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Re: Input on the possible solutions to the tax challenges of digitalization

Mazars welcomes the opportunity to provide comments to the consultation document published by the OECD on 13 February 2019, on Addressing the Tax Challenges of the Digitalization of the Economy, undertaken as part of the OECD's Base Erosion & Profit Shifting Project pursuant to a mandate from the G20 Finance Ministers with the goal of preparing a final report in 2020 aimed at providing a consensus based long-term solution, which will include a solution dealing with the impact of digitalization on nexus and profit allocation rules. The views expressed in this response are provided by Mazars in its role as tax preparers and consultants for global businesses and not on behalf of, or in consultation with, any particular client.

About Mazars and our general perspective on the proposals

Mazars is an international, integrated and independent firm, specializing in audit, accountancy, advisory, tax and legal services. As of January 1, 2019, Mazars and its correspondents operate throughout 89 countries and territories. Mazars draws upon the expertise of 23,000 professionals and 1,040 partners, working in 310 offices worldwide to assist major international groups, small/medium enterprises (SMEs), private investors and public bodies at every stage of their development.

For our SME clients, imposing additional compliance burdens involving documentation of intercompany transactions over and beyond existing transfer pricing requirements would represent a significant additional cost that could result in resource constraints. We are submitting comments particularly to express the needs of these clients, which may not often be represented in the OECD consultation processes.

Mazars' global connections allow us to advise a large number of clients in the start-up phase of their operations. This includes many app developers, including small start-ups that generate sales and engage in transactions worldwide. The client's customer transactions, such as purchases of goods or services, are often consummated over an electronic platform. Some small businesses brought within scope of any new regime may not have the tracking systems that could readily identify where customers are located at any particular relevant time, or where customers are using the product being marketed. Acquiring and implementing such systems may present further burdens.

It is important for our clients growing and investing in developing countries that any changes to existing rules can be applied consistently and effectively by the tax authorities in such countries and that those countries are able to participate in all administrative aspects of the proposals (with specific reference for example to APA and dispute resolution programs).

Finally, our observation is that current rule-making processes are very often focused on large multinational companies' operations and tax planning-practices and are designed to address those items. All entities strive to operate within the spirit, as well as the terms, of current taxation rules and guidelines, but many entities are confronted by rules drafted with a very different taxpayer profile in mind. In this context, we would like to highlight that the various thresholds mentioned in the consultation document, while welcome in principle, do not constitute a sufficient safeguard for small business. Thresholds are susceptible to change as the rules are finalized and therefore, we consider it imperative to comment on the systemic nature of the proposed reforms.

Pillar One – Revised profit allocation and nexus Rules

The consultation document describes several different approaches for revisions to profit allocation and nexus rules, all of which have the same over-arching objective: to recognize, from different perspectives, value created by a business' activity or participation in user/market jurisdictions that is not recognized in the current framework for allocating profits. The OECD requests comments on a number of specific topics with respect to these proposals, as well as on the policy, technical and administrability issues raised by each.

We outline our responses to the general and specific questions posed in the consultation document, confining our comments primarily to the administrability of the different proposals raised.

<u>Administration</u>

We are concerned that any proposal that introduces additional complexity and compliance requirements into these guidelines – for example, by requiring a split of profits derived from marketing spending relative to profits derived from R&D spending – would only create additional challenges and complexities, without arriving at a better allocation of profits for different jurisdictions. We recommend that any proposals adopted either (1) contain a carve-out for small/mid-sized businesses, so that the cost of complying with transfer pricing rules is no greater than it is today (ideally, it would be made simpler), or (2) contain an option for taxpayers to comply via reliance on a simplified safe-harbor mechanism. In this regard, we note again that because many of our clients are privately held (often family-owned) businesses, they may not prepare consolidated financial statements at a global level. Thus, any new rules that would require an allocation of profits based on a global computation may require these businesses to prepare additional financial calculations beyond what they are currently undertaking.

We further wish to highlight that taxpayers are still in the process of implementing the BEPS reforms (e.g., adjusting their transfer pricing systems to the DEMPE concept, etc.). Especially if intangibles are involved in cross border transactions this implementation caused a substantial compliance burden where the net difference in outcomes was not always apparent. In many cases, we believe that a sustainable approach to intangible analysis has already been found in the form of the DEMPE approach (to which we will make further reference below). In our view, the impact of this requires a fair chance in operational implementation before reaching for further reform.

