Association of International Certified Professional Accountants®

October 4, 2019

Tax Policy and Statistics Division
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development

Re: ***Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*** **– Comments on Income Allocation between Jurisdictions (Pillar One)**

Dear Sir or Madam:

The Association of International Certified Professional Accountants ("Association") appreciates the opportunity to provide additional and more detailed comments on your *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* ("Programme").

As described in your Programme, the proposals contained in the public consultation are grouped into two pillars which could form the basis for consensus:

- **Pillar One** – allocation of taxing rights and profit allocation and nexus rules; and
- **Pillar Two** – the remaining base erosion and profit shifting ("BEPS") issues centering on the development of a global minimum tax or "Globe."

In our previous submission, the Association outlined the key elements for a consensus-based, equitable, and successfully durable rebalancing of multi-jurisdictional taxing rights. In this letter, our comments focus on Pillar One and the income allocation between jurisdictions. The Association intends to submit additional comments related to Pillar One and Pillar Two.

EXECUTIVE SUMMARY

Income allocation to markets where value is generated ("economic nexus") is the underpinning of the OECD project regarding taxation of the digital economy.

The Association believes that economic nexus issues raised and litigated in the U.S. are useful in illustrating issues regarding the reallocation of taxing rights between jurisdictions. In particular, the experiences with (1) the U.S. Supreme Court in *South Dakota v. Wayfair*, and (2) a U.S. suit against a Brazilian individual ("Castroneves"), provide relevant contextual information in considering new profit allocation rules.

As outlined in our framework, defining parameters for allocating and apportioning income based on the advent of the digital economy is a multi-jurisdictional exercise in cooperation and enforcement. As the OECD works through the challenges of modernizing these rules, we offer the following points for consideration:

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- Income allocated should include a routine return to jurisdictions where valuable functions and activities occur, as this treatment provides jurisdictions the right to tax the output of activities that generate value within their borders;
- Minimum threshold exceptions to economic nexus are necessary to protect businesses, and such minimum thresholds should be agreed to globally;
- Developing and obtaining a consensus on workable and practical enforcement mechanisms is a priority;
- New rules to tax value should utilize aspects of existing tax law and consider the impact on individuals operating cross-border; and
- Before considering a fractional apportionment approach, OECD should take steps to recognize the importance of intangible assets.

ASSOCIATION'S FRAMEWORK

The Association submitted initial comments in May on your public consultation document on *Addressing the Tax Challenges of the Digitalisation of the Economy* noting that, in our view, a consensus-based, equitable, and successfully durable rebalancing of multijurisdictional taxing rights must have four elements:

(1) Any rules extending taxation nexus to businesses that lack a physical presence in a jurisdiction should be clear, measurable, predictable, and applied consistently and neutrally across all industries and business models, and across all jurisdictions;

(2) The arm's-length standard, which is based on economic reality, is flexible enough to accommodate many of the concerns raised and provides a basis for addressing these concerns. Exceptions to the arm's-length standard should consist solely of rules that are specific and limited in scope for attributing profits and losses to a jurisdiction. It is vital that any such rules are clear and administrable in its application and gives proper regard to all value creating activities and business investment that takes place in other jurisdictions;

(3) All participant Inclusive Framework jurisdictions must agree:
   (i) to adopt and fully implement the new consensus to ensure that all income is properly taxed only once across all applicable jurisdictions, and
   (ii) to immediately repeal any previous unilateral actions, including temporarily enacted provisions related to digital services (whether currently in effect or pending); and

(4) To resolve any controversy over taxing rights, and ensure prompt resolution of any situations potentially resulting in double taxation, all participant Inclusive Framework jurisdictions must include compulsory effective and practical mechanisms in their treaties and other bilateral agreements (such as, mandatory binding arbitration as a minimum standard subject to peer review).

SOUTH DAKOTA v. WAYFAIR

In the U.S., the issue of economic nexus at the state level was recently addressed by the U.S. Supreme Court in *South Dakota v. Wayfair*.[1] In this case, the Court held that economic nexus for internet retailers is established within a state jurisdiction solely by exceeding a minimum sales threshold. Once economic nexus is established, retailers are liable for the collection and remission of sales tax even though the retailer has no physical presence in the jurisdiction. The state sales tax is a gross receipts-type transaction tax analogous to a value-added tax ("VAT") as opposed to an income tax. Nevertheless, the economic issues raised are relevant to the OECD Pillar One discussion.

In reaching its decision, the Court determined there were at least two competing interests: (1) funding for state and local jurisdictional governments, and (2) smaller businesses' lack of capability to comply with state tax laws.

