**TAX EXECUTIVES INSTITUTE**

1200 G Street, N.W., Suite 300
Washington, D.C. 20005-3814
202.638.5601
tei.org

**2018–2019 OFFICERS**

JAMES P. SILVESTRI
*President*
PCS Wireless
Florham Park, NJ

KATRINA H. WELCH
*Sr. Vice President*
Texas Instruments Incorporated
Dallas, TX

JAMES A. KENNEDY
*Secretary*
OppenheimerFunds, Inc.
Denver, CO

MITCHELL S. TRAGER
*Treasurer*
Georgia-Pacific LLC
Atlanta, GA

BRIAN MUSTARD
*Vice President, Region I*
BCE, Inc.
Montreal, QC

KIMBERLY M. PEPE
*Vice President, Region II*
Lighthouse Management Services, LLC
New York, NY

GREGORY STAY
*Vice President, Region III*
Ahold USA, Inc.
Quincy, MA

EVAN G. ERNEST
*Vice President, Region IV*
Toll Brothers, Inc.
Horsham, PA

CRAIG SCHMIDTGESLING
*Vice President, Region V*
Givaudan Flavors Corporation
Cincinnati, OH

JOHN A. MANN
*Vice President, Region VI*
Abbott Laboratories
Abbott Park, IL

KRISTINE M. ROGERS
*Vice President, Region VII*
Love's Travel Stops & Country Stores, Inc.
Oklahoma City, OK

DINA ARMSTRONG
*Vice President, Region VIII*
Swedish Match North America Inc.
Richmond, VA

JENNIFER K. BOWERS
*Vice President, Region IX*
Fortive Corporation
Everett, WA

LINDA S. KIM
*Vice President, Region X*
The Wonderful Company
Los Angeles, CA

ANNA THEEUWES
*Vice President, Region XI*
Shell International B.V.
Netherlands

ELI J. DICKER
*Executive Director*

W. PATRICK EVANS
*Chief Tax Counsel*

29 November 2018

Principal Adviser
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

**Via email:** corporatetax@treasury.gov.au

**RE: Discussion Paper on the Digital Economy and Australia's Corporate Tax System**

Dear Sir or Madam:

On 2 October 2018, the Corporate and International Tax Division of The Treasury's Revenue Group published a discussion paper entitled "The digital economy and Australia's corporate tax system" (the Discussion Paper). The Discussion Paper explores options to address the perceived challenges to tax systems arising from digitalisation and the digitalised economy. The Treasury has requested stakeholder input on the options and specific questions set forth in the Discussion Paper. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to The Treasury's request for input.

**TEI Background**

TEI was founded in 1944 to serve the needs of in-house tax professionals. Today, the organisation spans the globe with 57 chapters, including membership in Australia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting fair tax policy at all levels of government. Our nearly 7,000 members represent 2,800 of the largest companies in Asia, Europe, and North America and South America. TEI's members work for companies operating across all industries and thus we believe our perspective brings a balanced view of how the options

set forth in the Discussion Paper may impact companies operating both inside and outside the "digital economy."

**TEI Comments**

TEI commends The Treasury for the analysis set forth in the Discussion Paper regarding the various challenges digitalisation presents to corporate taxation and the options presented to address such challenges. Achieving consensus in this area of international taxation is difficult and a real risk of double arises from uncoordinated, unilateral actions by individual countries; thus, we appreciate The Treasury's invitation for stakeholder input. In particular, the opportunity for interested parties to provide comment on the design of any interim tax measures aimed at digitalisation should help ensure that any such measures are appropriate. In TEI's view, the Discussion Paper provides a well-structured overview of the proposed updates to the international tax rules that may apply to the digitalised economy. Set forth below are a few general comments on the Discussion Paper, followed by our answers to the specific questions posed.

General Comments

The Discussion Paper poses thirteen specific questions for stakeholder input regarding the possible introduction of an interim tax on digital services in Australia. In TEI's view, however, Question 10 is the most important and influences the answers to all the other questions.