However, the justification for the reforms contained in the consultation paper is less convincing in many cases and the additional burden of compliance could be disproportionate to the challenges. We would therefore like to encourage the OECD to continue to advocate the implementation of all existing reforms with the aim of not adding further compliance burdens to the BEPS package.

Economic and Behavioral Implications

The costs of tax and accounting compliance may negatively impact the ability of small and mid-sized businesses to grow and expand their operations. Amounts spent on tax compliance (and on preparation of additional financial accounts, if needed) could mean, for example, that an additional machine is not purchased, or another employee not hired.

We fully understand the need to assess and discuss the revision of profit allocation and nexus rules to accommodate changing business practices involving digitalization and remote selling. However, considering the OECD's historical purpose of encouraging economic development and growth, we strongly believe that revisions to tax rules should not come at the expense of impeding the growth of the small and mid-sized businesses that serve as engines of economic growth and job creation in many jurisdictions. In other words, the introduction of additional rules must be justified by a thorough analysis of the economic impact. In the present case, this includes identification of the specific tax gap that justifies the introduction of taxation or the reallocation of taxation related to targeted digital activities. We consider this further below in the context of nexus and residual profit allocations.

A phased in approach – one in which the rules apply initially to larger companies – could provide some time for refinement before developing companies need to comply (if such compliance is justified with reference to the economic impact). We also hope that the OECD will similarly take into consideration how rules could apply to smaller countries, without the larger resources available to administer changes, as compared to other tax administrations.

The proposals, in whatever their final forms will be, will almost certainly result in significant additional compliance costs both in terms of time and expense for large and listed taxpayers in particular (assuming exemptions can be applied to small and mid-sized enterprises) and greatly increase the chance of double taxation. As the consultation acknowledges, the final proposals need to incorporate strong dispute prevention and resolution components. In this respect, we would welcome multilateral advance pricing agreement programs along with the other administrative measures suggested at paragraphs 84-86 of the consultation document. In our view the substantive changes in the international tax framework being proposed would be inequitable without such administrative measures to support both businesses and fiscal authorities.

Nexus

You have requested comments on the extent to which digitalization of the economy has allowed businesses to have an active presence in a jurisdiction not recognized by current profit allocation and nexus rules. In our experience, an online presence allows small and mid-sized businesses to make sales into, and thus generate profits from, jurisdictions where they could not have been able to develop an active physical presence – this result is often not a derivative of tax planning, but the realities of small business sales and marketing – most small and mid-sized businesses are simply not profitable enough to develop the infrastructure in multiple jurisdictions to support a physical presence.

We recognize that as an inadvertent consequence of the development of digitalized business models, the current profit allocation and nexus rules do not operate to subject these profits to an income tax in the country of sales. We believe however that VAT operates efficiently to impose a tax on those revenues in the jurisdiction where the sale takes place, in a manner that does not impose additional compliance and documentation requirements on small companies.

If a change to address nexus is politically unavoidable, any proposal which limits the application of new provisions in this respect would be welcome. In this respect, the approach suggested in relation to “user participation” is more targeted than the approach suggested for marketing intangibles. Whilst we understand the concerns raised by some countries over the impact of remote access to markets, the marketing intangibles approach appears to be a more significant departure from residence based taxation (and the arm’s length principle) and could perhaps be considered sourced based taxation, since this method has no regard to actual function, assets or risks and appears to allocate profit to a country simply because a foreign entity is trading with an enterprise located there. There is no distinction therefore, between “highly digitalized businesses” (which may be highly dependent on specific local market factors such as user contributions and data utilization) and “traditional businesses” that simply have significant remote trade with a jurisdiction. This would likely become distortive and inequitable (which reference to the place where functions are performed, assets utilized and market jurisdiction risks actually managed), have a greater impact on the compliance burdens of businesses and have potential for double taxation if not consistently applied.

Residual Profit Split and/or Fractional Apportionment for Digital Sales

In general, we do not support formula allocation methods as we consider these typically to be arbitrary and conceptually inconsistent with the arm's length principle. In our view, the introduction of such heterogeneous concepts would further increase complexity, inequity in taxation and uncertainty (especially if tax authorities were to begin to take the opportunity to extend the scope of the formal allocation to other categories of intangible assets). It is also not clear exactly how this proposal would be limited in the long run to the marketing of intangible assets.

