the production of wealth involves both the supply/residence side (manufacturing and production) and the demand/source side (transportation to the market where they are purchased and consumed). This is a more relevant category for business income.

    II. The location of the wealth; where the wealth is situated.

    Often this will be the location of the property. Relevant for passive investment income, the location of the investment capital could be in the state of source or the state of residence.

    III. The possession of wealth; which means, substantially, the legal framework of society and the place where property rights are enforceable.

    Under this heading, the right to enforce property rights can be in both the supply/residence side and the demand/source side, such as enforcing intellectual property rights or creditor/debtor obligations.

    IV. The disposition of wealth; which means the stage where the wealth has reached its final owner who can consume it, reinvest it ; but in the exercise of his will to do any of these things it resides with him and his ability to pay taxes is apparent.

    Under this heading, residence tax is most relevant as the owner consumes or disposes of the property. It could be noted that the property could well be situated in another state.

6. After analysing the above four principles, the 1923 Report concludes that the stages of production "up to the point where wealth reaches fruition, may be shared in by different territorial authorities".[9]
    It is acknowledged by the OECD, that "this "origin of wealth" principle has remained a primary basis for source taxation through the many committees and draft conventions prepared under the auspices of the League of Nations".[10]

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[7] Ibid, at 22 and 23.
[8] Ibid, at 23.
[9] Ibid, at 23.
[10] OECD, *Taxing Profits in a Global Economy-Domestic and International Issues*, OECD, Paris, 1991, at 32, discussing the numerous committee reports and founding double tax agreements that form the basis of the OECD Model Convention.

In a 1991 OECD Report, the OECD recognised the right for source countries to tax income originating within their borders, including income accruing to foreigners:[11]

> One justification for this entitlement is that the foreign-owned factors of production usually benefit from the public services and the protection of property rights provided by the government of the host country. A source-based tax like the corporation tax may also serve to prevent foreign investors from capturing all of the "economic rent" which may arise when foreign capital moves in to exploit the host country's production opportunities, e.g. its natural resources.

The benefit theory in the digital age

7. In 2003, a Technical Advisory Group (TAG) of the OECD produced a report examining the settings of the treaty rules and the taxation of business profits in the context of e-commerce.[12] The TAG could not reach agreement but clearly, some members felt that, even with the absence of any physical presence in the country of source, that country still had the right to tax business profits. This is important, because as Michael Lennard points out in his article, there was a lack of consensus in 2003, "even among a body composed almost entirely of representatives of developed countries, corporates or advisors".[13]

> 44. For some members, *source taxation is justified in such a case because the business profits of the foreign enterprise derive partly from the enterprise's use of important locational advantages provided by that country's infrastructure which make the business operations profitable. These may include, but are not limited to, means of transportation (such as roads), public safety, a legal system that ensures the protection of property rights and a financial infrastructure.*[20]
> 45. Other members, however, disagreed. For them, business profits derive from the carrying on, by the enterprise, of business activities and a country is only justified to consider that profits originate from its territory if the enterprise carries on activities therein. They do not regard an enterprise which may have access to a country's market as necessarily "using" that country's infrastructure and, even if that were the case, they consider that such mere use of a country's general infrastructure would be too incidental to the business profit-making process to consider that a significant part of the profits are attributable to that country.

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[11] OECD, *Taxing Profits in a Global Economy-Domestic and International Issues*, OECD, Paris, 1991, at 36-37.
[12] OECD, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?, Final Report,* Report of the OECD Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits, (2003), OECD, Centre for Tax Policy and Administration, Paris.
[13] M Lennard, "Act of Creation: The OECD/G 20 Test of "Value Creation" as a Basis for Taxing Rights and its relevance to Developing Countries", (2018), Transnational Corporations, Vol 25, No 3, 55 at 67.

> Footnote 20 reads: *Thus the benefit principle, which provides a justification for rejecting exclusive residence taxation (see above) can also be put forward as a principle for determining the source of the business profits. The same reasoning has also been articulated in terms of the "principle of economic allegiance"* (referred to in footnote 12) *(Emphasis added)*

8. Arvid Skaar concludes that even if a business does not have a physical presence in the source country it can still benefit substantially from its infrastructure and should make a contribution by way of taxation. In Skaar's view:[14]

> A [permanent establishment] is merely a piece of *evidence* of economic allegiance, not the reason for source-state taxation … It seems an enterprise which does not need to invest in immovable facilities, or other fixed places of business, may still derive considerable advantages from the community in which its income sources are located. Today, the performance of a business activity in another country, the duration of the activity and the profits arising from it, are *per se* significant arguments… [that] requires all enterprises which obtain such benefits from country to render a corresponding contribution to the society, whether or not they have a permanent establishment.

