March 6, 2019

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Re: Comment Letter on the Public Consultation Document: Addressing the Tax Challenges of the Digitalization of the Economy

The National Foreign Trade Council (NFTC) is pleased to provide written comments on the Public Consultation Document: Addressing the Tax Challenges of the Digitalization of the Economy, published February 13, 2019 (the "Consultation Document").

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD and the Inclusive Framework in establishing and maintaining international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations. A list of the companies comprising the NFTC's Board of Directors is attached as an Appendix.

The NFTC appreciates the opportunity to comment on the proposals for further work set out by the Consultation Document and being discussed by the Inclusive Framework. Given the enormity of the challenge undertaken by the Inclusive Framework – providing a consensus-based long-term solution to the tax challenges arising from the digitalization of the economy by 2020 – the NFTC believes that it is critically important to offer a broad range of stakeholders' opportunities for input into the process.

This letter opens with general comments regarding the objectives of the Consultation Document, the elements necessary to achieve a consensus solution, and the proposals in Section 2 and Section 3 of the Consultation Document. The letter then provides specific comments with respect to each proposal and responds to the specific issues raised by the Consultation Document.

General Comments

For decades, jurisdictions have allocated rights to tax the business income of multinational enterprises based on nexus rules grounded in physical presence, and profit allocation rules based on the arm's length principle, which has proven to be flexible and to accommodate. changes to business models and the economy over the past nearly 100 years. The purpose of this international tax framework is to provide an equitable allocation of taxing rights among jurisdictions, a principled framework for resolving competing jurisdictional claims to avoid double taxation of the same income, and certainty and stability of the tax system for the benefit of both tax administrations and taxpayers. These rules have facilitated enormous global economic growth by facilitating cross-border trade and investment. While the BEPS changes modified these rules to address concerns that they allowed profits to be artificially shifted to low or no-tax jurisdictions where value creation was not occurring, or converted into stateless income, in general the BEPS changes did not upset the traditional rules for allocating taxing rights between jurisdictions with legitimate claims to tax the business income of multinational enterprises.

The proposals in Section 2 of the Consultation Document (Revised Profit Allocation and Nexus Rules) appear to reflect concerns of some countries that the existing international tax framework does not provide the jurisdiction to which a multinational enterprise's goods or services are targeted (the "market" jurisdiction) an equitable allocation of taxing rights. Jurisdictions of course are free to agree to rebalance the allocation of taxing rights between market jurisdictions and other jurisdictions (e.g., the jurisdiction in which goods and services are developed or produced), but to continue encouraging future global economic growth and equitable allocation of taxing rights, jurisdictions should not act unilaterally. Rather, jurisdictions should continue to act on a consensus basis. In our view, a consensus-based and durable rebalancing of taxing rights must have four elements to be successful: (1) any rules providing that a business without a physical presence in a jurisdiction nevertheless has sufficient income tax nexus with that jurisdiction should be clear, measurable and predictable and be applied neutrally across industries and business models; (2) any rules for attributing profits (or losses) to a jurisdiction in a manner that deviates from the current post-BEPS Transfer Pricing Guidelines should be specific in scope, clear and administrable in application, and give due regard to value creating activities and investments by the business that take place in other jurisdictions; (3) all participating Inclusive Framework jurisdictions must agree to be bound by, and to implement, the new consensus, and to repeal any related unilateral actions currently in place; and (4) the rules must include effective dispute resolution mechanisms, such as mandatory binding arbitration, as minimum standards subject to peer review. The third and fourth elements are particularly important in the context of this work because any additional allocation of taxing rights to market jurisdictions will often result in an allocation of taxing rights away from other moderate or high-tax jurisdictions.

Based on these elements, we believed that two of the proposals in Section 2 of the Consultation Document – the "user participation" proposal and the "significant economic presence" proposal – are unlikely to form part of a consensus-based and durable rebalancing of taxing rights. Accordingly, we believe that the Inclusive Framework should focus primarily on the "marketing intangibles" proposal, and the significant design and implementation challenges related to that proposal.