With respect to the residual profit split method, we note that application of this method on a broad scale is often a complex, time consuming and impractical exercise. As many entities use other methods to analyze their related-party transactions, they do not currently perform the type of analysis that has been proposed to allocate residual profit among different jurisdictions. Again, we request that any rules adopted allow for application of a simplified method by small and mid-sized businesses, particularly in calculation of returns to specific jurisdictions and spend.

It is worthy of note that some tax authorities' experience with such a profit split method may be limited (or indeed not usually accepted) and that the application of the method, particularly in the context of (currently) vaguely defined concepts such as the marketing intangibles, will significantly increase uncertainty about taxation - as well as potential costs of conflict resolutions.

With respect to the fractional apportionment method, certain small and mid-sized businesses do not prepare consolidated financial statements at the global level. In the event that any type of apportionment method based on global profits is adopted, we request that such rules be modified for SMEs to reflect the reality of their accounting practices. To the extent that a limitation of scope is not provided for small/mid-sized businesses, we request that a simplistic safe harbor approach or reasonable method that takes into account the realities of how different industries operate be allowed as an alternative approach.

Turning to the specific proposals based on user participation nexus in principal, we recognize the difficulties of applying existing transfer pricing rules to determine profit allocation. For example, a rigorous and consistent application of the OECD DEMPE analysis may conclude that residual profits should be allocated according to particular contributions to these functions (recognising the limitation of legal ownership alone in this respect); however, user participation is not currently an explicit feature of this analysis.

If user participation is to be considered a contributor to intangible value generation, our view is that it may not be appropriate to allocate the whole residual profit to this factor alone and that allocations should be made to other DEMPE functions which harness that user value. This principal appears consistent with what is proposed at paragraph 24(2) of the consultation document i.e. there is an attribution of "*a proportion of those* [residual] *profits to the value created by the activities of users*" although OECD confirmation of this principal would be welcome.

In this respect, safe harbour residual profit allocations to user participation in the form of "*simple pre-agreed percentages*" could perhaps be considered in order to provide simplicity and certainty for businesses and we would welcome further OECD consultation in this respect. It is however our view that the businesses should have the option to determine the just and reasonable apportionment of profits to user activity rather than having on obligation to apply a formulaic method. Again, further OECD consideration and guidance on such apportionments would be welcome. In such cases there would also be a clear need for a fast and effective multilateral advance pricing agreement programme to provide certainty for both businesses and tax authorities and to prevent double taxation.

Reducing complexity, ensuring early tax certainty and avoiding multi-jurisdictional disputes

As we have emphasized throughout these comments, reducing complexity is key to ensuring that any proposed solutions are viable from both a substantive and compliance perspective for taxpayers. The reality is that small and mid-sized businesses may lack the resources and budget to ensure compliance with significant changes to transfer pricing rules that may not accord with existing arm's length standards. Requiring such businesses to perform additional sets of accounting computations, followed by additional tax calculations would, in many cases, siphon resources away from investment in the growth of their businesses.

We recognize that the cross-border tax system includes a number of mechanisms that allow businesses to ensure early tax certainty, such as Advance Pricing Agreements, the CAP program in the United States, and the current ongoing pilot program ICAP. However, pursuing an APA for many small and mid-sized businesses can be prohibitively expensive as the cost often outweighs the potential benefits that could be achieved. For these taxpayers, early certainty can be achieved only through the availability of safe harbors and simplified compliance mechanisms.

Pillar Two – Global anti-base erosion proposal

The second part of the consultation document proposes a combination income inclusion rule and base eroding payments rule. The income inclusion rule proposes to tax the income of a foreign branch or a controlled entity if that income was subject to a low effective tax rate in the jurisdiction of establishment or residence while the proposal for a tax on base eroding payments suggests denial of a deduction or treaty relief for certain payments unless these payments were subject to an effective tax rate at or above a minimum rate.

Income Inclusion Rule

On the income inclusion rule, the consultation document outlines a number of issues that need to be resolved before the proposal could become workable, including (1) what types of entities should be covered; the definition of the minimum level of ownership or control required in order to apply the income inclusion rule; and the ability of minority shareholders to access the information required in order to determine and calculate their tax liability; (2) the mechanism for determining whether a corporation has been subject to tax at the minimum rate (i.e. the design of the effective tax rate test); (3) the design of any thresholds or safe harbors to facilitate administration and compliance; (4) the rules for attribution of income to shareholders based on their control or economic ownership including mechanisms to prevent taxpayers structuring around the rules; (5)

whether the included income should be taxed at the minimum rate or the full domestic rate; (6) mechanisms for avoiding double taxation including rules governing the use of foreign tax credits and corresponding adjustments to the scope of any related exemptions.