9. There are at least five major areas where the source country makes a contribution to the carrying on of digitalised business in their jurisdiction:[15]
    - the contribution to the business environment and economy: this includes the general business confidence, corruption and law and order, affluence and ability to consume. Often goods and services purchased by a resident in the source country are then consumed either in the production of further business activities (requiring a viable fiscal environment) or in private consumption (requiring a consumer with spending power);
    - the contribution to the technological infrastructure: this includes suitable telecommunications infrastructure, Wi-Fi and broadband, and a population with appropriate devices (computers and smartphones);
    - the contribution to the legal system: this includes providing reliance to enforce payment for transactions, uphold intellectual property rights (such as trademarks), and maintain a competitive and conducive business environment. The protection of intellectual property rights (for example in the case of computer software) is critical to vendors of intangible products and digitalised services. The ability to deal with fraudulent and criminal behaviour is also important as are consumer protection laws;

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[14] A Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle,* (Deventer, Boston, Kluwer Law and Taxation Publishers, 1991), at pp 559-560.

[15] See also D Pinto, *E-Commerce and Source-Based Income Taxation,* (IBFD Publications BV, the Netherlands, 2003), at 22-23.

- the contribution to infrastructure: modern infrastructure to allow physical delivery of goods in a timely and protected way, provision for waste disposal for packaging materials;
- the contribution of users to the digital business: this may take many forms but include the role of users and social media (designing or providing content), the contribution individuals make to the network effect (family, followers and friends), the provision of assets and services as part of the sharing economy (either physically located or physically performed in the source jurisdiction), the process of review, validation and assessment (on services or goods), etc.

10. It seems clear that the benefit theory retains its credibility as a justification to tax non-residents in circumstances where the non-resident enterprise is enjoying or utilising the type of contribution made by the source state (or by economic actors, for example, users, in the source state). This is not a modern idea but appears to have been present right from the original theoretical construct in the 1920s compromise. The concept of economic allegiance, while it is admittedly indistinct, clearly encompasses an apportionment of taxing rights between states when the activities carried on by a non-resident enterprise utilise and benefit from public services, legal, and technological infrastructure provided in the source state.

11. Such an approach reflecting the application of the benefit theory to digitalised business has been applied by the Supreme Court of the United States in the context of state taxes. South Dakota v Wayfair, Inc[16] is an important decision which upheld the right of the South Dakota Legislature (or other US states) to enact a law requiring out-of-state sellers to collect and remit sales tax when they deliver items to in-state purchases. From now on, states can require remote sellers to collect use tax if the seller has a "substantial nexus" with the taxing state. There is not a great deal of clarity about what constitutes a substantial nexus and Reuven Avi Yonah has predicted that this will lead to more litigation.[17] Justice Kennedy, delivering the majority judgment cited a previous Supreme Court decision that "such a nexus is established when the taxpayer [or collector] avails itself of the substantial privilege of carrying on business in that jurisdiction".[18] In this case, the majority considered that the "nexus is clearly sufficient based on both the economic and virtual contacts

[16] *South Dakota v Wayfair, Inc., et al, Certiorari to the Supreme Court of South Dakota,* No. 17-494. Argued April 17, 2018-Decided June 21, 2018, 585 US-(2018).
[17] R. Avi-Yonah, "The International Implications of *Wayfair*." *Tax Notes* 160 (2018): 215-9.
[18] *South Dakota v Wayfair, Inc., et al, Certiorari to the Supreme Court of South Dakota,* No. 17-494. Argued April 17, 2018-Decided June 21, 2018, 585 US-(2018) at 22, citing *Polar Tankers, Inc v City of Valdez,* 557 U.S. 1, 11 (2009).

respondents have with the State".[19]

12. There is a remarkably clear statement by the Supreme Court of the benefits theory, expressed by Justice Kennedy as follows:[20]

