Harnessing Talent and Providing Quality Service

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Dear Sirs,

We thank you for providing us an opportunity to study the proposals contained in the Consultation Document on *Addressing the Tax Challenges of the Digitalisation of the Economy* and offer our comments thereon.

1. The user participation proposal

1.1 *Preliminary remarks*

1.1.1 The 2015 Action 1 Final Report on the Digital Economy acknowledged the difficulty in ring-fencing the digital economy from the rest of the economy. 'Attempting to isolate the digital economy as a separate sector would inevitably require arbitrary lines to be drawn between what is digital and what is not' the Report stated. However, the Report recommended focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges or BEPS concerns [Para 115 of the 2015 Action 1 Final Report].

1.1.2 The user participation proposal is targeted at certain highly digitalised businesses where 'soliciting the sustained engagement and active participation of users is a critical component of value creation'. Such activities and participation of these users which create brands, generate valuable data, and establish market power by developing a critical mass of users is not to be seen in traditional businesses. Though the Consultation Document lists out three business models where such active user participation is evident, the document does not rule out other business models which could satisfy these criteria [Para 28 of the Consultation Document].

1.2 *Key features of highly digitalised businesses*

1.2.1 We are of the view that focussing on highly digitalised businesses with active user engagement and participation does not affect horizontal equity or the level playing field for the purposes of taxation. The 'active user engagement and participation' test comes naturally in highly digitalised businesses. In fact, the high amount of digitalisation promotes user engagement and participation from which businesses derive profits. For the businesses, active user engagement and participation is not an end in itself but lead to generation of profits through offering of goods or services. The business models listed by the Consultation Document are unique and businesses offering similar products or services are absent in the traditional field. In other words, there is really no risk of violating horizontal equity or of not providing level playing field to traditional businesses.

1.3 *Profit allocation*

1.3.1 An active user base in a highly digitalised business is the nexus for allocating taxing rights to a jurisdiction. The allocation of profits of such highly digitalised business to various jurisdictions as a proportion of the active user base is fraught with difficulties.

1.3.2 Identifying the taxpayer or taxpayer group, to determine its or their global profits, ascertaining the active user base in each relevant jurisdiction,

identifying an allocation key to apportion profits to these jurisdictions are easily spotted. There could be many more complexities some of which could latent and manifest after some time.

1.3.3 In summary, the revised residual profit split method of allocating profits of an MNE group based on 'active user engagement and participation' and applying agreed to allocation keys to apportion these non-routine profits to various jurisdictions and resolving the various difficulties of interpretation and computation appear impractical.

1.4 ***Suggestions and recommendations***

1.4.1 It is important to acknowledge that the active user engagement and participation is only a proxy to determine nexus for taxing such businesses by a jurisdiction. The businesses may not earn out of these users but by their active engagement, they provide a revenue model for these businesses to earn from providing goods and services.

1.4.2 Since it is possible for businesses which deal in goods and services to satisfy the active user engagement and participation test, identifying the nature of revenue which will be subject to this tax will be crucial for this proposal to succeed.

1.4.3 Instead of taxing profits of such highly digitalised businesses, it is more reasonable and practical for a taxation regime where jurisdictions impose a tax on the revenues generated by such businesses from their territory. Such tax could be in the form of a final withholding tax on gross basis from payments made from that jurisdiction.

2. The marketing intangibles proposal

2.1 *Marketing intangibles and market-nexus*

2.1.1 The Consultation Document acknowledges an "intrinsic functional link" between the marketing intangibles and the market jurisdiction [Para 32]. We agree with this proposition.

2.2 *Favourable demand conditions and market -nexus*

2.2.1 Further, we agree that favourable demand conditions in a market do not create value or profits for a MNE unless there is active intervention in the market [Para 33]. However, though favourable demand conditions in a market may not be because of the active intervention by a firm in that market, the exploitation of such demand conditions by the firm generates profits to it which can be directly attributed to that market. Para 33, in fact, acknowledges the economic relevance of such demand conditions in a market which lead to profits to an MNE. In a profit allocation, it is illogical to attribute the profits due to favourable demand conditions in a market to another jurisdiction. The exploitation by the firm of these conditions falls within what the Document calls "active intervention" in the relevant market which consequently results in profits to the firm.

2.2.2 The distinction drawn between marketing intangibles and market conditions arise out of the understanding that the former can be owned while the later cannot. As the 2013 Discussion Draft on Intangibles stated, it is necessary to distinguish intangibles from market conditions or other circumstances that are not capable of being owned or controlled by a single enterprise [para 43].

2.2.3 However, the objective of the Consultation Document is to identify aspects which could be relied upon to confer nexus with the market jurisdiction and permit taxation of consequent profits in that jurisdiction. The ability or otherwise to own is not relevant for the identification of the nexus.

