BRESLIN CONSULTING™

Breslin Consulting, LLC
1200 18th Street, NW, Suite 700
Washington, DC 20036
Tel: 202 468 9347
pbreslin@breslinconsulting.com
www.breslinconsulting.com

November 30, 2018

Principal Adviser
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
AUSTRALIA
corporatetax@treasury.gov.au

(*delivered via email*)

The digital economy and Australia's corporate tax system (October 2018): Treasury Discussion Paper (the "paper")—Comments of Breslin Consulting, (the "comments")

Comments by Pat Breslin[1]

Dear members of the Treasury:

Thank you for the opportunity to provide comments on the October 2018 discussion paper addressing the digital economy and Australia's corporate tax system.

I have extensive experience in areas directly relevant to the paper, the digital economy, and international tax and intangibles valuation issues. For example, as a business executive in the early stages of the digital economy, I negotiated complex, intangibles-focused arm's length transactions focused on online distribution of music and media and other e-commerce solutions. Thus, I have dealt directly with many issues addressed in the paper—not only as a consultant and expert, but as an independent party to actual, rather than hypothetical, arm's length intangibles transactions.[2]

Furthermore, my experience as an economist and expert on matters involving transfer pricing, intellectual property and other intangible property (collectively, "IP") extends to include both tax and

[1] The author would like to thank Jianwen Lu and Robert Strissel for their research in areas related to the digital economy and international tax, which supports these comments.
[2] See, for example, pages 3 to 5 of Response to "Request For Input Regarding Work On Tax Challenges Of The Digital Economy," P. Breslin response and comments submitted to OECD Committee on Fiscal Affairs (December 2013), available at: http://breslinconsulting.com/assets/P._Breslin_response_to_request_for_input-tax-challenges-digital-economy_Dec_2013-Jan_2014.pdf

non-tax litigation matters, such as commercial disputes regarding IP infringement and other arm's length transactions.

I have previously offered comments in response to multiple OECD requests regarding BEPS Action 1 regarding tax challenges in the digital economy,[3] and also discussed some of my views during the November 1, 2017 OECD consultation at the University of California, Berkeley, before the OECD Task Force on the Digital Economy (TFDE) ("Berkeley consultation"). I have also submitted comments in response to requests for input from other countries on these same topics—for example, in January 2018 comments submitted in response to the United Kingdom HM Treasury position paper *Corporate tax and the digital economy* (November 2017).[4]

Additionally, I have been invited on multiple occasions to present my comments during OECD consultations concerning transfer pricing, intangibles transactions, R&D cost contribution arrangements, and related issues of relevance to this paper. I have listed relevant publications and comments I have submitted to the OECD, as well as my presentations at OECD consultations, among other publications and events, on my firm website.[5]

Comments on Section 1.1

The author finds the Australia-specific experience and statistics a helpful alternative lens through which to understand the global nature of the digitalised economy and its evolution—extending views of the experiences of other countries engaged in this global discussion.

The paper's summary of the OECD focus on three factors common to highly digitalised business models ("the three factors") is also well-balanced by noting that these factors "are not unique to" highly digitalised business models. While this point is sometimes made (including by this author), it is rarely taken as fully into account in many proposals and papers on digital taxation—some of which risk imposing discriminatory treatment against certain businesses and business models.

The remaining comments will focus on Discussion Question 1.

---

[3] Ibid, *see also,* for example, P. Breslin response to, "BEPS Action 1—Request For Input On Work Regarding The Tax Challenges of the Digitalised Economy (22 September – 1 November 2017)," available at: http://breslinconsulting.com/assets/P._Breslin_Response_to_Request_for_Input_-_Tax_Challenges_of_the_Digital_Economy_10.13.2017_final.pdf , as well as, "Comments on OECD BEPS Action 1: Address the Tax Challenges of the Digital Economy," Breslin comments submitted to the OECD Committee on Fiscal Affairs (April 2014), available at: http://breslinconsulting.com/assets/P._Breslin_April_2014_comments-action-1-tax-challenges-digital-economy.pdf

[4] *See* http://breslinconsulting.com/assets/P._Breslin_Response_to_UK_HM_Treasury_request_Digital_Economy_Jan_2018.pdf.

[5] *See,* for example, a list of publications at: http://breslinconsulting.com/publications.html , and OECD presentations and other events listed at: http://breslinconsulting.com/events html

Discussion Question:

1. Is user participation appropriately recognised by the current international corporate tax system? If not, how should value created by users be quantified and how should it be taxed?

In the author's view, the short answer to the first question is 'yes.' To state it more completely, user participation is recognised in the third-party transactions between such unrelated party users and a given corporation—in an arm's length exchange of value.

It is important to recognise the natural divide between value created internally by the multinational firm and value it receives from external, third party customers. This dividing line is the end of the corporate value chain. In principle, corporate income tax seeks to align profits with value created *within* the firm. (See BEPS Action items 8-10.)

In this respect, the value consideration provided by a user is factored into the arm's length price it pays to the firm. This non-price value does not necessarily increase corporate revenue or profits in any direct or easily discernible way. Further, it does not seem inherently attributable to any one or other value-creating affiliate, activity or operation within the firm. User-created value—as perceived—may best be seen as among terms and conditions of the arm's length selling arrangement, at least in most cases.

Just like the firm itself, customers (or users) often provide consideration other than standard payment terms. It is easy to overlook such in-kind consideration, but it is frequently present.