> Wayfair offers to sell a vast selection of furnishings. Its advertising seeks to create an image of beautiful, peaceful homes, but also says that "one of the best things about buying through Wayfair is that we do not have to charge sales tax." *What Wayfair ignores in its subtle offer to assist in tax evasion is that creating a dream home assumes solvent state and local governments. State taxes fund the police and fire departments that protect the homes containing their customers' furniture and ensure goods are safely delivered; maintain the public roads and municipal services that allow communications with and access to customers; support the "sound local banking institutions to support credit transactions [and] courts to ensure collection of the purchase price," and help create the "climate of consumer confidence" that facilitates sales.* According to respondents, it is unfair to stymie their tax free solicitation of customers. *But there is nothing unfair about requiring companies that avail themselves of the States' benefits to bear an equal share of the burden of tax collection. (emphasis added)*

13. The absence of physical presence, therefore, did not in any way constrain the US Supreme Court from deciding that the substantial virtual connections to the State were sufficient to constitute a substantial nexus. The Supreme Court applied the benefit theory to recognise substantial virtual connections. While the context is one of state taxation, it is difficult to see any theoretical difference between interstate arrangements and cross-border taxation.

14. This brief analysis traces the application of the benefit theory to source taxation from the original 1923 economists report to more recent consideration by the OECD and influential courts such as the US Supreme Court. From a policy perspective, it is submitted that application of the benefit theory to current ways of doing business facilitated by highly digitalised business models, such as multisided platforms, fully justifies the current approach taken by the OECD Secretary it in its proposal for a unified approach under Pillar One. This becomes even clearer when one considers the allocation of taxing rights from an historical perspective.

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[19] Ibid, at 22.

[20] South Dakota v Wayfair, Inc., et al, Certiorari to the Supreme Court of South Dakota, No. 17-494. Argued April 17, 2018-Decided June 21, 2018, 585 US-(2018) at 16.

The history of international double taxation: The '1920s compromise'[21]

15. The 1923 Report proposed that an ideal solution would be that the individuals "whole faculty" (the taxpayer's capacity or ability to pay) should be taxed but only once, and that the "liability should be divided among the tax districts according to his relative interests in each".[22] This division of taxation should occur after ascertaining where the "true economic interests of the individual are found". As discussed above, this required an analysis of the "economic allegiance" that exists between the taxpayer and the state and involved an evaluation of four factors:
    i. the production of wealth (also described as the origin of the wealth or acquisition);
    ii. the position of wealth (also described as the situs and location of the wealth);
    iii. the enforcement of the rights to wealth (legal enforceable rights) and
    iv. the disposition of wealth (the consumption or sale in a market).[23]

    Even after carefully working through these four "fundamental considerations"[24] and trying to apply the various contributions made by different states to the production and enjoyment of income, the economists concluded "that it is almost impossible in economic theory to get a direct assignment of a quantitative character of finally resultant income amongst all the national agents who may be said to have had a finger in the pie".[25] Given this theoretical difficulty, they concluded that in practice it was going to be necessary to have "a compromise or arbitrary assignment" of taxing rights.[26] While the 1923 Report suggested a theoretical preference for residence taxation, later discussions were far more pragmatic.

16. In 1925 a Committee of Technical Experts, having been appointed by the Fiscal Committee of the League of Nations delivered their report with suggestions for alleviating double taxation (the 1925 Report). According to Graetz and O'Hear, the 1925 Report "was an effort to transform the pro-residence 1923 Report into a more balanced product".[27] The Technical

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[21] This is the terminology employed by Michael Graetz and Michael O'Hear in their important article on the history of the US tax policy and in particular the impact of Thomas Adams, a professor of economics at Yale and tax advisor to the Treasury Department and Treasury's principal adviser on issues of tax policy and administration. M Graetz and M O'Hear, "The 'Original Intent' of US International Taxation", (1997) 46 Duke LJ 1021, at 1026.

[22] League of Nations Economic and Financial Commission (Bruins, Einaudi, Seligman and Stamp), *Report on Double Taxation*: Document E. F. S. 73. F. 19 at page 20.

[23] Ibid, at pp 20 to 24.

[24] Ibid, at p 22.

[25] Ibid, at p 45.

[26] Ibid.

[27] M Graetz and M O'Hear, "The 'Original Intent' of US International Taxation", (1997) 46 Duke LJ 1021, at 1080.