2.3 *Trade intangibles and market-nexus*

2.3.1 The Consultation Document itself declares that the marketing intangibles proposal is to address a situation where an MNE group can essentially "reach into" a jurisdiction, either remotely or through a limited local presence [para

30]. The nexus is to be sought only where there is a lack of physical presence of the MNE in a market jurisdiction.

2.3.2 The Document goes on to describe why trade intangibles do not have an intrinsic functional link with market jurisdictions. It goes on to give an example of a patent for a car engine developed which allows similar mileage to be achieved in different markets [para 34].

2.3.3 However, the assumption that trade intangibles do not have a link with the markets is flawed. Any invention which is not directed at exploitation is theoretical and of no relevance to taxation. Inventions are made and then exploited in the markets and not in the labs. A car engine developed may not enable the vehicle fitted with it to achieve the same mileage in every market due to differing road and environmental conditions. It is most likely that engines are customised for particular conditions.

2.3.4 On the contrary, there exists a clear link between the manufacturing intangibles and the markets. For instance, patent protection is available and clearly linked territorially. Even where an invention is not protected in a market jurisdiction under patent laws, the confidential nature of know-how and trade secrets may be protected to some degree (i) under unfair competition or similar laws, (ii) under employment contracts, and (iii) by economic and technological barriers to competition [July 2013 Discussion Draft on Intangibles]. Such know-how and trade secrets are intangibles for the purposes of transfer pricing guidelines.

2.3.5 The objective of the G 20 Project is about identifying a nexus with the market jurisdiction and allocating taxing rights to that jurisdiction in respect of the profits attributable to that nexus. An approach which is based on a functional analysis of an MNE Group is akin to a transfer pricing analysis of transactions of the MNE and is unlikely to offer anything different from such a transfer pricing analysis. This whole exercise in identifying a nexus with the market

jurisdiction, if dependent on the activities of the MNE in that jurisdictions, could be futile or give insignificant allocation of profits for market jurisdictions to tax.

2.3.6 No doubt, value creation leads to profits, but where the value is created to derive those profits would be matter of debate. Instead of value creation as a proxy for determining taxing rights, it would be far easier to identify where profits are generated. This approach does not deviate from the underlying value creation proposition, but goes to the root of what is subject-matter of taxation, that is, the profits. The focus of taxation is value realisation.

2.3.7 Further, a patent to build the car engine is specific to a particular territory. Patents are legal rights and the patentee enjoys a live link with the market where it is sought to be exploited. Hence there is really no justification for limiting the attribution proposal to only marketing intangibles. Manufacturing intangibles like goods which are customised or indigenised as well as legal rights like patents which afford protection territorially have equal, if not more, claim to a link with the markets.

2.4 The Consultation Document recognises that the difference between the user participation proposal and the marketing intangibles proposal is that the later proposal seeks to cover within its ambit consumer product businesses using LRD structures on the grounds of equity, coherence and to provide a level playing field [Para 42]. There appears to be an attempt to broad-base the applicability of the marketing intangibles proposal and to avoid 'ring-fencing' digitalised businesses by including the consumer trading businesses using LRD structures. The justification of including only such consumer trading businesses under this proposal may end up being arbitrary and such limitation should be removed.

2.5 **Suggestions and recommendations**

2.5.1 The difficulties in computing the residual profit split suggested in the Document would be enormous. Considering the complexity of the computations and the likely lack of agreement on the various parameters for allocation of profits between different market jurisdictions which would lay their claims for taxing MNE's profits, the whole proposal will lead to a quagmire of disputes and consequent litigation. A formulaic percentage on gross revenue from each market appears to be a better and more logical solution to the same. With the home country extending foreign tax credit to such taxes paid in the market jurisdictions, the instances of double taxation of income would be minimal. The MNE will not pass on the burden of such tax onto the consumers in the market jurisdictions and would not lead to any trade related issues as well.

3. Significant economic presence proposal

3.1 The significant economic presence (SEP) proposal has been in the works since the 2015 Action 1 Final Report. **Considering the complexities and difficulties that come with the user participation proposal and the marketing intangibles proposal, the SEP proposal, in our view, is more comprehensive and conceptually appropriate.**

3.2 *SEP nexus factors*

3.2.1 The Consultation Document states that the significant economic presence proposal 'is motivated by the view that the digitalization of the economy and other technological advances have enabled business enterprises to be heavily involved in the economic life of a jurisdiction without a significant physical presence' [Para 50].

3.2.2 A common criticism of the significant economic presence proposal is that the import of goods or services into a country enables the supplier to be involved in the economic life of that country even before digitalisation. This criticism appears to be incorrect. A supplier of goods is not involved in the economic life of a country merely because goods or services are imported into that country. The goods or services themselves may become part of the economic circumstances there, but not the supplier or his business. That may be the reason why no tax is attracted on merely selling goods to a country which is trading with a country as against trading in a country. This distinction gets blurred due to high level of digitalisation through which businesses can avoid creating physical presence, and consequently, tax exposure in market jurisdictions.