The proposals in Section 3 of the Consultation Document (Global Anti-Base Erosion Proposal) appear to reflect the concern that, notwithstanding the BEPS changes and U.S. tax reform, opportunities remain, at least for non-US multinationals, to shift profits to low or no-tax jurisdictions or to convert profits to stateless income. We believe that the Section 3 proposals are not closely related to the Section 2 proposals, as they address low or non-taxation rather than the allocation of taxing rights between jurisdictions. The Section 3 proposals are properly thought of as expanding the scope of the BEPS project and supplementing the BEPS changes. The BEPS changes have resulted in considerable changes in behavior among multinational enterprises and governments. New tax legislation, including the EU's Anti-Tax Avoidance Directive (ATAD) and the U.S. Tax Cuts and Jobs Act (TCJA) have gone beyond the BEPS minimum standards. We therefore recommend that if the Section 3 proposals are considered, such consideration comes only after a review of the efficacy of the BEPS changes that have already been put into place, as required by Action 11, and careful consideration of the policy rationale for a universally agreed global minimum taxation regime, to determine whether further measures are needed.

Revised Profit Allocation and Nexus Rules – In General

As described above, in our view a consensus-based and durable rebalancing of taxing rights must have four elements to be successful – clear and neutral rules as to any deemed income tax nexus standard; profit attribution rules that give due regard to value creating activities; an agreement by all participating Inclusive Framework jurisdictions to implement the new consensus; and effective dispute resolution mechanisms.

Given these elements, we believe that the "user participation" proposal and the "significant economic presence" proposals are unlikely to garner consensus amongst members of the Inclusive Framework. Accordingly, we recommend that the focus be primarily on the "marketing intangibles" proposal.

The "Marketing Intangibles" Proposal

The "marketing intangibles" proposal posits that an MNE group's residual profit attributable to marketing intangibles should be allocated across all jurisdictions where the group is deemed to have a marketing presence. Notably, the proposal is neutral as regards to industry or business model, and appropriately implemented would not affect the allocation of routine returns or profits attributable to trade or other non-marketing intangibles consistent with the arm's length principle. However, the proposal would represent a departure from the arm's length principle regarding the allocation of profits attributable to marketing intangibles and ignores the concept of DEMPE functions related to marketing intangibles, which purports to identify value creation along the supply chain and properly remunerate entities in accordance with functions performed, activities undertaken, and risks assumed. Considering that there already is a functioning framework for the allocation of profits in place, it is difficult to view the marketing intangibles proposal as anything other than an attempt to allocate more revenue than what is currently justifiable under economic principles to market jurisdictions. A more justifiable approach would be to separate "central marketing intangibles" (the profit attributable to which would be allocated under the DEMPE framework) from the "local marketing intangibles (which would be subject to the proposed allocation to market jurisdiction). Because the marketing intangibles proposal is a departure from the arm's length principle, its suggested allocation of additional profits to jurisdictions based on residual income generated by marketing intangibles (e.g., customer lists, trade names and proprietary market intelligence) raises several questions around its application that remain to be addressed.

To carry out a global residual profit split that the marketing proposal suggests is necessary to determine residual profit attributable to marketing intangibles, one needs to identify the entities making up the MNE group whose residual profits are to be split. It must also be determined what the correct base is for determining profits. Which non-routine marketing intangibles will be included in the profit split? How will profits be ascertained under a multi-entity approach? How will it be determined which market jurisdiction takes the lead in auditing an MNE and developing and proposing an adjustment? Will the Inclusive Framework agree to assign responsibility for the audit to a particular market jurisdiction? If so, on what basis? Would all market jurisdictions be entitled to their share of the residual (however defined) or only those that proactively open an audit of the taxpayer and assess the additional tax? All of the changes required to apply a new marketing intangibles proposal will require international coordination on an unprecedented scale. Also, it is unclear whether Option 2 would also imply a recognition that the marketing intangible is jointly owned by all jurisdictions involved in a profit split. This is relevant for various rules on the taxation of assets such as depreciation/amortization or capital gains. E.g. will capital gains on the sale of a brand be taxed in all market countries and how would they be allocated? In the absence of a sale, would a taxable exit be deemed to occur in jurisdictions that cease to be allocated economic ownership?

These are just some of the issues the proposal raises but has yet to resolve. More are discussed below. While we believe that the work of the Inclusive Framework should focus primarily on this proposal, we cannot endorse it. At a minimum, the marketing intangibles proposal should be explicit in stating that it is a departure from the arm's length principle and the other principles stemming from the BEPS work as regards to the allocation of profits attributable to marketing intangibles, and another policy justification for introducing a set of rules unmoored to currently prevailing principles should be articulated. Such an admission will allow the Inclusive Framework to dispense with attempts to shoehorn any new rules into the arm's length principle – an impossible task. Finally, should some form of the marketing intangibles proposal be required to reach consensus amongst members of the inclusive framework and stabilize the international tax system, it should be drafted as narrowly as possible.

