BonelliErede

Comments to the OECD Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy

OECD – Tax Policy and Statistics Division, Centre for Tax Policy and Administration

To

BonelliErede

From

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Comments to the OECD Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy

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Date

First and foremost, we would like to thank you for the work done in drafting the OECD Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy ("**Report**"). We are pleased to provide a preliminary set of comments and observations to contribute to the implementation of the work done so far by the Task Force on the Digital Economy, which is committed to providing a consensus-based long-term solution.

For the sake of clarity, it is worth nothing that we will focus our comments on "Questions for public comments on Revised profit allocation and nexus rules" (as provided by para. 87 of the Report). For making easier the consultation of our comments please find here below a table of contents.

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I. 1. What is your general view on those proposals? In answering this question please consider the objectives, policy rationale, and economic and behavioural implications.

I.A Introduction

We appreciate that the common aim of the three proposals introduced by the Report "is to recognise […] value created by a business' activity or participation in user/market jurisdiction that is not recognised in the current framework for allocating profits"[1], and in particular to avoid cases of non-taxation (or unfair taxation).

In this regard, the Report identifies the following three proposals:

(i) The "user participation" proposal, which we understand would only tackle certain digitalised businesses (i.e., social media platforms, search engines and online marketplaces);

(ii) The "marketing intangibles" proposal, which we understand would have a wider application, i.e., it would apply to all industries rather than being limited to only a subset of highly digitalised businesses; and

(iii) The "significant economic presence" proposal, which is aimed at modifying the existing nexus "on the basis of factors that evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means"[2].

We strongly believe that, along with the objectives mentioned above, any amendment to current international tax principles must also:

(i) Cover both physical and non-physical presence;

(ii) Confirm the arm's length principle ("**ALP**") as the cornerstone for allocating income among jurisdictions; and

(iii) Opt for a solution that avoids any potential drawback in terms of double taxation.

We based our analysis on three pillars that we identified as key to achieving these objectives:

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[1] See para. 11 of the Report.

[2] See para. 51 of the Report.

(i) Perimeter (i.e., highly digitalised businesses or wider application);

(ii) What to tax (i.e., physical vs. significant economic presence);

(iii) How to tax (i.e., ALP vs. withholding tax or fractional apportionment method).

I.B Perimeter (i.e., highly digitalised businesses or wider application)

We strongly agree with the following statement from the various OECD Reports on Addressing the Tax Challenges of the Digital Economy: "Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes"[3].

This is most true if one considers that in the current economy more and more MNEs are using primarily digital tools (e.g., e-commerce) to develop other business areas, in parallel with "traditional businesses". Given this, the criticism surrounding the capability of the ALP to properly reflect the value created by local presence of highly digitalised businesses may be extended also to "traditional businesses" operating through digital tools.

The Report addresses this issue when it states that "the current rules are seen as under-allocating income to particular jurisdictions due to the ability of highly digitalised businesses to remotely and non-physically participate in those jurisdictions [...]" and suggests that "consideration should be given to whether that policy concern (and reforms to address that concern) are relevant also to more traditional businesses"[4].

In light of the above, the scope of the Report should not be limited to highly digitalised business since it should be focused on the application of the ALP to digitalisation in a wider sense. This would be the best solution to: (a) ensure a consistent application of the same principles for all the industries avoiding at the same time mismatch through the relevant fiscal years, and (b) avoid drafting a narrow definition of what will be covered by these new rules and what will fall outside their scope.

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[3] See OECD (2014), *Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing; OECD, BEPS Action 1 Final Report Addressing the Tax Challenges of the Digital Economy, 2015; OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[4] See para. 14 of the Report.

I.C What to tax (i.e., physical vs. significant economic presence)

As a preliminary remark, we agree with the Report that we must analyse and cover (through the development of the "nexus") also situations where a physical presence does not exist.

In our opinion, physical and significant economic presence ("**SEP**") are two different sides of what should be the key factor: local presence[5]. Local presence is defined as the activity (performed directly or indirectly) that facilitates market penetration.