Funding for State and Local Jurisdictional Governments

The state sales tax laws were effectively unenforceable. For example, assume a consumer in one state jurisdiction (the "market jurisdiction") completed a purchase via the internet from a retailer located in another state jurisdiction (the "retailer jurisdiction"). If the retailer did not have a physical presence in the market jurisdiction, the vendor was not required to collect sales tax on the transaction from the consumer. As a result, generally, no sales tax was paid on that purchase – either to the market jurisdiction (the consumer's jurisdiction) or the retailer's jurisdiction.

Although consumers were legally obligated to pay sales tax directly to their home (market) jurisdiction if sales tax was not paid at the time of the transaction, there was no effective mechanism to enforce collection of the tax. Consumers rarely paid the tax to their home jurisdiction if the sale occurred across interstate borders. Thus, the consumer could avoid paying sales tax on the transaction in both the market jurisdiction and the retailer jurisdiction.

The Court noted that if consumers did not pay sales tax on the transaction to the market jurisdiction, the market jurisdiction's government was harmed financially. Therefore, the Court held that the state where the consumer is a resident (the market jurisdiction) has a right to collect sales tax from any online transaction. Retailers had to begin collecting sales taxes on online transactions.

It is important to note, however, the government of the retailer's jurisdiction was generally not affected. The Court's decision *did not shift a right to tax from one jurisdiction to another*. It merely provided a mechanism to collect sales tax already due – but effectively uncollected – in the market jurisdiction. Since there was no tax owed to the retailer jurisdiction, either prior to or after the case, the retailer's jurisdiction did not lose (or gain) any tax dollars.

[1] 585 U.S. ___, 138 S. Ct. 2080 (2018).

Smaller Businesses' Lack of Capability to Comply with State Tax Laws

Another key issue from the U.S. Supreme Court's holding in *South Dakota v. Wayfair* was a concern about the complexity inherent in economic nexus, and specifically the effect of such complexity on smaller businesses which might not have the economic or other resources necessary to fully comply with the tax laws of jurisdictions outside of their own.

A crucial point of the Court's decision was that a minimum amount of revenue from a jurisdiction, i.e., sales into a jurisdiction, was required before an enterprise became subject to tax in that jurisdiction.

REWARD JURISDICTIONS WHERE FUNCTIONS AND ACTIVITIES OCCUR

In contrast to *South Dakota v. Wayfair*, under Pillar One of the OECD proposals, business profit and the income tax attributable to that business profit, are shifted between jurisdictions. The retailer jurisdictions are harmed while the market jurisdictions benefit. In other words, the Pillar One proposals provide more tax dollars for consuming countries and fewer tax dollars for exporting countries, shifting the right to tax and the receipt of tax between countries.

Two of the options under Pillar One, (1) the modified residual profit split method using the routine / non-routine approach, and (2) distribution-based approaches, ensure a minimal amount of taxable profit in the retailer jurisdiction to reward that jurisdiction for the functions and activities performed within that country. These types of approaches provide some level of economic balance between (i) taxing value as it is generated pre-sale (e.g., during product procurement, development, manufacturing, and delivery), and (ii) taxing value realized upon sale (e.g., exploitation of the marketing intangible). These types of approaches appear reasonable, as each jurisdiction is (i) rewarded for the activities and functions that occur within its borders, and (ii) compensated for the government-provided infrastructure and services utilized in the production or delivery of product and services within its borders.

Pillar One also contains proposals that do not reward a jurisdiction for activities or functions that occur within its borders pre-sale. Those proposals shift all rights to tax profits (e.g., the draft G-20 approach and the modified residual profit split method that does not provide for a routine return) to countries that performed no activities other than generating revenue, whether by simply placing an online sale (in the form of a digital transaction) or through some other forms of cross-border revenue. Profits generated by significant people functions – the development of high-value research and development ("R&D"), procurement, manufacturing activities and process intellectual property ("IP"), marketing and administrative support functions, and other direct output and results of job creation and performance – would no longer be taxable in a jurisdiction unless the sale of product occurs within the same jurisdiction where the product is produced.

In other words, a manufacturing jurisdiction would lose the right to tax profits from the value generated within that jurisdiction by its citizens and residents, as all rights to tax would follow where the sale occurs – regardless of the length of or the value generated by the supply chain that made such sale possible. Governments in the producing countries would lose the rights to recover tax revenue necessary for the

maintenance of roads and other infrastructure necessary to support the development and production activities. Such approach does not appear to reflect an economic balance as it ascribes all taxable value to where a product is sold and fails to reward jurisdictions for the efforts within its borders to develop, manufacture, or manage products.