The "User Participation" Proposal

The "user participation" proposal is problematic in that it appears to specifically target only certain companies (or business lines within companies), which goes against the tenets of neutral, fair and efficient tax policy. Companies across diverse business sectors leverage data and information and communication technology to optimize their daily business operations. The proposals focus on activities may require businesses that have in-scope activities, even though not core to their revenue generation, to determine if their revenue and profit is subject to the user-based income tax nexus and allocation rules. These requirements would be exceedingly complex, bordering on un-administrable. The proposed addition of a revenue threshold makes this targeting even more pronounced, compounding the lack of fairness. The proposal is not founded on economic analysis and therefore we are skeptical that the Inclusive Framework could agree to a uniform proportion of non-routine profits to allocate to the "value of users" because there is no agreed upon principle to guide such an allocation while ensuring an appropriate return to value creating activities and investments, such as activities related to the development of product or other trade intangibles. It is unlikely that this proposal can form the foundation of a principled and durable consensus framework.

The "Significant Economic Presence" Proposal

The "significant economic presence" proposal is problematic in that it would effectively establish a system of global formulary apportionment for multinational enterprises. The proposed tax nexus rules are amorphous and would likely be met in each significant jurisdiction by most large multinational enterprises. The apportionment of profit would depend on globally agreed allocation keys applied to globally agreed profit (or loss), rather than on the arm's length principle. Further, any controversy over apportionment would require a global audit of the multinational enterprise by the tax authorities in each jurisdiction that challenges the apportionment, placing difficult and expensive administrative burdens on every multinational taxpayer. We are skeptical that the Inclusive Framework could agree to global standards for determining profit and global allocation keys, or effective dispute resolution mechanisms, given that agreement on such items have been elusive even among smaller sets of much more homogeneous jurisdictions (e.g., the states of the United States, or the countries of the European Union). Other problems of global formulary apportionment are discussed in Chapter 1 of the OECD Transfer Pricing Guidelines, to which all OECD member countries (and many other countries) adhere. It is unlikely that this approach can form the foundation of a principled and durable consensus framework.

Deemed Tax Nexus Standard

First, significant work is necessary to develop an appropriate deemed tax nexus standard that is neither over- nor under-inclusive. The marketing intangibles proposal contemplates a new tax nexus threshold that, if met, would subject a business without a physical presence in a jurisdiction to tax within that jurisdiction. It is important to develop a clear and principled standard for deemed tax nexus. The proposal suggests that a multinational enterprise would have tax nexus in each jurisdiction in which "significant marketing intangibles" held by the business are derived and/or used. Accordingly, data on customers constitutes a "marketing intangible" that would give rise to tax nexus in the jurisdiction in which the customers are located, while a brand or trade name constitutes a "marketing intangible" that would give rise to tax nexus in the jurisdictions in which the brand and trade name are known. Is mere knowledge of a brand a sufficient threshold to impose taxation? Merely selling into a jurisdiction should not give rise to a deemed tax nexus because favorable market conditions alone do not constitute the creation of marking intangibles through the active intervention of the business in the market. Thus, for example, the sale of commodities into a jurisdiction presumably would not give rise to a remote presence for the remote seller.

Without further elaboration, however, this proposition could lead to a very low or trivial threshold for tax nexus and could give rise to surprising results. For example, a business may sell branded products or services into various markets in which the business has no physical presence using full-risk unrelated-party distributors. Alternatively, a business may sell branded component products (e.g., automobile parts) to an unrelated manufacturer for further processing (or possible inclusion as a subcomponent in a part) and distribution into various markets in which the business has no physical presence and sell the same component products to distributors for re-sale to consumers as parts. Finally, a business may provide enabling products or services (e.g., information and communication technology) to an unrelated multinational enterprise that support the multinational enterprise's operations in many jurisdictions. In each case, an unrelated seller of goods or services in the market jurisdictions takes on the market risk related to operations within those jurisdictions and earns an appropriate arm's length return. It is not clear whether, or under what circumstances, it would be appropriate in these cases to deem the remote seller or service provider to have a deemed income tax nexus in the market jurisdictions, or whether it would be appropriate to allocate business profits of such businesses to such market jurisdictions. Marketing intensity varies widely between industries, business models, individual companies, product lines, and markets. If the objective of this work is to provide guidance for the entire digitalizing economy in 128 Inclusive Framework member countries then the rules need to be capable of concluding, depending upon the facts, that little or no additional marketing intangible income is allocable to a particular jurisdiction