Physical presence issues are manageable through the application of the current Article 9 of the OECD M.C.[6] linked to the provisions contained in the TPG[7] (this avoids changing the current double tax conventions or working on a new multilateral instrument[8]). In this respect, in our view it is more important to perform an appropriate value chain analysis in order to better frame the local role of a business' physical presence taking into account the peculiarity of the digitalised business and to broaden the concept of "marketing operations".

Although one of the approaches suggested by the Report (i.e., the marketing intangibles proposal) may appear to be consistent with some of the most remarkable achievement of the OECD Base Erosion and Profit Shifting project ("**BEPS**") it may underestimate the factual and logical framework which support DEMPE analysis involving intangibles.

We believe that the approach on the physical presence will cover the majority of digitalised business (based on our experience, almost all the MNEs involved in highly digitalised business or traditional business now relying on digitalisation have a physical presence in the most important markets).

SEP must be treated in the context of Article 5 of the OECD M.C. The main issues here are: (a) how to deal with SEP when it co-exists with physical presence, and (b) how and whether a minimum threshold should be set.

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[5] For the purposes of this document, local presence covers both physical and significant economic presence.

[6] See OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD Publishing ("**OECD M.C.**").

[7] See OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris ("**TPG**").

[8] Similar to the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*.

With reference to point (a), we believe that a single taxpayer approach should be implemented to reduce complexity. This will attribute the business of the SEP at the level of physical presence (if any).

With reference to point (b), we believe it is important to distinguish between the different factors listed by the Report, with more emphasis put on the performance of marketing activities.

I.D How to tax (i.e., ALP vs. withholding tax or fractional apportionment method)

The ALP must remain the cornerstone in calculating taxable income in intra-group transactions also because due to the BEPS project transfer pricing outcomes are now more aligned with value creation. Since Actions 8-10 of the BEPS project aimed at granting coherence across international tax principles by improving certainty and transparency, any divergency from the ALP may risk to misalign taxation from value creation.

Furthermore, since several countries has in force double tax conventions covering both associated enterprises (Article 9 of the OECD M.C.) and permanent establishments (Article 7 of the OECD M.C.), in our opinion, the same principles have to be applied also to digitalisation which means that the same approach must be applied for physical and SEP.

In light of the above, we would recommend not to opt for:

(i) Introducing a withholding tax on certain digital transaction as this could trigger double taxation, and

(ii) Refraining from introducing a fractional apportionment method.

As a consequence, Chapters I and VI of the TPG must be the key guidance for: (a) properly delineating the local roles (through an in-depth value chain analysis); and (b) understanding the role of the local presence vis à vis the relevant of the intangibles.

Furthermore, we do not share the position according to which a difference should be made between marketing and trade intangibles. Conversely, we believe that the current wording of paras. 6.15 and 6.16 of the TPG has to be confirmed.

The correct approach would be to assess whether the local presence, taking into account the value chain, has a significant role in a group's marketing and sales function.

This would allow the application of a transfer pricing method based on a return on turnover that would capture both the local market penetration and the market share.

II. 2. To what extent do you think that businesses are able, as a result of the digitalisation of the economy, to have an active presence or participation in that jurisdiction that is not recognised by the current profit allocation and nexus rules? In answering this question, please consider: i. To what types of businesses do you think this is applicable, and how might that assessment change over time? ii. What are the merits of using a residual profit split method, a fractional apportionment method, or other method to allocate income in respect of such activities?

II.A Introduction

The most important MNEs involved in the highly digitalised business (i.e., activities listed in para. 19 of the Report, such as social media platforms, search engines and online marketplace) have a physical presence in the most important markets[9]. This trend is also seen in traditional businesses with a broad impact on the digitalisation of the economy.

However, two issues currently prevent the transfer pricing outcome from being fully aligned with value creation: (a) the uncertain characterisation of the physical presence (which has huge impacts on the transfer pricing methods applied for remunerating the local presence); and (b) the absence of a nexus rule for businesses that operate on the local market without a local physical presence.