Experts allocated personal taxes to residence, and impersonal schedular taxes to the source jurisdiction broadening the role and scope of source taxation. In doing so, they reflected that the majority of their group came from debtor rather than creditor nations. The decision on the division was made on the basis of "purely practical purposes" and "no inference in regard to economic theory or doctrine should be drawn from this fact".[28]

An expanded group of countries were added to the group of Technical Experts[29] and developments took place of great significance including the introduction of the concept of a "permanent establishment." Thus business profits in the draft bilateral convention contained in the report of the Committee of Technical Experts in 1927 (the 1927 Report) would be taxable only in the source state where they possess permanent establishments.[30]

The draft bilateral convention contained in the report of Government Experts of 1928 (the 1928 Report) was starting to look relatively familiar to modern eyes. It had a rule to tax industrial, commercial or agricultural undertaking in the state in which the permanent establishment was situated and this included "centres of management, branches, mining and oil fields, factories, workshops, agencies, warehouses, offices, depots" but a *"bona fide* agent of independent status (broker, commission agent, etc)" was expressly excluded from being a permanent establishment.[31]

17. It is very difficult to justify the allocation of taxing rights on a coherent theoretical basis. Thomas Adams, who was involved in the 1927 Report and the 1928 Report criticised Edwin Seligman's (and by implication the 1923 Report's) theory of "economic allegiance" which was the touchstone for the conclusions reached by the four economists. Writing about this theory he said:[32]

> I find this theory, I regret to say, little more than a generalised label covering a number of separate judgements which the authors of the theory have reached about the expedient place to tax certain persons or transactions, conclusions based upon diverse considerations which unfortunately vary with the business habits and stages of development of the various countries of the world.... The theory leads many of its advocates to endorse exaggerated claims concerning the rights of the

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[28] League of Nations (Technical Experts from seven jurisdictions: Belgium, Czechoslovakia, France, Great Britain, Italy, Netherlands and Switzerland), *Double Taxation and Tax Evasion*: F 212; Geneva, February 7, 1925, at p 15.
[29] Expanding the group from 7 to 13 members.
[30] League of Nations (Technical Experts from Argentina, Belgium, Czechoslovakia, France, Germany, Great Britain, Italy, Japan, Netherlands, Poland, Switzerland, USA, Venezuela), *Double Taxation and Tax Evasion*: C. 216. M. 85; Geneva, April 1927 at p 10.
[31] League of Nations (General Meeting of Government Experts), *Double Taxation and Tax Evasion*: C. 562. M. 178. Geneva, October 1928, at p 8.
[32] Thomas Adams, "Interstate and International Double Taxation", in Roswell Magill (ed) (1932), *Lectures on Taxation*, 101, at 125.

> jurisdiction of domicile (residence). These exaggerated claims rest partly on the fact that their advocates are citizens of creditor states.

18. There was universal recognition in the 1923 Report, 1925 Report, and the subsequent reports that sourced-based taxation could occur in an unfettered way, absent any international agreement to the contrary. The resultant (current) international tax system, the 1920s compromise, was an arbitrary, negotiated, and pragmatic outcome from discussions taking over five years. Apart from familiarity and conservatism (which is not to dismiss these virtues lightly) there seems every reason to consider a renegotiation of international tax rights if the existing regime is under significant pressure.

Allocation of profits to the market jurisdiction was ignored in the 1920s compromise but should this be continued?

19. According to the OECD, in the view of many countries that justify taxation of highly digitalised business models because of a misalignment between the existing nexus and profit allocation rules between the location in which profits are taxed on the location in which value is created: [33]

> …most of the countries in this group *reject the idea that a country that provides the market where foreign enterprise's goods and services are supplied on its own provides a sufficient link to create a nexus for tax purposes*, regardless of the scale of these supplies. Instead, they consider that profits should continue to be *taxed exclusively with the factors that produce the income are located*, in accordance with the long-standing principles of the existing tax system (e.g., aligning profit with value creation). *(Emphasis added).*

20. These countries are deeming value to be created only by activities on the supply side (research and development, production and marketing) and not on the demand side (purchasing the goods or services). Maartin de Wilde asks the question: "if the demand side is relevant for creating income, why then does international tax law currently take no account of this when apportioning companies' international profits? The answer would seem to be that this is simply how things have evolved as "….a 'product of history' ".[34]

21. Devereux and Vella carefully (and correctly) point out that ignoring value creation on the demand side "flies in the face of basic economic logic."[35] They then go on to illustrate how value is created on the market (demand) side:[36]

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[33] OECD, "Tax Challenges Arising from Digitalisation-Interim Report (2018), OECD publishing, Paris, paragraph 390 on page 172.
[34] M de Wilde, "Tax Jurisdiction in a Digitalizing Economy; Why "Online Profits" are so Hard to Pin Down", (2015) Intertax, Vol 43, issue 12, 796 at 798.
[35] M Devereux and J Vella, "Taxing the Digitalised Economy: Targeted or System-Wide Reform?" British Tax Review (2018),4, 387 at 394.
[36] Ibid.