3.2.3 However, there are difficulties in determining the appropriate factors which determine existence of a significant economic presence in a jurisdiction.

3.2.4 The factors which could determine a significant economic presence listed in the consultation document require to be defined with more focus. We agree that merely earning of revenue from a jurisdiction without the other factors will be insufficient to establish a significant economic presence. However, presence of a domain name or a local payment mechanism ought not to be given disproportionate weightage as the presence of users and/or customers will encompass such factors anyway.

3.3 *Fractional apportionment method*

3.3.1 Many of the metrics suggested in the Consultation Document may end up being arbitrary and unworkable. The fractional apportionment method requires determining the tax base, identifying allocation keys and giving appropriate weightage to the keys. All the three steps require a consensus amongst the several countries in the Inclusive Framework. That seems highly unlikely and even if such a consensus is reached, the result is likely to be highly arbitrary.

3.3.2 The suggestion that the global profit rate of an MNE group be applied to the revenue in a particular jurisdiction to determine the tax base will lead to a situation of taxing an enterprise even where it incurs losses in the digitalised business just because the Group as a whole is profitable. The converse, where there are losses at the group level, but no tax is payable in respect of a profitable digitalised business amounting to a SEP in a jurisdiction, is starker. An international tax regime should not be sustained on such iniquitous measures.

3.4 **Suggestions and recommendations**

3.4.1 Considering the above, a withholding tax mechanism needs to be given serious consideration. Instead of limiting withholding taxes only as a collection mechanism and enforcement tool, it is suggested that jurisdictions where SEP is found to exist impose a final tax (withholding or otherwise) on the revenue generated from a jurisdiction. This suggestion will meet the needs of simplicity and ease of administration.

3.4.2 Though such a final tax on revenue appears similar to a tax on turnover and an indirect tax, it may be borne in mind that the taxpayer suffering such a tax will be entitled for foreign tax credit in its home jurisdiction and will have no incentive to pass it on to its customer.

4. Suggestions common to the proposals

4.1 **All the three proposals in the Document should be attracted only above a threshold which is required to be suitably fixed. The threshold is required to be fixed to further better administration of the proposals, but cover a significant percentage of businesses to avoid targeting only specific large players. Naturally, revenue from a jurisdiction will be an important factor and influence the threshold.**

4.2 **The thresholds under the various proposals need to apply to individual entities and not groups. Group operating profits, user-base or other metrics need to be used only as anti-avoidance measures. A variation of the anti-fragmentation rule in Action 7 could also be applied to prevent avoidance by MNE Groups of the thresholds by breaking down the group involvement through involvement of multiple entities belonging to the same group. This will ensure clear identification of the entity paying the tax and being eligible for credit in its home jurisdiction.**

4.3 **It may be clarified that the rules determining nexus to the market jurisdictions and allocating profits to that jurisdiction should equally apply to allocating losses as well.**

4.4 **Any new nexus and attribution rules would result in profits being allocated to the market jurisdiction which hitherto were not so allocated. There could be some concern about how the transition to any new nexus and attribution rules will play out. It is our understanding that the new rules are in addition to the existing transfer pricing rules and both will co-exist. Accordingly, there ought to be no impact of one set of rules on the other. For instance, there is no 'transfer' of marketing intangibles to the market jurisdiction contemplated by the new proposals. This aspect may be required to be elaborated in the final rules for the same.**

4.5 **The residual profit split method which is suggested in the proposals is not well known or widely used. If at all the method is selected, sufficient guidance needs to be incorporated in the final proposals to enable the taxpayers and the tax administrators to apply it consistently so that disputes are reduced and consequent risk of double taxation is minimised.**

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4.6 **The methods suggested naturally do not rely on a functional analysis which is followed in a traditional transfer pricing study. This departure is understandable. The fundamental aspect of the digitalisation problem is a 'remote participation' by an multinational enterprise in a jurisdiction and the absence of a taxable physical presence or only a limited taxable presence which does not attribute any significant profits to that jurisdiction. In this scenario where there is hardly any function performed by the enterprise in the market jurisdiction (as these are achieved remotely) a functional analysis as used for traditional transfer pricing purposes would hardly be of use and needs to be roundly rejected. The Consultation Document has recognised this clearly.**

We, at the Bombay Chartered Accountants' Society, are excited about the new international tax regime which holds out to be fair and equitable. We offer all the help to the BEPS Project, and look forward to further developments keenly, especially, the public consultation meetings to be held to finalise the Action 1.

Yours sincerely,

For Bombay Chartered Accountants' Society

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