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

Sent via email: TFDE@oecd.org

Subject: Comments on Public Consultation Document "OECD Secretary-General Tax Report to Finance Ministers and Central Bank Governors" dated October 2019

Ladies and Gentlemen:

We are truly grateful for this opportunity to share our insights, pose our questions and validate our assumptions with respect to this transformative era for international tax and global transfer pricing. The Organisation for Economic Co-operation and Development ("OECD"), the World Economic Forum and the World Bank have collectively and independently validated that global economic growth hinges on the integration of digitalisation. With limited exception, the essence of digitalisation is arguably embedded in a multi-national corporation's global value chain. As such, there is no debate with the expansive reach of digitalisation within the global economy; the challenge to the Secretariat and the Members of the OECD/G20 Inclusive Framework on BEPS ("Members") lies within the calibration of the Pillar 1 framework to align with the microeconomic reality in which the taxpayer operates as well as the nature of the relevant business model.

As global transfer pricing strategists, Aptis Global agrees that the digitalisation of the worldwide economy merits reconsideration of the international tax and transfer pricing framework and is encouraged that the arm's length principle has been largely sustained under Pillar 1 with respect to traditional transfer pricing conventions, thus continuing to serve as the transfer pricing foundation through the fourth industrial revolution.[1] Given the velocity of this project as well as the pace of economic change, we respect the urgency in finding a balanced, collaborative solution for the Members that would preempt the disruption potentially caused by unilateral measures.

From a macroeconomic perspective, one can easily align with the famous notion of the novelist William Gibson that "the future is already here – it's just not very evenly distributed."[2] In turn, the implications, both benefits and burdens, from participating in the framework vary for each type of economy. We concur that the Unified Approach best captures the varying expectations from the Members; it will be the industry- and market-specific parameters yet to be defined that will determine whether the arm's length principle has indeed been preserved.

In preparing our comments, we have relied upon the underlying assumption that the intention is to create a fair and transparent framework. In our view, fairness would be constructed through such economic

[1] "OECD Secretary General Tax Report to G20 Finance Ministers and Central Bank Governors," October 2019, p. 16.
[2] "What is the fourth industrial revolution?", Nicholas Davis, January 19, 2016, p. 1, par. 5, https://www.weforum.org/agenda/2016/01/what-is-the-fourth-industrial-revolution/.

adjustments and parameters, which align each market accordingly; transparency would result in mitigating abuse of the system, and the framework would be one that creates a sound, consistent foundation. We understand the aim to more evenly distribute the advantages of what we now broadly refer to as the digitalisation of the global economy while mitigating the volume and inefficiencies of transfer pricing disputes. At the same time, Aptis cautions the Secretariat with respect to the inherent risks of oversimplification, providing our own insights that could refine the Unified Approach while preserving the foundation of the arm's length principle.

We have sought to anticipate the implications for multi-sided platform, "digital-born companies" in comparison to the "non-digital born" companies, surrounding the Unified Approach of Pillar 1 comprised of five "building blocks", namely: scope, nexus, profit allocation, elimination of double tax and dispute prevention and resolution. The following discussion addresses certain implementation and theoretical challenges in the pursuit of further clarification and guidance from the Secretariat.

The interpretation and interaction of Scope and Nexus

Given that the Secretariat has broadened the Scope under Pillar 1 to include all "consumer-facing businesses," effectively expanding scope beyond highly digitalised businesses, and is considering certain industries that will be subject to an upfront "carve-out," our comments are primarily focused on the potential issues and questions that may arise for this revised breadth of scope, commonly known as the non-digitally born business models, comprised of the "bricks and mortar" companies that bear some element of digital capability within the supply chain. To that end, we have provided comments on the three building blocks that have distinguished implications for this group, namely: scope, nexus and profit allocation.

Based upon the premise that the scope for the New Taxing Right is defined by a business flow (e.g., tangible, intangible or service) that is *ultimately* consumer-facing (e.g., directly or indirectly) in the absence of a physical presence, the implementation challenges for taxpayers lie in defining the subtle nuances found when interpreting this scope, the threshold parameters, and the potential industry and market adjustments needed to account for such differences.

As a litmus test, scope assessment first determines the presence of online sales, confirming or negating the digital nature of the sale of either a good or service, or the sale of data itself, collectively representing "digital differentiation" and all presumably in the absence of a physical presence. The integration of digital assets within the supply chain, such as the deployment of data, yields another area requiring further guidance. Please consider distinction between the following scenarios in defining the indirect use of data and the implication of the descriptive term "consumer, market-facing":

1. Healthcare data is used by a company without a physical presence in a market to inform the local governmental agency of a medical crisis that may/may not result in the direct/indirect sale of a solution/product in that market, would such activity be characterized as a consumer market-facing activity with the government as the user of the data?
2. From a different angle, if patients are directly targeted for the sale of solutions/products based upon their healthcare records in a market where the seller does not have a physical presence, would this activity be considered a consumer, market-facing activity?