The Association believes a balanced approach that also provides a routine return to jurisdictions for the functions and activities that occur within their borders is most appropriate. Such approach would provide a stronger nexus between the commercial economics and the taxation of profits over an approach that does not provide for such routine return. The calculation of the routine return should not be complex and should not cause business enterprises to create overly burdensome processes (to capture the necessary information for the calculation).

MINIMUM THRESHOLD EXCEPTIONS

Minimum threshold exceptions to economic nexus are necessary to protect businesses. The approach in *South Dakota v. Wayfair* is both fair and practical. Small and medium sized companies generally do not have the resources to track or comply with the laws of a myriad of jurisdictions. Imposing taxation in a country only above a minimum threshold would not only reduce compliance burdens on small and medium sized taxpayers, but would also relieve governments from attempting to collect *de minimis* amounts of revenue from businesses where the cost of collection may exceed the amounts received in a cross-border context.

The Association encourages a global minimum threshold before economic nexus is imposed. Further, for simplicity and ease of administration, this minimum threshold should be globally agreed across all countries in the Inclusive Framework.

CASTRONEVES

In a 2008 case that deals directly with economic nexus and multinational income allocation, two-time Indianapolis 500 winner and "Dancing with the Stars" contestant Helio Castroneves was indicted on six counts of tax evasion for allegedly failing to report $5.5 million dollars of endorsement income to the U.S. Treasury by hiding money through offshore accounts.[2]

A key issue in the case was whether the U.S. had a right to tax not only income generated by foreign athletes from U.S. sited performances, but also intangible income directly related to such U.S. sited performances that was generated and paid outside of the U.S. Mr. Castroneves was a tax resident of Brazil, and there is no tax treaty between the U.S. and Brazil.

In this case, the IRS publicly acknowledged it focused on taxing income of foreign athletes and entertainers whom it believed were not paying their fair share of U.S. taxes from activities performed inside its borders. The IRS did not focus on tournament earnings, as U.S. sited tournament earnings are

[2] *U.S. v Helio and Katucia Castroneves*, 1:08-20916CR.

easy to identify and tax under the U.S. tax regime. Rather, the IRS specifically focused on endorsement income generated from sources around the world directly related to and generated as a result of Mr. Castroneves, a foreign athlete, participating in U.S. sited tournaments.

In most foreign jurisdictions, endorsement income is generally considered a type of royalty income or income from an intangible asset. This income is generally taxable solely in the home country of the foreign athlete – in this case, Brazil. The U.S. argued, however, the endorsement income received from foreign sources that are directly related to an individual participating in U.S. sited tournaments should be, at least partially, taxable in the U.S. due to the value underlying the endorsement income generated within its borders.

The U.S. lost its case and the argument in *Castroneves* that non-resident jurisdictions have the right to tax worldwide income from value generated within their jurisdictional borders – a position similar to the Pillar One debate at the OECD. Nevertheless, the case highlights taxation issues not yet publicly addressed in the Pillar One discussion.

ENFORCEMENT MECHANISMS

The Association encourages the OECD to develop and obtain consensus on workable and practical enforcement mechanisms as a high priority.

In considering enforcement in an international sphere, the OECD consensus should encourage compliance in multiple jurisdictions. In a new taxation system where the physical presence standard is removed, seizing assets (subject to judgment) is not an option. Thus, mechanisms are essential to encourage a high degree of "self-compliance" by non-resident entities and individuals.

As discussed earlier, states in the U.S. did not have a mechanism to enforce collection and remittance of sales tax prior to *South Dakota v. Wayfair*. Under such an environment, taxpayers rarely paid the sales taxes owed to their home market jurisdictions – despite their legal obligation. Therefore, it is unlikely that taxpayers would voluntarily pay income tax to a foreign country jurisdiction without a tax collection mechanism. Withholding taxes may address some situations, but would not solve most cases.

For example, consider the U.S. case against Mr. Castroneves. The U.S. attempted to tax income earned outside the U.S. by a non-resident, but the U.S. did not have nexus over that income under the current international tax rules. Under the Pillar One proposals at the OECD, it appears that the U.S. would obtain economic nexus over the endorsement income earned by Mr. Castroneves, but the question remains as to how the U.S. would attach taxing rights to and collect tax on such income paid by foreign endorsees.

Enforcement is a challenging issue for the OECD to address. Specifically, in regards to Pillar One:

- Assuming a withholding tax mechanism was in place, how would foreign parties paying endorsement income ("foreign endorsees") know to withhold or pay tax to the U.S.?
- If they knew to withhold, how would the correct amount due be determined?