> The income being allocated among countries owes as much to the market as it owes to the various parts of the supply chain. Income depends on the price charged at the point where supply and demand meet: it simply would not have arisen in the absence of a market. It is not entirely clear why the international corporate tax system should depart from a simple and uncontroversial economic understanding of value creation.

22. As previously referred to in the 1923 Report, the economists discussed the production of wealth and gave an example which supports the same point-taxing rights can be shared between the supply and demand sides of the market:[37]

> The oranges upon the trees in California are not acquired wealth until they are packed, and not even at this stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where a consumer can use them. *These stages, up to the point where wealth reaches fruition, may be shared in by different territorial authorities. (Emphasis added)*

23. The current international tax system does not allocate taxing rights in respect of business profits unless the PE threshold is established and, furthermore, the business of the foreign entity is being carried on through the PE. The 1920s compromise prevents the source state from fully taxing active business income and allocates some taxing rights to the residence state where the PE threshold is not met.

24. Non-resident enterprises can “do” business in a jurisdiction in many different ways, some requiring a physical presence in the jurisdiction and some not (contracts might be concluded or partly performed in the source country which may not require actual physical presence). Most countries domestic sourcing rules require certain activities to be carried on in the country in order to constitute business income. Sometimes this threshold under domestic law is quite low and quite vague.

Significant changes in the way in which large amounts of business are done and the consequential implications on the international tax system

25. The work by the OECD in their various interim[38] and final[39] reports on Base Erosion and Profit Shifting highlight the ways in which the business models used in the digital economy provide new ways of doing business,

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[37] League of Nations Economic and Financial Commission (Bruins, Einaudi, Seligman and Stamp), *Report on Double Taxation*: Document E. F. S. 73. F. 19 at page 23.
[38] OECD (2018), Tax Challenges Arising from Digitalisation-Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD publishing, Paris.
[39] OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241046-e

and better ways to do existing business practices. These can be summarised into four major areas:

i. Network effects and globalisation;
ii. Pricing and dealing between user groups;
iii. Efficiencies, economies of scale and low marginal costs; and
iv. Data capture, reviews and content creation (including user participation).

It is commonly considered that these new business models are currently challenging and will in the future dramatically challenge the existing tax system particularly in the area of corporate income tax.

26. The tax challenges presented by these new business models include:

i. a vanishing ability to tax business profits due to the ability to do business without physical presence;
ii. the previously unmeasured value of the use of data and the contribution of users in various multisided platforms;
iii. the network effect caused by global marketplace access;
iv. the mobility and difficulty in the valuation of intellectual property;
v. the correct characterisation of transactions (business profits versus royalties);
vi. for certain transactions, a perceived failure of the current transfer pricing practices.

Consequential Submissions on Policy Considerations

As a consequence of the above analysis, it is submitted that the following conclusions can be drawn:

27. As a matter of policy, there is a sound theoretical basis (namely the benefits theory) which justifies source taxation when non-residents conduct business with consumers in the market jurisdiction.

    This justification has long been recognised from the earliest days of tax theories but more recently in the 1923 Report, the early work from the League of Nations and more recent work in the OECD (paragraphs 3-6 above).

    This policy-based conclusion can be extended logically to the digital age with equal force and evidence of this is found in a recent decision of the US Supreme Court (paragraph 7-14).

28. The current international tax settings were an historical compromise (the 1920s compromise). There is no reason, apart from certainty and history, not to revisit these original settings if certain assumptions (for example, that there will be sufficient a quantity of properly rewarded intermediate entities located in the source jurisdiction) no longer exist (paragraphs 15-18).

29. The current international tax settings did not largely allocate profits to the market, but only to factors of production located in the residence jurisdiction. This can be viewed as part of the historical 1920s compromise and whilst pragmatic and convenient it is difficult to justify this from a theoretical perspective. Accordingly, a new compromise could sensibly allocate profits to the market and, with appropriate safeguards to ensure genuine economic activity, not require a physical presence in the marketplace to establish a taxing right (paragraphs 19-24).