Before addressing these two issues in detail, an overview is needed of the activities generally performed locally. Notably, in almost all cases the subsidiaries of highly digitalised groups do not directly invoice local customers and, therefore, do not book any form of turnover regarding the group's core business in their profit and loss accounts. However, their activities are often focused on: (a) evangelising on the local market the tools developed by the group's headquarters; (b) scouting for business partners on the local market (e.g., suppliers, buyers, agents, merchants); (c) performing marketing activities; and (d) providing logistic services. Conversely,

[9] As stated in para. 13 of the Report.

engineering/R&D activities are usually carried out at a central level by either the headquarters or the regional hubs.

In light of the above, the transfer pricing policy of highly digitalised groups has often been structured by granting to the local subsidiaries a remuneration based on the cost incurred plus a mark-up (in the form of either a cost plus or a TNMM), thus shifting all extra profits/losses to either the headquarters or the regional hubs (depending on the business model chosen).

II.B Local presence: physical vs significant economic presence

II.B.1 Appropriate characterisation of the physical presence

A significant issue is the transfer pricing method applied to remunerate the physical presence (more linked to highly digitalised businesses) since the selection of a transfer pricing method based on costs is not interlinked with the local turnover/result. This may create an outcome that is not aligned with value creation especially in those circumstances where the local presence relates (directly/indirectly) to the local sales of services/goods.

In this respect, the amendments made to Chapter I of the TPG on transfer pricing analysis provide the actual delineation of the transaction as the key starting point to avoid a transfer pricing outcome not aligned with the value creation:

> 1.35 The process then narrows to identify how each MNE within that MNE group operates, and provides an analysis of what each MNE does (e.g. a production company, a sales company) and identifies its commercial or financial relations with associated enterprises as expressed in transactions between them. The accurate delineation of the actual transaction or transactions between the associated enterprises requires analysis of the economically relevant characteristics of the transaction. These economically relevant characteristics consist of the conditions of the transaction and the economically relevant circumstances in which the transaction takes place. The application of the arm's length principle depends on determining the conditions that independent parties would have agreed in comparable transactions in comparable circumstances. Before making comparisons with uncontrolled transactions, it is therefore vital to identify the economically relevant characteristics of the commercial or financial relations as expressed in the controlled transaction. [emphasis added]

With regard to highly digitalised business, the peculiarity of the business (which has a huge impact on the value chain and the roles of the different group entities) suggests that an in-depth value chain analysis needs to be performed to fully understand the actual nature of the local roles from the perspective of the specific business. In this

respect, the situation outlined under para. 1.55 of the TPG can be often found in the highly digitalised business:

> 1.55 The functional analysis may show that the MNE group has fragmented highly integrated functions across several group companies. There may be considerable interdependencies between the fragmented activities. For example, the separation into different legal entities of logistics, warehousing, marketing, and sales functions may require considerable co-ordination in order that the separate activities interact effectively. Sales activities are likely to be highly dependent on marketing, and fulfilment of sales, including the anticipated impact of marketing activities, would require alignment with stocking processes and logistics capability. That required co-ordination may be performed by some or all of the associated enterprises performing the fragmented activities, performed through a separate co-ordination function, or performed through a combination of both. Risk may be mitigated through contributions from all the parties, or risk mitigation activities may be undertaken mainly by the coordination function. Therefore, when conducting a functional analysis to identify the commercial or financial relations in fragmented activities, it will be important to determine whether those activities are highly interdependent, and, if so, the nature of the interdependencies and how the commercial activity to which the associated enterprises contribute is co-ordinated. [emphasis added]

The fragmentation mentioned by the TPG can be relevant in cases in which the local entity may have a significant role in the sales and distribution function, despite apparently not being involved in the sales process. This should be considered bearing in mind the peculiarities of highly digitalised business (e.g., online platforms, standard terms and conditions).

