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OECD Public Consultation Document "Addressing the Changes of the Digitalisation of the Economy" dated 13th February 2019

Dear Madam or Sir,

Thank you for the opportunity to comment on the OECD's Public Consultation Document "Addressing the Changes of the Digitalisation of the Economy". We welcome the work by the Inclusive Framework and the OECD to resolve Base Erosion and Profit Shifting (BEPS) issues, i.e. resolve issues of non-taxation as well as issues of double taxation. We support the general approach to prefer policies that lead to low compliance costs for businesses and reduce administrative costs for tax administrations. Policies that bear the risk of double taxation must be accompanied by a robust mechanism to resolve double taxation and improve legal certainty for businesses.

Consultation Document p. 23, No. 87 – views on pillar 1

Existing systems compared to the proposals named pillar 1

The OECD's project, BEPS, has aligned the right to tax profits from economic activity in the jurisdiction where value is created. The BEPS measures are currently implemented. Thus, it cannot be fully assessed if the results suffice.

The aim of the BEPS project was to align the actual taxation of profits with the place of value creation. That is currently thought to be, where the economic substance is, i.e. functions of the business are performed and business risks are

located. It should be noted that discussing a reallocation of taxing rights is not a BEPS issue as such. Nevertheless, changes in the international political consensus how to allocate taxing rights should be agreed on a broad basis, ideally with all countries. Currently, representatives of 129 countries are members of the Inclusive Framework. The Inclusive Framework can be regarded as a good platform to discuss such changes.

The proposals named “pillar 1” deal with the idea to reallocate taxing rights to the market jurisdiction, even if there isn’t any or only minimal economic substance in the market jurisdiction according to a “traditional” functional and risk analysis. To make sure that profits are taxed exactly one time, it is essential to agree internationally upon the allocation of the right to tax. A situation of international coordination and political agreement is preferable compared to a situation in which countries are taking unilateral measures without international coordination, because the latter would most likely lead to unresolved double or multiple taxation issues and create new loopholes.

Compared to the existing level of international coordination any amended policy should prove to be a more workable and practicable environment and create a higher level of international coordination. It does not seem advantageous to move to a proposal that does not fulfil this condition.

The three proposals named “pillar 1” have one feature in common: They introduce the paradigm according to which the existence of consumers located in the market jurisdiction – under (differing) further conditions – is seen as relevant link to allocate taxing rights to the market jurisdiction. The new (consumption-oriented) paradigm shall not replace the current (production-oriented) paradigm, but both paradigms shall be applied parallelly. The proposals have in common that they add complexity to the allocation mechanism. We believe that these more complex proposals are

- more difficult to coordinate internationally,
- more likely to create the risk of loopholes because substance is no longer the only variable along which profits are allocated to countries for taxation and
- more likely to create situations of double and multiple taxation that need to be resolved.

Whereas the traditional understanding of “substance” and “value creation” is a complicated but measurable criterion, fictitiously reallocated “value creation” is much more complicated to measure. If this complexity is reduced by formulaic apportionment, taxation is insofar no longer transaction-based, no longer

correlated to the facts and circumstances of the individual case but to aggregated figures and therefore more likely to trigger fairness issues.

We believe that further work is necessary before it can be assessed if any of the three proposals summarized under the name “pillar 1” is advantageous compared to the current system.

Pleading for a principle-based transactional approach to the allocation of profits to the country with the right to tax

Rules that are derived from a principle-based approach are more likely to form a consistent legal environment and enable businesses to align their economic activity with the intention of the law. If a rule is designed to mitigate between conflicting principles in the individual case the decisions and the reasoning behind the rule should become as explicit as possible to enable businesses to apply the same principles of mitigation to new cases. We believe that a principle-based approach is preferable to a formulaic apportionment mechanism regarding legal certainty, a level playing field for businesses and the ability of tax administrations to reach consensus in case of dispute resolution procedures.

This is especially true when comparing a formulaic approach working with aggregated figures with a principle-based approach that is consistently developed into a system of rules to be applied to transactional data instead of aggregated figures. For reasons of practicability the factors in an apportionment formula are likely to be aggregated figures. There is still very little experience with a formulaic apportionment approach of taxes between sovereign countries. Furthermore, it seems rather unexplored how to deal with international fairness issues without a system of international tax courts and how robust different formulaic apportionment methods would prove to be against tax structuring in practice.

The current allocation of taxing rights is a principle-based approach mainly using transactional data. If the Inclusive Framework was to amend the existing consensus, it would in our view need to be explicit about how new principles and existing principles interact with one another and be concise about a consistent set of rules derived from these principles.

Therefore, we believe it is favourable to use a principle-based approach that is consistently broken down into rules which are applied to transactional data.

Scope of changed taxing rights

Globalisation and digitalisation have increased the number of cross-border transactions and have made global communication cheap and available to businesses and consumers. Business models have in the past adapted and increasingly will adapt to the new business opportunities that emerge due to this development. Thus, it is reasonable to expect a continuous change in business models and further economic sectors to become digitalised. Rules limited in scope to existing businesses are likely not to catch emerging business models. We believe that proposals that are designed to ringfence existing businesses, will in the long run not be helpful to meet the challenges of taxing globalised and digitalised businesses. The new principles should in general apply equally to all businesses.