Question 10 queries, "Should Australia pursue interim options ahead of an OECD-led, consensus-based solution to address the impacts of the digitalisation of the economy on the international tax system?"

While we understand the political pressure to take unilateral action, TEI strongly recommends Australia fully participate in the OECD Task Force on the Digital Economy (TFDE) and act based on the consensus that the TFDE hopes to achieve by 2020. Unilateral actions inevitably lead to double taxation, additional administrative difficulty, uncertainty for multinational enterprises (MNEs), and may result in detrimental effects on foreign direct investment and international trade.

Answers to specific questions

*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?*

The corporate income tax is a tax on the corporate enterprise's profits, which includes many different inputs, costs, revenue streams, and expenses. In TEI's view, an attempt to separate any individual activity that may contribute to an enterprise's profit is inconsistent with the current international tax consensus, OECD guidance, and bilateral income tax treaties. Thus, attributing a "value created" to user participation is a difficult exercise. Unless there is

international consensus on how "user participation" is defined and valued, unilateral actions will only add to uncertainty and double taxation.

More broadly, "user participation" is a recently developed concept advanced by a few countries and is a departure from the traditional source vs. residence taxing jurisdiction framework. Value creation in the digital economy is a complex subject involving intellectual property, significant people functions, and the significant risk of producing and launching products (as evident from the high failure rate of start-ups). As such, we believe that a holistic approach to assessing value creation based on an objective assessment of functions, assets, and risks is more balanced than focusing on "user participation."

Further, focusing on user participation will likely result in double taxation as it will not reflect a MNE's contribution of costs to create intellectual property. In TEI's view, the traditional arm's length economic analysis of functions performed, assets deployed, and risks undertaken is a better approach to determining the relative income among related parties for purposes of determining the amount of income of an MNE in a particular country. Without this determination, implementation of a digital tax based on the jurisdiction of consumption will likely result in double taxation.

*Double Taxation Agreements*

More broadly, it is important to maintain the integrity of the international tax system, including the difference between the income tax where taxing rights are governed by Double Taxation Agreements (DTAs), and indirect taxes. In the business profit article of the typical DTA, if a local resident carries on business in a jurisdiction with which the local country has a DTA, the profits derived from the business will not be subject to tax unless the business is carried on through a permanent establishment in that jurisdiction.

Changing taxing rights to reflect user-created value along a quasi-indirect tax approach or gross revenue basis will affect taxing rights reflected in a DTA. User-created value reflects the source of the income and does not consider the functions, assets, and risks of the resident company. As noted above, this will result in double taxation and ignores the costs, risks, and functions associated with the company's intellectual property.

In short, any perceived shortcomings in the corporate income tax or DTAs should be resolved within that framework, rather than resorting to indirect taxes as an alternative.

*Adverse Impact to Economy*

We also note that The Treasury should consider the impact of any targeted interim digital measure on the economy. Smaller companies and start-ups tend to incur losses in their early years as they penetrate the market. Assuming a user created value and applying it as a base for imposing tax will tend to keep such companies from selling into the market. In the long run, this

may harm the Australian economy and affect innovation as it is not commercially viable for a business to sell into a market that imposes a tax on gross revenue without regard to whether the business makes a profit.

*Question 2. Is the value of intangible assets including 'marketing intangibles' appropriately recognised by the current international corporate tax system? If not, how should value associated with intangibles be quantified and how should it be taxed?*

The OECD Transfer Pricing Guidelines (the Guidelines) have evolved over many years, with active participation of OECD Member States. The Guidelines form the basis of the United Nations and other internationally agreed conventions with respect to the allocation of profits to related parties in international transactions. The Guidelines, as updated following the OECD's Base Erosion and Profit Shifting project (the BEPS project), provide detailed information on the identification and valuation of tangible and intangible assets. As the recent update to the Guidelines is the result of an international consensus, in TEI's view there is no reason for a further revision to the Guidelines as the question suggests.