Under Pillar One, all proposals would require such income to be apportioned to various countries and, therefore, withholding should be withheld and remitted to various countries. In this case, remittance is not only due to the U.S. and Brazil, but any number of other countries where economic nexus would exist. However, the foreign endorsees would not and should not be required to calculate how much of Mr. Castroneves' income would be taxable.

Other than Mr. Castroneves requesting that certain amounts be withheld for specific jurisdictions, it is difficult for foreign endorsees to know how much to withhold. However, such approach places the taxpayer in a position to control whether or not a foreign government would learn of his income source, creating an opportunity for tax avoidance or tax evasion. The enforcement mechanism would break down. Therefore, a key design issue is determining how to identify and enforce withholding and payments to the various countries.

Additional complexity arises as, in this case, Mr. Castroneves was an individual who may face either worldwide or territoriality taxation. One example would be attempting to claim relief from double taxation. He was not a business with sophisticated accounting or tax departments. The OECD should address these types of real-world issues while working on Pillar One.

EFFECT ON INDIVIDUALS

Any new rules should also consider the effect on individuals, noting that countries generally tax individuals on one of two systems of taxation, worldwide or territorial basis, or on some variation thereof. The U.S. is one of a handful of countries that taxes its citizens upon their citizenship and their worldwide income, while most countries tax their citizens upon the basis of territoriality. The issues facing individuals can differ if they are taxed on a worldwide basis or a territoriality basis, including foreign tax credit concerns. As the OECD considers issues regarding the reallocation of taxing rights and the modification of the tax nexus rules, the effect on individuals under both types of taxation systems needs to be addressed.

RECOGNITION OF INTANGIBLE ASSETS

A third Pillar One alternative, fractional apportionment, attempts to reward a jurisdiction based on the pro-rata portion of revenue, property and equipment, and payroll indicia (head count or salary costs) located or generated within each jurisdiction. However, this approach does not consider the value of many businesses' most valuable assets – their intangible assets. Specifically, digital business – the taxing of which is the impetus behind the international efforts to modify how cross-border profits are taxed – generate most of their profits from intangible assets. If fractional apportionment does not take into account intangible assets, the formulary approach cannot properly apportion income.

In order to include intangible assets in a formulary approach, however, the OECD would need to address a couple of issues. First, the OECD must determine the general requirements or expectations surrounding the annual valuation of intangible assets (many of which are difficult to value). It is also important that

the valuation requirements are not burdensome, or only minimally burdensome, to businesses (from both a financial and administrative perspective).

In addition, the OECD would need to establish a fair and administrable method for sourcing intangible assets to specific countries. This process is necessary to determine the tax base of different jurisdictions. The OECD would likely allocate certain IP, such as know-how and process-based IP related to manufacturing, to the country where such activities occur. However, the OECD would need to determine how to address "marketing" intangibles (such as goodwill, customer lists, long-term contracts, marketing processes, etc.) which are more difficult to value or geographically assign. Other challenging intangible assets to address include trade secrets (e.g., the secret formula to make Coca-Cola), trademarks (e.g., IBM or BMW), copyrights (e.g., the value of Disney characters), and similar IP.

The OECD must address these issues before fractional apportionment could reflect a proper attribution of profits or value.

CONCLUSION

Defining parameters for allocating and apportioning income based on the advent of the digital economy is a multi-jurisdictional exercise in cooperation and enforcement. Income allocated to any jurisdiction should include a routine return to jurisdictions where valuable functions and activities occur, as this approach would provide jurisdictions the right to tax the output of activities that generate value within their borders. Minimum threshold exceptions to economic nexus are also necessary to protect economic enterprises, and such minimum thresholds should be agreed to globally.

Developing and obtaining international consensus on new rules to tax value may be based on many aspects of existing tax law, and the effect on individuals operating cross-border should be considered. The application of the parameters of the enforcement and capability of the tools utilized will be critical to ensure equitable and effective compliance in each jurisdiction.

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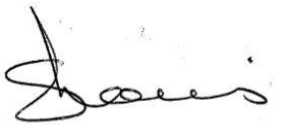
We appreciate your consideration of our thoughts and welcome the opportunity to discuss them further. Please feel free to contact Samantha Louis, Association Vice President – Global Advocacy at samantha.louis@aicpa-cima.com, or +44 (0) 203 814 2205; or Edward Karl, Association Vice President – Taxation at edward.karl@aicpa-cima.com, or +1 202 434 9228.



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