Further, any mechanism that allocates taxing rights according to data contributed by users should in our view consider that the value of the atomic consumer data that is contributed to the business model is very low. In many existing business models the user gets a digital service at near to zero marginal cost in exchange for each piece of consumer data. One further driver for the value of consumer data is realised in the time and place where the atomic units of collected data is collated into machine-readable data structures or databases. This work is usually not done manually but by algorithms. Such algorithms are therefore also a value driver. Further, a data scientist's work supported by complex algorithms for big data analysis renders value to the database. The results are in turn stored in other data structures that are further value creating components.

A principle-based approach should be explicit on which of these factors are deemed to form a link to the market jurisdiction and which are not. In our view at least some of these value drivers are not necessarily linked to the market jurisdiction and profits related to these value drivers should not automatically lead to a taxing right in the market jurisdiction.

Consultation Document p. 29, No. 110 – views on pillar 2

The tax rate is one of many factors that a sovereign jurisdiction sets when it positions itself to attract business activities to its territory. Fair tax competition between jurisdictions is basically acceptable and lies within a jurisdiction's sovereignty. The limits between fair and unfair tax competition should be agreed upon by the community of sovereign jurisdictions. The International Framework is a good platform to find an international consensus what tax rates shall be regarded as unfairly low and would thus be regarded as unfair tax competition by the community of jurisdictions in future.

It would be fair and consistent, if the International Framework agreed on mechanisms to make the sovereign unfairly competing jurisdiction stop its policy of unfair tax competition and set effective tax rates according to such new international consensus. The proposals named “pillar 2” do not elaborate on such a mechanism, yet.

Under the assumption that unfairly competing jurisdictions will not be ready to align their tax systems with the international consensus, the proposal immediately targets businesses that have economic substance in such jurisdictions. It has to be seen as a success of the BEPS project to have aligned profit taxation with the place where value is created, i.e. where economic substance is according to a functional and risk analysis. However, if the value happens to be created in a low tax jurisdiction, the jurisdictions fairly competing now propose to tax businesses as if the value was in a fictitious jurisdiction that is also fairly competing. It may be doubted if it is justified to put economic pressure on businesses that create value in these low tax jurisdictions. Under the prerequisite that no other means exist to put pressure on low tax jurisdictions, this could be regarded as a legitimate policy rationale, if agreed by all jurisdictions unanimously.

Taking this understandable second-best policy rationale as a starting point it becomes evident that

- the effective minimum taxation proposal (i.e. the income inclusion rule) can only be applied to entities that can legitimately be treated like one entity; this is obviously not the case where the participation is lower than 50%.
- the additional tax that is levied under an effective minimum tax proposal must not be higher than the difference between the internationally agreed effective minimum tax rate and the actual tax rate in the low tax jurisdiction.
- the effective minimum tax rate must be appropriately low. Otherwise, it would limit a jurisdiction’s sovereign in an inappropriate way.
- the effective minimum tax rate test must be proportional to the aim to prevent unfair tax competition and must not limit the sovereignty of jurisdictions. The test must further be accompanied by administrative mechanisms to agree on the relevant income and related expenses and the effective tax rate at which it is taxed. Otherwise, costs for tax administrations and businesses are likely to be inappropriately high.

Further work is necessary before the economic effects of the policy can be assessed. Depending on the rule design existing defensive rules (e.g. CFC rules) may overlap with the new effective minimum taxation rules. A consistent rule

design should seek to avoid double or multiple income inclusion as well as income inclusion and additional deduction limitation.

From a German perspective it must not be forgotten that the principle of equality (Art. 3 para. 1 of the German Grundgesetz (i.e. Constitution)) is construed by the Federal Constitutional Court in a way that an equal ability of the individual natural and legal person to pay (corporate) income taxes shall lead to an equal tax burden. The Income Inclusion Rule seems to be designed in a way that a shareholder is subject to higher taxation because the entity held is in a low tax jurisdiction. Holding shares in a company with active business in a low tax jurisdiction does not necessarily increase the shareholder's ability to pay taxes. The rules should be designed in a way that the increased taxation of the shareholding entity is justified with regard to the constitutional principle of proportionality.

Mandatory dispute resolution mechanisms necessary

All proposed policies would further increase the number of double taxation disputes, if they were adopted. Therefore, they should not be adopted without a mandatory mutual agreement procedure. It is necessary to introduce a mechanism that renders legal certainty for businesses early in time.

It would also be most helpful to introduce a reliable and fair mechanism for joint audit by tax authorities. The OECD's ICAP pilot could among others be a feasible approach.

We hope these comments are helpful in the further discussions of the Inclusive Framework. In case of any further questions please do not hesitate to contact us.

Best regards,

Dr. Kelm

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Technical Director Taxes and Law