Unless this is intended to be as bright a line as it appears, we would appreciate further guidance around how the means of deployment of data in the marketing process is used to determine whether it falls into the scope of the New Taxing Right.

Working from the assumption that the Secretariat will further explore any industries for exception deemed to not bear consumer, market-facing intangibles, the current industry exceptions include extractives,[3] commodities,[4] and financial services.[5] Aptis Global concurs that it is appropriate to exclude the extractive industry in the absence of digital business flows with embedded consumer, market-facing intangibles. We also agree that commodities would be appropriately excluded from the new nexus scope as the key value drivers for this regulated business are embedded in trader know-how coupled with access to the exchange trading markets themselves via capital, typically with no direct "market-facing," nor consumer-driven element. Financial services merits exception, given the regulatory nature with further understanding across sectors necessary to capture the breadth of the business model types found within this industry.

Threshold will be a critical area of refinement in the Secretariat's guidance. For those taxpayers that fall fully within the qualitative parameters of the Unified Approach scope, they will be able to apply consolidated revenue to determine whether they have triggered further analysis of the New Taxing Right. For those companies that will need to segment their business flows to accurately capture what is covered by the scope, the process of capturing consistently reliable "Group Business Line" financial data in validating the threshold, whether it be in GAAP or IFRS, will be a burdensome and complex administrative process.

The Secretariat may consider simplification through a Safe Harbor payment that could allow those companies that are not able to sufficiently produce such financial data to satisfy the scope requirements prescribed under the Unified Approach. Moreover, a loss exception for the scope threshold would require a more complex analysis and would go beyond the intention of simplicity. To that end, a broader rule surrounding total system losses should be considered by the Secretariat to avoid a distraction for these companies suffering overall losses to attempt to derive a loss, or a profit, attributable to a specific segment of their business. Please also address an acceptable timeframe for a recurring loss exception.

The next step in the analysis contemplates whether the identified revenue streams are sufficiently connected to a market jurisdiction, confirming whether the new nexus exists by jurisdiction. To validate the presence of the new nexus, it must be determined if an enterprise has "sustained and significant involvement in a local economy" in the absence of a physical presence. [6]
Given the multiple levels of distribution that may exist within an organization's supply chain, the task of identifying the jurisdictions in which revenue arises is not straightforward. Serving as trigger points in the

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[3] "OECD Secretary General Tax Report to G20 Finance Ministers and Central Bank Governors," October 2019, p. 15.

[4] "OECD Secretary General Tax Report to G20 Finance Ministers and Central Bank Governors," October 2019, p. 17.

[5] "OECD Secretary General Tax Report to G20 Finance Ministers and Central Bank Governors," October 2019, p. 17.

[6] "OECD Secretary General Tax Report to G20 Finance Ministers and Central Bank Governors," October 2019, p. 17.

new nexus analysis, the identification of primary points of distribution within a supply chain should be manageable as they theoretically represent the same points in determining scope. However, the secondary points of distribution, which may be activities entirely conducted by a third party, become increasingly complex to identify and even more so to capture in a company's financial records for tax reporting purposes.

To further explore the noticeably less bright line distinction in this step between what is traditionally "B2B" versus "B2C", it would be helpful to have more guidance around the following scenarios:

1. Company A sells branded widgets directly to consumers through both its own bricks and mortar retail stores and online through its own websites. Within the product, there are two sub-assembly components that are branded on the finished product by Companies B and C. The sub-assembly of Company B is a globally-recognized brand that does not sell to end consumers and is only sold as an intermediary good to OEMs. Would Company B be implicated and thus considered subject to the New Taxing Right for the online sales of Company A given that its globally-recognized brand would theoretically be contributing to the marketing intangible driving the sale to the consumer by Company A?
2. Company C sells both exclusively-branded goods, bearing its globally-recognized brand, through its own retail stores and websites as well as sub-assembly components to OEMs such as Company A. Would Company C be obliged to the New Taxing Right under both its exclusively-branded goods and its sales to OEMs bearing its brand on the finished good?
3. Company D sells components to Company B that in turn sells to Company A; is Company D implicated under the new nexus by the direct sales of Company A to consumers?
4. With respect to Companies B, C and D, assuming they could be implicated in the business flows of Company A under the New Taxing Right, how would the ancillary transactions around online sales of after-market parts and installation services be treated in this scenario?