Framework for Specially Allocating Profits (Losses) to Marketing Intangibles

Second, in cases where the marketing intangibles proposal applies, significant work is necessary to provide guidelines for the determination of profit (or loss), if any, allocable to the marketing intangibles. The marketing intangibles proposal would specially allocate profits (or losses) to the market jurisdiction as if the physical or deemed presence of the business in the market owned, and undertook all risks related to, some or all of the marketing intangibles of the business related to that market jurisdiction. The Consultation Document suggests alternative methodologies for isolating profits (or losses) that would be specially allocated to marketing intangibles from other profits, including: (1) the application of normal transactional transfer pricing principles, and (2) a revised residual profit split analysis that uses more mechanical approximations. While each approach merits further exploration, in general we favor the application of existing transfer pricing principles. Put another way, the allocation of routine returns, and the allocation of profits attributable to product and other trade intangibles, would continue to be based on existing principles, namely the arm's length principle. A portion of non-routine marketing returns (as determined by traditional transfer pricing principles), if any, would be allocable to local jurisdictions. If this approach is adopted, it is critical that this adherence to the arm's length principle be stated clearly. This approach would ensure that all routine returns and all non-routine returns to product and other trade intangibles, which are developed through capital intensive research and development and which spur innovation and growth, would continue to be determined under the arm's length principle (based on traditional transfer pricing methods, the application of which would be determined following a most appropriate method analysis), and would not be subject to re-allocation to market jurisdictions.

While meriting ongoing study, the alternative revised residual profit split analysis will need work. Based on the experience of our members, residual profit splits can be complicated to implement and administer. A residual profit split often relies on data that may not be generated or maintained in the ordinary course of business and is often based on assumptions regarding the extent to which costs are related to the development of intangibles, and the period over which such costs are expected to generate returns. Applying a traditional residual profit split analysis to the global operations of all multinational enterprises would require an enormous commitment of resources. The Consultation Document also states that traditional transfer pricing principles would allocate non-routine profits to trade intangibles while new rules (beyond the arm's length principle) would be used to allocate non-routine profits to marketing intangibles. Businesses have only one pool of worldwide, non-routine profits to allocate, so it is difficult to understand how two separate sets of allocation rules would be applied to a single profit pool. Accordingly, the Consultation Document's lack of clarity on this point could lead to opportunity for market jurisdictions to leverage the new rules and allocate the majority of non-routine profit to marketing intangibles. For these reasons, we believe that reliance on the traditional transfer pricing methods, the application of which would be determined following a most appropriate method analysis, is required. The Consultation Document further suggests a more mechanical or formulaic approach to identifying residual profits attributable to marketing intangibles. While formulaic or mechanical approach may be appropriate in apportioning specially allocated returns from marketing intangibles among market jurisdictions once traditional transfer pricing principles have been used to identify the non-routine market profit share of the aggregate pool, care must be taken not to sweep in non-marketing intangibles as marketing intangibles. The relative contribution of product and other trade intangibles on the one hand, and marketing intangibles on the other, can vary dramatically by industry, and between businesses within industries. As previously noted, if the objective of this work is to provide guidance for the entire digitalizing economy in 128 Inclusive Framework member countries, then the rules need to be capable of concluding, depending upon the facts, that little or no additional marketing intangible income is allocable to a particular jurisdiction.

We note that in either case, it would be possible that losses could be specially allocated to a market jurisdiction even where a business has no physical presence in, and incurs no expenses in, the jurisdiction. For example, a business in a start-up or growth phase of developing the systems and product or service offerings necessary to gather and analyze user data within a jurisdiction may suffer an overall loss once returns to routine functions are taken into account. That loss may reflect an investment in marketing intangibles that may give rise to profits in the future. A failure to allocate such marketing intangible-related losses to the marketing intangibles, and therefore to the market jurisdictions, would result in an inappropriate or overallocation of losses to the jurisdiction in which the business performs routine functions or in which the business develops trade intangibles.