This value chain analysis should aim at assessing whether the local entity plays a significant role in the marketing and distribution function. This would lead to:

(i) Having the nexus with the local group business; and

(ii) Selecting a transfer pricing policy based on a return on turnover (either a resale price method or a TNMM based on a return on sales as profit level indicator).

The outcome under point (ii) is supported by:

(i) Para. 2.27 of the TPG where it outlines that the resale price method "is probably most useful where it is applied to marketing operations";

(ii) Para. 2.93 of the TPG, which states that in relation to TNMM "typically, and subject to a review of the facts and circumstances of the case, sales or distribution operating expenses may be an appropriate base for distribution activities".

Since it is our opinion that the local presence is characterized as marketing operation and should be remunerated via a resale price method/TNMM with a return on sales

as profit level indicator, it should be verified whether the position taken by para. 13 of the Report according to which "only a modest return may be allocated to these "limited risk distributors"" does not lead to an over-simplification. In fact, it is worth noting that under the limited risk distributor ("**LRD**") definition fall heterogeneous cases both in consideration of the industry and the functional profile of the entities involved.

Before addressing how to determine an appropriate return aligned with local value creation, it is key to consider also situations in which no local presence exists (bearing in mind that we strongly believe that remuneration for both physical presence and SEP should be based on the same principles).

II.B.2 Nexus in the absence of a physical presence

Two possible cases of absence of a local presence may exist: (a) presence of a local subsidiary that is not involved at all in a portion of the business that entails local sales; and (b) absence of a local subsidiary/office.

The first case falls within the second issue outlined in Section II.A: does a link (apparently not existing) exist between an MNE's local presence and its other business?

In this respect, we need to investigate whether indirect benefits derive from the physical presence for the other business (totally managed by remote). Indeed, if the local subsidiary performs marketing activities by organising also local conferences/events and, therefore, contributing to the brand awareness on the local market, indirect benefits may exist. This is also the case of traditional businesses that rely on digital tools to increase their local business. If we think about e-commerce in the fashion luxury business, it is usually performed in parallel with the usual retail activity. In such a case, the existence of local advertising (conducted/paid by the retailer) and a point of sale with windows displaying all the products (where the customer could try products then purchase them through the e-commerce channel) will in all likelihood trigger/attract also online sales. Therefore, although the retailer does not materially sell the goods to the customer, its significant role also in online sales is undeniable.

This, with the aim of reducing complexity, could suggest that a nexus should be attributed to the local subsidiaries also on the other business (although only an indirect local role can be found) and, therefore, that the SEP should be remunerated through transfer pricing.

This is not the case if a physical presence is absent in relation to both other group businesses and the business managed remotely. Since this scenario does not fall under Article 9 of the OECD M.C., Article 5 combined with Article 7 of the OECD M.C., should apply by relying on a SEP factor outlined in para. 51 of the Report. More specifically, on the factor mentioned in point (6) of the Report: "sustained marketing and sales promotion activities, either online or otherwise, to attract customers".

Indeed, even groups without a physical presence in a certain market usually perform local advertising activities through local media. By contrast, if a minimum amount of advertising activities is not conducted, it is difficult to trigger a SEP in the form of a permanent establishment and consequently to attract profits deriving from the market.

II.B.3 Conclusion on physical vs significant economic presence

The key starting point to avoid attributing profit to the local presence not aligned with value creation is performing an appropriate value chain analysis (consistent with Chapter I of the TPG) to understand: (a) the local activities, (b) the role of the local activities in the group's value chain, and (c) any direct/indirect effects on the sales of services/goods on the local market.

This could lead to: (a) any physical presence being characterised as a marketing activity; (b) any physical presence also attracting any other local business indirectly affected by the marketing activities performed by the physical presence; and (c) any relevant local factor that even in the absence of a physical presence may trigger a SEP.

In this respect, we believe that to reduce complexity, two main principles should apply to businesses with a physical presence: (a) force of attraction, and (b) single taxpayer approach (i.e., the SEP is relevant only for the purposes of attributing turnover to the physical presence). If a business has no physical presence, a SEP in the form of a permanent establishment should exist.