The examples intend to highlight the potential for uncertainty as to where the nexus trail ends as a transaction may not become "consumer facing" until it has been distributed two or more levels down the supply chain; further clarity is required as to how these extended points of the supply chain would be sourced in a new nexus analysis. By the same token, clarification as to when the nexus analysis begins is also worthy of further insights. To the example above, a component supplier to a sub-assembly manufacturer could be twice-removed from the OEM (e.g., original equipment manufacturer) sale that is ultimately made to a consumer through a digital platform; practical insights from the Secretariat as to where to begin a new nexus analysis in a supply chain and where to end, accordingly, would be useful.

For purposes of measuring the significant and sustainable presence under nexus, a secondary level of threshold test would be appropriate at the local market level, subject to refinements. This could be integral with the taxpayer's election for a Safe Harbor yet would nonetheless be necessary to validate whether each jurisdiction would merit pursuing the calculation of the New Taxing Right under the Unified Approach. For example, an entity may fall within scope under a threshold applied to group or consolidated revenue, yet the nexus tests could yield an insignificant presence in a local market that would require neither a minimum safe harbor nor a Unified Approach calculation at the local level.

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We would appreciate additional insight from the Secretariat regarding the measures of sustainability in affecting a local market nexus, considering both the pragmatic financial data challenges around implementing the scope and threshold nexus tests, and the interpretation as to how conventional income sourcing principles might be adapted to this new nexus test.

We recognize the herculean effort ahead in achieving Member consensus, which is precisely why market and industry adjustments used in determining scope and nexus should be vetted and validated among the Members early in the 2020 process. However, the effort to comply with an unnecessarily complex system that captures unintended taxable income in its purview could be an indefinitely herculean burden to the taxpayer. As such, the Unified Approach thresholds should thus be normalized at both the Group/ Business Line level and the local market level, subject to macro- and microeconomic data adjustments, to then determine the amount of the New Taxing Right under the building block: "Profit Allocation."

Profit Allocation

While the Secretariat has maintained the foundation of the arm's length principle, the Pillar 1 Unified Approach also embodies a departure from the arm's length principle with respect to the New Taxing Right. Under this framework, there are three types of taxable profit potentially available for allocation: A, B and C, whereby A represents the New Taxing Right, which is derived from factors outside the traditional transfer pricing conventions, otherwise covered under B and C. In our analysis, we have interpreted the Secretariat's October 2019 report to include the following mechanics for determining profit allocation under the Unified Approach, applied once a taxpayer has met the qualitative and quantitative threshold test of Group/Business Line Revenue under scope as well as both the nexus test and satisfied the local market threshold:

> Step One: Determine the (presumably Industry/Market-Adjusted) minimum percentage of Total System Profit to be allocated to the New Taxing Right, indicative of a minimum profit allocation for the marketing intangible collectively present in the local jurisdictions.
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> > While this is termed as "Amount A", we would interpret this to potentially be the first of two components of A, depending on the Residual Profit remaining after the following steps, and thus consider this first component to represent a placeholder of allocated profit to ensure a minimum return to market intangibles.
> >
> > The industry and local economic differences around an appropriate allocation merit further guidance and refinement for implementation. Moreover, the segmentation of the Business Line revenue to determine the relevant total system profit is potentially a notably complex exercise for what is otherwise viewed as a litmus test. To that end, a safe harbor framework is a critical consideration for large multinationals with numerous countries that fall into the New Taxing Right as much as for the middle-market multinationals that may not have the resources to properly conduct the analysis, all of whom may also be simply unable to collect the appropriate data due to common systems limitations.
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> Step Two: Determine the minimum Operating Margin appropriate (presumably Industry/Market-Adjusted) for the Amount B indicative of an arm's length return for the distributor.

If the intent under B is to establish a simplistic, realistic, and arguably modest, minimum level of operating margin for a distributor, critical discernment is necessary to distinguish a Limited Risk Distributor ("LRD") from a Full Risk Distributor ("FRD"), particularly in light of what is being remunerated for marketing under A and potentially C.

Moreover, this quantitative framework should be adapted by industry. It is suggested that the B profit allocation would be limited to that of a routine return of an LRD and all other functions, risks and assets borne by the entity in question for B that would be borne by an FRD would then fall under C.

Aptis Global considers it appropriate to capture losses for Full Risk Distributors under the Unified Approach; this is economic reality that cannot be ignored. In transfer pricing theory, an LRD merits a routine return and should not bear losses, with limited exception around start-up operations and extraordinary operational and business circumstances. In the case of a Full Risk Distributor, the profit/loss attribution would fall into C and any such losses would be able to offset any remaining residual that would otherwise be shifted to A.

As the most commonly contested transfer pricing transactions in the world, distribution returns should be given depth and detail in the Unified Approach guidance. In the absence of sufficient guidance, unilateral approaches may surface that create unnecessary disputes.