Apportioning Specially Allocated Profits to Market Jurisdictions

Third, significant work and negotiation is necessary to provide an agreed standard for apportioning a modest portion of specially allocated non-routine returns from marketing intangibles, if any, among market jurisdictions. To the extent that companies locate DEMPE functions in accordance with marketing in the market country, we believe the need to allocate additional profit to the market country is not supported. The DEMPE principles are carefully reasoned rules for attributing profit from intangibles to the functions of the taxpayers—the effect of these rules has not been determined from empirical evidence and should not be abandoned. Additional marketing profit should not be based on worldwide profit margin, rather only the portion of a company's worldwide profit margin attributable to marketing AFTER relevant allocation to DEMPE functions in a country, should be allocated among market jurisdictions. We would support a mechanical or formulaic approach, with apportionment factors developed based on a flexible application of the arm's length principle, only if it is agreed among all Inclusive Framework jurisdictions.

Mandatory Binding Arbitration Dispute Avoidance and Resolution

Fourth, and most importantly, all jurisdictions must agree to be bound by, and to implement, the new consensus which must include mandatory binding arbitration as a minimum standard subject to peer review. This is critical to avoid double or multiple taxation of the same income. The non-routine profits from marketing intangibles that would be specially allocated to market jurisdictions are currently subject to tax in other jurisdictions, such as the jurisdiction in which a brand or other marketing intangibles are developed, owned or managed, under traditional transfer pricing principles. Without broad agreement on the circumstances in which such profits can be specially allocated to market jurisdictions, and on the amounts that may be so allocated, double taxation will result. Similarly, agreement as to the apportionment of any specially allocated non-routine profit among market jurisdictions is critical so as to avoid the double taxation that would result if different jurisdictions applied different keys or metrics to this determination.

Accordingly, the consensus solution must include an agreement to implement consistent standards in domestic law and/or tax treaties, and mandatory binding arbitration as a minimum standard and subject to peer review. Without mandatory binding arbitration, a consensus solution would be illusory, as countries interpret or apply the new principles to maximize their revenue. Mandatory binding arbitration needs to work for all tax administrations and all multinational enterprises, regardless of size or sophistication.

Global Anti-Base Erosion Proposal

As noted above, we believe that the Section 3 proposals are not closely related to the Section 2 proposals, as they address profit shifting to low or no-tax jurisdictions rather than the allocation of taxing rights among jurisdictions. The Section 3 proposals are properly thought of as expanding the scope of the BEPS project and supplementing the BEPS changes. U.S. tax reform eliminated deferral of foreign subsidiary earnings and opportunities for stateless income for U.S. multinational corporations. The BEPS changes have also resulted in considerable changes in behavior among multinational enterprises. We therefore recommend that Section 3 proposals be considered (if at all) only after a review of the efficacy of the BEPS changes that have already been put into place, as required by BEPS Action 11, and careful consideration of the policy rationale (if any) for a universally agreed global minimum taxation regime, to determine whether further measures are needed.

Our recent experience with U.S. tax reform, particularly with the enactment of the GILTI (section 951A) and BEAT (section 59A) rules, has highlighted the difficulty of crafting global base erosion rules of the type proposed in Section 3. In general, we believe such rules should be narrowly tailored to meet the stated policy objective of deterring profit shifting to no or low-tax jurisdictions where value creation is not taking place. As an initial step, the Inclusive Framework should evaluate the efficacy of the BEPS changes that have already been put into place and provide data to support the need for any additional proposals. If such proposals are needed, then consideration should be given to an income inclusion rule that ensures that the profits of a multinational enterprise are subject to tax at a minimum rate in the enterprise's home jurisdiction. This rule would apply only if the foreign profits of the multinational enterprise are subject to tax at rates below a minimum threshold on an aggregate basis, rather than on an entity-by-entity basis, and only to the extent necessary to ensure that profits are taxed at this minimum rate. Foreign tax credits should be permitted so as to avoid double taxation. The income inclusion rule should apply at the level of the ultimate parent only and not on a country by country basis which would add enormous complexity and result in increased tax controversies.

A tax on base eroding payments should be considered only as a secondary rule to the extent such payments are made to related parties that are not within the scope of an income inclusion rule (e.g., because the jurisdiction of the ultimate parent has not yet adopted such a rule). This priority rule reflects the relatively stronger claim of the home jurisdiction to tax otherwise untaxed profits of the multinational enterprise, as opposed to the jurisdiction from which deductible payments are made.

Sincerely,

Catherine G. Schultz

Catherine G. Schultz
Vice President for Tax Policy