That said, if another class of intangibles is identified, any valuation should be based on international consensus through the OECD's Inclusive Framework, which includes more than 120 countries. If transient intangibles, such as marketing intangibles, are included, the costs of creation of those intangibles should be amortisable and value reductions or extinguishment should be deductible.

*Question 3. Are the current profit attribution rules 'fit for purpose'? If not, how should profits be attributed?*

With respect to profit attribution, again, the OECD has just recently issued updated guidance.[1] Thus, in TEI's view any change should be agreed to multilaterally through the OECD's Inclusive Framework and not be the subject of unliteral action.

*Question 4. What are your views on allocating taxing rights over residual profits associated with: (i) user contribution to 'user' countries, or (ii) 'marketing intangibles' to market countries?*

In TEI's view, unilateral assertion of taxing rights creates a risk of double taxation and potentially harms international trade and investment. Breaking international consensus in this area, as suggested by the question, creates very real incentives for other jurisdictions to take similar unilateral actions, leading to the breakdown of the international consensus that forms the basis of bilateral double taxation agreements.

---

[1] *See* OECD Report on *Additional Guidance on the Attribution of Profits to Permanent Establishments* available at http://www.oecd.org/tax/transfer-pricing/additional-guidance-attribution-of-profits-to-permanent-establishments-BEPS-action-7.pdf.

Thus, allocation of taxing rights should be discussed in the context of Australia's existing tax treaty network and the broader international tax treaty framework, with regard to source and residence state issues without undue focus on any particular sector or industry.

In TEI's view, allocating taxing rights over residual profits associated with user contributions or marketing intangibles does not reflect the nexus rules or arm's length principle of transfer pricing. Thus, to allocate taxing rights based on user contribution and marketing intangibles to countries will only cause confusion and result in double taxation.

Instead, taxing rights over residual profits should remain in the jurisdiction where intellectual property owner is located and is tax resident. The tax resident should be able to demonstrate substance in creating intellectual property value, to receive the bulk of the residual profit, based on the concept of development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE) as addressed in BEPS Actions 8-10.

*Question 5. Should existing nexus rules for determining which countries have the right to tax foreign resident companies be changed? If so, how?*

The Discussion Paper does not specify the basis for any change to the nexus rules, but the implication or expectation appears to be that nexus should be based on a digital rather than physical presence. Any change in nexus is closely linked to international double taxation agreements and should therefore only be changed when there is international agreement on the basis for the change. In TEI's view, Australia should wait for the OECD's TFDE report expected in 2020 before making any decision or taking further action on nexus and should encourage other members of the OECD's Inclusive Framework to do the same.

*Question 6. From a tax perspective, do you consider that the digitalised economy is distinguishable from traditional economy? If yes, are there economic features of the digitalised economy that present special challenges in the context of taxation? How are these features relevant for assessing the costs and benefits of various models of taxation?*

The OECD's TFDE concluded in 2015 that the digitalised economy could not be ring fenced from the rest of the economy, and the subsequent work of the TFDE does not appear to have changed that view. All firms are increasingly using digitalised processes, as are tax administrations, but this does not change the fundamental economic activity that the vast majority participate in and which creates their taxable profits. Unless the TFDE reaches a different consensus, international taxation should not be changed to reflect a different view that is not shared by major economies. Separate treatment and different taxation for a few enterprises creates a risk of international trade conflict as well as double taxation

*Question 7. Can and should any changes to the international nexus and profit attribution rules be ring-fenced to apply only to highly digitalised businesses? If so, how?*

It is difficult to see how a ring-fencing policy could apply and how it could be drafted to target both current perceived inequalities as well as future changes. With the rapid changes in technology, there seems to be a risk that any attempt to ring-fence based on an understanding of current technologies and commercial activities would be soon overtaken by technological change leading to unintended consequences.