Step Three: Determine the routine return appropriate to the remaining intercompany transactions under the traditional transfer pricing methodologies, which would include a newly-established maximum or ring fence as a fixed profit allocation for "Principal Operating Companies," with and without intangible property returns, as well as those transactions that would earn a routine return for functions outside of distribution, such as manufacturing; R&D services and management services. In isolation, the intent is that for Steps Two and Three under B and C, the arm's length principle continues to serve as the principled foundation for traditional transfer pricing measurement.

The implementation complexity of the A:B:C calculations begins with the allocation of shared services costs across C transactions, yet should also consider an appropriate allocation of costs toward A. The conventional transfer pricing methodologies grounded in the arm's length principle will create the obvious element of profit allocation toward the routine return transactions. The challenges continue with the remuneration of the Principal Operating Companies ("POC's") in the business model and the IP owners. The residual effect on profit ultimately allocated to A, coupled with a potential cap on residual returns to the POCs and the IP owners allowed under C transactions, could compromise the spirit of the arm's length principle.

A fixed level of remuneration allocated to an entrepreneur changes the fundamental characteristics of being the risk-taker and reward-reaper. Regardless of the qualitative result, allocating a minimum threshold of profit to A for market intangibles, implicitly constrains the level of the POCs and IP owners' return. Given the trade-off to avoid

unilateral measures, the best way to mitigate this is to establish industry and local market adjustments that would attempt to moderate this impact on C to create a balanced framework.

Step Four: Given the assumption in Step Three that ring fences the maximum return allowable for Principal Operating Companies and IP owners, it is possible to have residual profit after calculating the first component of A, B and all of C. In this event, we assume that this secondary residual profit would revert to A as additional profit subject to the New Taxing Right.

Further allocating any other residual profit to then augment the minimum return expected for A further exacerbates the issue of compromise to the entrepreneurial return intended in the arm's length principle.

Moreover, the risk that there is some degree of potential overlap within the interaction of A:B:C also highlights the exposure to double taxation.

Step Five: Allocation bases for the total profit ultimately allocated to A under the New Taxing Right could include basic metrics.

While this may be appropriate in most industries, there are some industries where a weighted-average of metrics that are tied to the Balance Sheet may be fundamentally more appropriate. The allocation key used to allocate profit to the market jurisdictions under A should be considered in tandem with the threshold determined for scope and nexus, which is assumed to be revenue.

Refinements

With respect to the Group or Business Line threshold under scope and the second threshold applied at the local market level under nexus, Aptis Global would like to emphasize the overall use of industry financial data to establish industry-specific revenue thresholds, perhaps by industry sector where appropriate, further aligned by the local market's economic data, such as GDP, as well as Safe Harbor alternatives. We would also suggest identifying trigger events that would require an update of such threshold amounts and adjustments along with some time element linked to the economic cycle of the local economy, recognizing that an economic shock, such as a depression or abnormal event, such as a war, would necessitate a more immediate revision for that market.

Given that the mechanics of A under consideration would include a baseline return, Aptis encourages the Secretariat to use microeconomic data to form benchmarking norms by industry in establishing an expected range for the measurement of an appropriate level for A. In some industries it would be appropriate to also create such guidance at the sector level, given the disparity of business models that may exist within an industry. The application of balance sheet ratio analysis would also be appropriate in setting these parameters. Such benchmarks would serve as general guidelines and would not substitute the arm's length remuneration required in compliance requirements. Given that the timing of analyzing the obligation under the New Taxing Right may differ from the preparation of transfer pricing compliance documentation, these guidelines would only be practically used in the benchmarking of the calculation of the New Taxing Right.

As with any allocation bases analysis, a risk exists for oversimplifying the allocation drivers themselves. To that end, in capturing the role of capital in profit generation, a more asset-intensive industry would bear a different ratio in establishing such minimum returns than an industry with less capital requirements. While the tangible assets would be generally tied to the physical presence, the effective deployment of capital benefits both a digital business and a bricks and mortar business, albeit differently.

Although our comments have focused on the first three building blocks, naturally, any changes to nexus and profit allocation would require modifications to the dispute resolution mechanisms, APA framework, and mutual agreement procedures. These changes would not be in isolation from the fundamental changes required to Articles 5, 7, 9, and 10-13, accordingly.

Conclusion

We commend the OECD's timeline in addressing this transformational endeavor that will shape taxation for decades to come. It is an honor to have this opportunity to provide our insights; we greatly welcome any insights or queries from the OECD regarding our input. If there are questions regarding this submission, please contact me at kkimball@aptisglobal.com or +1 858 433-2701.

Kind regards,

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[7] The author would like to thank Sofie Stas, Principal and European Leader, Aptis Global, and Su Merck, Aptis Strategic Advisor, Aptis Global, for their collaboration and contributions to this research.