For example, assume a consumer can buy an identical product at a price of 10 either in a store or through a catalogue. If she goes to the store and pays in cash, the seller receives 10 for the product and, in effect, an in-kind "free" delivery is provided by the buyer, for the buyer. While this spares the retailer some effort and costs—it also bears others in operating the store. The arm's length product sales revenue is 10.

Thus, the buyer's consideration is a payment of 10 plus time and cost to go to the store—lest this sale would not have taken place. But would one suggest attributing a tax to the retailer for this consumer value contribution? Even if one were to, how then to differentiate taxing rights between businesses with different types of consumers making different in-kind value contributions?

If instead a consumer buys the product by catalogue, the retailer makes a sale worth 10 and includes a shipping charge of 2. Here, the retailer makes the same product revenue and arranges a delivery service either at cost or for a small profit—perhaps outsourcing delivery and passing it through to the customer with no effect on the firm's profit.

How should we differentiate the profit attribution *within the firm* under these two scenarios (*i.e.* driving to store *vs.* catalogue delivery)? Does our assessment change if the consumer offers personal information to the catalogue department, including his garment size, measurements and all the necessary payment, address and delivery information?

Under each scenario, for profit attribution we should look at the value contributions and corresponding function, asset and risk allocations within the firm. User value creation appears fully considered in the arm's length value exchange between the firm and external parties.

Alternatively, consider a volume discount scenario. At regular sticker prices, ten units of the same item are sold at a price of 2 a piece for a total of 20. If a consumer purchases in bulk he can buy 25 units for a total of 40, or at 1.6 apiece.

Why is the seller willing to cut price at higher volumes? The seller considers, in effect, an in-kind benefit of not needing to stock and store these bulk units. Doesn't the buyer contribute to this benefit—taking product off the seller's hands? Is this consumer-created value?

Perhaps, but its effect is baked into the arm's length exchange of value considered by each of the parties. In all of these scenarios, the seller is contributing value and resources (*e.g.* leasing property to operate a store), and the consumer contributes value in the exchange, in terms of payment and other transaction costs, time and effort.

In any commercial transaction, the parties each exchange value—from one to the other—either in the form of cash (or another form of payment), in kind (*e.g.* a product, service or other consideration), and often in combinations of both thereof.

Thus, each party realises costs and benefits in any transaction; *and* to each the benefits must outweigh the costs or the transaction would likely not occur (or not occur again in the future).

Comments on Section 4.2, *Should taxing rights change to reflect user-created value?*

User-created value is an overstated premise in much of the digital tax discourse, in the author's view. It is relevant and worthy of discussion, but there are some misconceptions in need of review and rebalancing. For example, Section 4.2 notes:

> Highly digitalised businesses may benefit from user-created value in several ways:
>
> • **User data**: data collected from consumers allows advertising to be targeted specifically to consumers that are likely to be interested in the advertised goods or services, thereby increasing the value of these advertising services to businesses;
>
> • **User-generated content**: users contribute to digital economy businesses in a variety of ways, including, for example, providing reviews, ratings, photographs or live biographical updates. This content adds credibility and trust, and attracts additional users; and
>
> • **Network effects**: as more users participate in a particular online platform, it becomes more attractive to businesses to participate (and vice versa), which can in turn see the platform attract more users or businesses.

The first phrase quoted above is also true of less digitalised businesses, as discussed above. One might go as far as to say, "*all* businesses may benefit from user created value." In the author's view, it is not clear that this longstanding fact of commercial activity justifies proposed changes in taxing rights.

Indeed, "users" here are not unlike traditional "customers" or "shoppers" in many important ways. When consumers purchase from "physical" retailers—in stores, through catalogues or by telephone order, for example—they have always shared their "user data" in most cases.

For example, all delivery orders—from the milkman to the clothing catalogue—have required customers (users) to provide, at least, their name, address, and telephone numbers. For credit purchases, additional personal and financial "user data" was necessary—and these requirements expanded to enable "charge cards" and later credit cards.

These once new, now decades-old, forms of payment (accepted almost everywhere) also entailed providing yet more "user data" in any transaction—perhaps to another third party, *i.e.* the credit card issuer. Most of the same user data was required to shop in the physical store retail context as well, with the potential exception of cash transactions which have seen steep declines.

Retailers—ranging from small shops to large catalogues and stores—also have always benefited from customer-provided information. They retain and use information about customers, and their past experiences with them, to promote and advertise (or simply recommend) new products and services.

This information would often affect advertising on both an aggregate and granular level—from newspaper and television advertising targeted at localities and age groups, to one on one salesmanship and customer service experiences.

No doubt, targeted advertising is an attractive concept to sellers, and one that is enhanced by digitalised methods. But it is not exclusive to them. Thus, it can be argued, bullet 1 above is not strongly suggestive of a need for changing taxing rights. Bullet 2 appears to be a stronger case, but insufficient in the author's view. Bullet 3, "Network Effects" is another subject often used to justify taxing rights in the market jurisdiction without sufficient support or explanation—though it too will remain beyond the scope of the current comments.

The main point we attempt to make here is not that there are not significant and important changes related to digitalisation and commerce. The main point is that user data and aspects of customer- or user-created value have always been part and parcel to value exchange—between both buyer and seller—for fairly basic yet compelling reasons.

Indeed, customer-provided information often is—and largely has been—*necessary* simply in order to effectuate a transaction. This was true in a wide variety of commercial contexts well before digitalisation. How else would a seller deliver the product to a buyer? Or accept a consumer's request for credit, or use of a credit card? User information was exchanged to enable transactions.

Sincerely,

Pat Breslin
Washington, DC
November 30, 2018

(*delivered via email*)