In all cases, we strongly believe that the remuneration should be determined based on the same current version of Articles 7 and 9 of the OECD M.C. For this reason, we strongly suggest the avoidance of having specific mechanisms for businesses with a physical presence (i.e., ALP) and businesses with a SEP (e.g., fractional apportionment method or withholding tax).

II.C How to remunerate the local presence

II.C.1 The mechanism to be selected for remunerating the local presence

(A) Introduction

As outlined in the comments to question 1, the milestones for addressing the tax challenges of digitalisation are as follows:

(i) Capturing both physical and non-physical presence;

(ii) Maintaining the ALP as the cornerstone of any proposal and preserving common cross-industry rules; and

(iii) Adopting a multilateral solution.

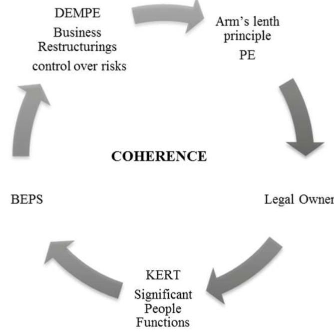
The solution to be endorsed for determining an appropriate attribution of profits to the local presence taking into account the value creation must properly consider the three characteristics of highly digitalised business models: (a) scale without mass, (b) heavy reliance on intangible assets, and (c) data and user participation[10].

In this respect, we believe that, although the OECD is considering solutions "going beyond the arm's length principle", the most appropriate approach can still be found in the framework of the ALP by granting a strict application of the principles established in the TPG. In particular, we believe that one of the TPG milestones should be stressed[11].

More specifically, DEMPE has aligned the OECD's standard principles on the attribution of the remuneration deriving from the exploitation of intangibles and Chapter VI of the TPG to the standard developed since 2008 for attributing profits to permanent establishments, which relies on an analysis of the key entrepreneurial risk-taking functions (KERT) and significant people functions. Therefore, after the OECD BEPS project, the application of the ALP is coherent in its framework regardless of the level of legal presence.

[10] See para. 4 of the Report.

[11] References are made to the concept of control over risk, which is implemented in Chapter I (general part), Chapter VI (DEMPE on Intangibles) and Chapter IX (business restructurings) of the TPG.



This should be also the starting point for finding a reliable, stable and coherent solution for tackling the tax challenges of digitalisation. Conversely, a solution departing from the current framework would risk: (a) jeopardising one of the milestones of transfer pricing; and (b) causing several mismatches generated by constant changes to the principles (DEMPE was only introduced in October 2015) since MNEs have significantly modified their business models focusing on the outcomes of BEPS project.

(B) A withholding tax mechanism would lead to double taxation

One solution envisaged (and currently set out in some unilateral web-tax legislation) is based on the application of withholding tax.

This solution is consistent with a European Commission proposal, whereby a 3% withholding tax on gross revenues is envisaged as an interim solution before implementing the long-term solution. We are extremely concerned about the application of a 3% withholding tax on gross revenues, as it completely disregards: (a) the group's overall profitability, and (b) the value drivers of the business. More specifically, the following issues arise:

(i) A 3% rate appears inconsistent with the value creation;

(ii) Potential double taxation could ensue;

(iii) The application of the same rate regardless of whether a physical presence exists discourages the incorporation of local entities and is completely inconsistent with the principles of Chapter I of the TPG (i.e., two situations with different functions (or intensity of the functions) will end up with the same remuneration); and

(iv) Distortive competition appears to occur in the internal market.

With regard to point (i), a 3% withholding tax on gross revenues equates to a tax on profitability (in terms of operating income) of between 12.5% (considering a CIT of 24%) and 20% (considering a CIT of 15%) (see table 1 below).