Consistent with our approach above, we confine our comments to this proposal primarily to the administration issues relevant to small and mid-sized businesses. With regard to the behavioral implications of the proposal, we caution that a minimum tax imposed by some jurisdictions but not others could prompt businesses to take tax into greater consideration when choosing where to initially incorporate. For our small privately held companies, significant changes in the dynamics and cost of headquartering a company in one jurisdiction as opposed to another could have a large impact on the choice of where to initially set up operations. To counteract such incentives, we recommend that any minimum tax proposals be designed to ensure that they are adopted broadly.

We are also concerned that the income inclusion rules as proposed will negatively impact on countries that are able to support the economic substance and value creation of intangibles but do not require a substantial corporate income tax base to finance their public spending. In this case a minimum rate of tax perhaps favors more developed countries who are, perhaps arbitrarily, able to set and benefit from what they consider to be a minimum level of taxation without regard to foreign local substance. Where countries have implemented strong CFC provisions we consider that there should not be a requirement to instead adopt an income inclusion rule.

In connection with any inclusion rule, we stress the importance of ensuring that any proposals ensure that small and mid-sized businesses have an option for complying in a way that takes into account smaller budgets for tax and accounting compliance. In particular, rules that require taxpayers to determine and analyze the effective tax rates applied in multiple jurisdictions exact large compliance costs. We note in this regard that we are seeing significant challenges for many of our clients in complying with the U.S. income inclusion rule enacted in 2017 (the global intangible low-taxed income provision, generally known as GILTI). The type of modeling, calculations, and analysis needed to comply with this provision is once again simply beyond the resources and budgets of many of our clients. Any inclusion rule adopted by the OECD will need to be much simpler than the U.S. version in order for it to be practically administrable by our client base.

We also caution that any income inclusion rule would need to ensure that the risk of double taxation and multiple jurisdictional taxation is not increased. Separate reporting and compliance in multiple jurisdictions for multiple levels of tax on a single set of profits introduces its own set of complexities. When jurisdictions have different methods of defining income, such complexity, and the potential for double taxation, is further increased.

It would be preferable for any proposal to exclude from scope small and mid-sized businesses, at least as an initial matter. If that is not feasible from a policy, technical, or political perspective, we recommend that safe harbors be adopted in this area as well – for example, if the group has no affiliates in tax haven jurisdiction, the rule might not apply; alternatively, if the group can show an overall effective tax rate in excess of a certain amount, the rule might not apply.

Base Eroding Payments Rule

On the base erosion payments rule in principle, the consultation document poses questions about the scope of payments covered by the rule and, in particular, the need for a workable scope that addresses the full range of profit shifting risks while minimizing the administration and compliance burdens and limiting the potential for economic double taxation or over-taxation; and the mechanics of this effective tax rate test including whether it should be applied on an entity-by-entity or transaction-by-transaction basis and the development of robust and workable tests for calculating the effective tax rate on each type of payment.

Once again, we stress the importance of ensuring that any base eroding payment rule be administrable by small and mid-sized businesses. For example, these businesses would find it very challenging to perform an effective tax rate test that requires consideration of the effective tax rate paid with respect to every intercompany payment. Notwithstanding that we are not generally in favor of such provisions, as a minimum we recommend that here, too, simplified rules be adopted and that consideration be given first to excluding from scope altogether small and mid-sized businesses (as the United States did in adopting an anti-base erosion rule (BEAT) in 2017); alternatively, that the rule exclude from scope intercompany payments when no group member is organized in a tax haven jurisdiction; or that the rule would not apply so long as the parent company jurisdiction has an inclusion rule in place.

We conclude by emphasizing the importance of the contributions of small and mid-sized businesses to the health and continued growth of the global economy and domestic economies, and the need for any coordinated tax rules to ensure that these businesses can comply with international tax rules in a reasonable and efficient way that allows them to maximize resources dedicated to the continued growth of their businesses and the global economy. Introduction of new and complex rules should include either a carve-out for smaller businesses, or simplified rules for small businesses.

On behalf of the global partnership of Mazars we respectfully submit our comments to the consultation document published by the OECD on 13 February 2019. For any clarification please contact the undersigned.

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