The ongoing problems within the EU member states on the targeting of activities or processes for the proposed Digital Services Tax or Significant Digital Presence demonstrates that a definition of targeted economic activity and service providers is very difficult to agree upon. Again, it would be better to wait for any international consensus or common definitions that may come out of the OECD's TFDE work.

*Question 8. Are there changes other than to nexus and profit attribution rules that should be made to the existing international corporate tax framework and/or Australia's tax mix to address the challenges presented by globalisation and digitalisation?*

There should be no change and no "other change" until the BEPS Project recommendations have been fully implemented and been given time to work by the OECD's Inclusive Framework members. Making additional modifications while the BEPS changes have not been fully implemented, on the basis that "BEPS has not worked," makes little sense and creates additional costs and uncertainties for MNEs and tax administrations.

*Question 9. What does the experience of other countries that have introduced interim measures or that are contemplating them mean for Australia?*

While interim measures may be politically attractive, governments, including Australia, should wait for the outcome of the OECD TFDE's work. A few countries have implemented interim measures, but there is very little evidence of what works and what does not, or how to design and implement effective digital measures. The experience of the EU in the detailed design of a Digital Services Tax shows how difficult it is to identify what activities should be included and how a tax should be administered. There is also no agreement within the EU about whether an interim solution is justified at all, or whether attention should be directed at developing a longer term, internationally agreed approach to the issue.

*Question 10. Should Australia pursue interim options ahead of an OECD-led, consensus-based solution to address the impacts of the digitalisation of the economy on the international tax system?*

As noted above, in TEI's view Australia should not take unilateral action, but should work with other countries to identify the relevant tax issues, and how they can be addressed through

a consensus-based international approach. As more countries explore unilateral actions, there is a greater likelihood of the breakdown of the internationally agreed basis for taxation of MNEs.

*Question 11. What indicators could be used to identify businesses that benefit most from user-created value? Would an interim measure applied to digital advertising and/or intermediation services accurately target that value? How broadly or narrowly should 'digital advertising' and 'intermediation services' be defined?*

The experience of the EU member states and the European Commission in trying to identify user-created value should be recognised here. Identifying businesses that benefit most from user-created value is a difficult economic analysis and requires international consensus to avoid double taxation. The TFDE and the OECD's Inclusive Framework should be the forum for exploring this question and any future action should be based on internationally agreed and measurable criteria supported by robust economic analysis, and careful assessment of the long- and short-term effects of creating a taxable value that exists outside of current commercial transactions.

That said, one indicator might be internet traffic with respect to a particular business. However, the data created by users is not necessarily valuable on its own. It is what the platform does with the data that adds value (if any).

*Question 12. The choice of 'nexus' for an interim measure (or a longer-term 'virtual' PE proposal) involves significant trade-offs between ease of administration and the risk of avoidance. Which nexus option strikes the best balance between these considerations?*

Administrative ease includes comity with the current international tax framework to avoid the complications of double taxation. As such, TEI is of the view that a broader, consensus-based consideration to any modification of the PE principles would better accord with the OECD TFDE's report due in 2020, and as noted above recommends The Treasury follow that approach.

*Question 13. What are your views on thresholds for an interim measure, taking into account the need to meet Australia's international trade obligations?*

In TEI's view, thresholds are useful to avoid imposing unreasonable compliance burdens on small and medium sized enterprises, although we do not believe interim measures are warranted in the absence of an international consensus for action on the "digital economy," for the reasons set forth above.

**Conclusion**

TEI appreciates the opportunity to provide input on the Discussion Paper. TEI's comments were prepared under the aegis of TEI's Asia and European Direct Tax Committees. If

you have any questions about the Institute's comments, please contact Benjamin R. Shreck of the Institute's legal staff, at +1 202.464.8353, or bshreck@tei.org.

Respectfully submitted,
Tax Executives Institute

James P. Silvestri
International President