30. The increasing ability, efficiency, competitive advantage, and profitability of digitalised businesses[40] result in substantial consumer-orientated businesses being able to trade remotely. As a result of the current international tax settings, the consequence of this dis-intermediation (the removal of a tax-paying intermediary) means a substantial erosion to sourced base corporate income tax (paragraphs 25-26).

31. From a policy perspective, the conclusions reached above support the approach (or something along similar lines) taken by the OECD Secretariat in their Proposal.

Other Observations

With respect to the specific proposals in the Unified Approach and with respect to the actual methods proposed:

Scope

32. There are considerable challenges inherent in defining a large consumer/user orientated retail business. It may be better (the OECD approach seems to assume this) to have a definition based purely on turnover/sales and to exclude certain types of businesses/industries where the consumer/user aspect is missing. The taxing rights of the market jurisdiction are based upon the concept of value being created in that jurisdiction either by the actions of users or features of the marketplace such as the creation of marketing intangibles. Markets which are purchasing raw commodities including those provided by extractive industries are unlikely to fall within the concept of a large consumer/user orientated retail business and should be excluded.

    The size and definition of the multinational group should be able to be determined by consolidated financial accounts and in the vast majority of cases, these entities will be listed on stock exchanges and audited by major accounting firms. These accounting, securities, and regulatory protections should standardise reporting obligations and these requirements already traverse the complex issues of which entities are

[40] In particular those operated by multi-sided platforms enjoying substantial network effects.

included within the group and the exclusion of intercompany transactions.

33. Given the reporting obligations for country-by-country reporting, the threshold of €750 million seems to be appropriate.

New Nexus

34. The calculation of Amount A (allocating profits to the marketplace in circumstances where there is no physical presence) will result in significant complexity. Bearing in mind that this is a significant departure from the 1920s compromise but still justified on theoretical grounds, the cost and complexity of calculation can be balanced with a significant threshold (the "included taxpayer" threshold) as the Secretariat suggests. This will mean that smaller multinationals can retain existing international tax principles, whilst more sophisticated taxpayers have the means and tax infrastructure to deal with the calculations.

35. On the other hand, the threshold for inclusion in a jurisdiction (the "included jurisdiction" threshold) should be set having regard to the purchasing power of the jurisdiction. This is to reflect that smaller countries should not be penalised by reduced taxing rights simply because of the size of their economy.

    Accordingly, a suggested threshold could reflect both the relative population, size and gross domestic product (GDP) or some variant of GDP per capita. There are, of course, many inadequacies in such a calculation but nonetheless, some broadly comparable measure is required. This threshold could be reset every five years so that the calculations are broadly consistent but still reflect the changing economic situation of the jurisdiction concerned.

Calculation of Amount A

36. Although these questions are best answered by experienced multinational financial accountants and their advisors my observations are twofold:
    I. the plea to make the calculation/formulas as simple as possible; and
    II. notwithstanding this plea, to try to reflect regional profitability (provided this information is relatively easily obtained which should be the case).

Amount B

37. With respect to Amount B, it would seem that such a formulaic calculation (being based on an arbitrary agreed estimate) is designed to reduce costs and standardise taxing rights across jurisdictions. If this can reduce costs of compliance and reduce disputes then this is a laudable objective. Standardising the formula to include third-party distributors with the

objective of reducing tax-driven structuring is also sensible.

38. Although it would be more work at first, there must be merit in having differential rates for different types of business depending upon the profitability of the industry/region concerned. So it makes sense for there to be a fixed percentage adjusted by the industry and region.

Amount C / dispute prevention and resolution

39. With respect to Amount C, the concern would be that this is an adjustment available only to tax authorities to extend amounts calculated under other formulations to an arm's-length amount. This is likely to increase the number of disputes and add complexity and cost. In the spirit of the other objectives in the formulation of Amount B, it might be better to accept the relative imprecision of such calculations and not have the additional step required in Amount C. In other words, it might be necessary to "live with rough and ready outcomes" of the formula and periodically revisit its assumptions and the basis of the calculation rather than allowing jurisdictions to constantly dispute the formula.

40. In this respect, perhaps the time has come to have some type of independent tribunal or authority responsible for setting the percentages on a transparent basis. The revenue authorities of countries unhappy with the determinations could make submissions with any consequential changes taking place on a prospective basis rather than any retrospective adjustments.