Table 1: Value attributed to the market through a 3% WHT

	SCENARIO	A	B	C
A	GROSS REVENUES	100	100	100
B	FULL COST	87,5	85	80
C=A-B	OPERATING INCOME	12,5	15	20
D	CORPORATE INCOME TAX RATE	24,00%	20,00%	15,00%
E=C*D	CORPORATE INCOME TAX DUE	3	3	3
F	WEB TAX RATE	3%	3%	3%
G=A*F	WEB TAX DUE	3	3	3
H=C/A	PROFITABILITY (RETURN ON SALES)	12,50%	15,00%	20,00%

This would lead to an attribution to the market of a value far from that currently achievable through an arm's length approach. In some cases, it could lead to a higher taxation on profitability than that achieved at group level.

Additionally, some of the highly digitalised groups achieve a lower consolidated return on sales than that implicitly taxed with a 3% withholding tax. This is a further confirmation that a withholding tax on gross profit does not have an outcome aligned with value creation and can lead to double taxation due to: (a) it being applied on gross revenues and, therefore, not taking into account the significant expenses borne (particularly for R&D); and (b) credit being generally granted by the resident country within the limits of the resident taxation on net profit (so-called limited credit). The combination of points (a) and (b) could lead to an excess of foreign tax credit that will never be recovered.

By contrast, in our experience, independent parties acting as distributors of advertising on local markets achieve on average a return on sales of 2 – 6%. This result is mainly consistent with the application of a 1% withholding tax, with the advantage that it relies on third party data and can be updated every year based on the relevant economic circumstances (where a withholding tax is a pre-determined rate not adjusted to take into account the economic circumstances).

Table 2: taxation with the application of ROS and WTH

	SCENARIO	A	B	C
A	GROSS REVENUES	100	100	100
B	FULL COST	95,82	95	93,3
C=A-B	OPERATING INCOME	4,18	5	6,7
D	CORPORATE INCOME TAX RATE	24,00%	20,00%	15,00%
E=C*D	CORPORATE INCOME TAX DUE	1	1	1
F	WEB TAX RATE	1%	1%	1%
G=A*F	WEB TAX DUE	1	1	1
H=C/A	PROFITABILITY (RETURN ON SALES)	4,18%	5,00%	6,70%

In light of the above, we strongly recommend against introducing any withholding tax.

II.C.2 The Arm's Length Principle is still the framework where to find the solution

The landmark cases of BEPS led supranational organisations to reconsider all the pillars of international taxation, particularly the ALP, which has been always the standard for allocating taxable income among different countries.

In 2011 the EU Commission proposed the Directive on a Common Consolidated Corporate Tax Base (CCCTB), in which the EU Commission affirmed the following[12]:

> A key obstacle in the single market today involves the high cost of complying with transfer pricing formalities using the arm's length approach. Further, the way that closely-integrated groups tend to organise themselves strongly indicates that transaction-by-transaction pricing based on the 'arm's length' principle may no longer be the most appropriate method for profit allocation.

In 2013, when the BEPS project was launched, the OECD expressed the view to reconsider the ALP by also analysing a possible departure for at least specific topics[13]:

> A major issue is transfer pricing and the enforcement of the arm's length principle. […] In other instances, however, multinationals have been able to use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it into low-tax environments. […] Alternative income allocation systems, including formula-based systems, are sometimes suggested. However, the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalisation. Nevertheless, special measures, either within or beyond the arm's length principle, may be required with respect to intangible assets, risk and overcapitalisation to address these flaws.

Despite the above envisaged alternatives to the ALP, the OECD's official view, as confirmed by the latest version of the TPG, continues to be that the ALP should govern the evaluation of transfer prices among associated enterprises because this principle works in the majority of cases and no realistic and equal effective alternatives currently exist[14]:

> While recognizing the foregoing considerations, the view of OECD member countries continues to be that the arm's length principle should govern the evaluation of transfer

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[12] See, 2011 Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base (CCCTB).

[13] See, OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing.

[14] See para. 1.14 of the TPG.

> prices among associated enterprises. The arm's length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets, or intangible assets) is transferred or services are rendered between associated enterprises. While it may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups, acceptable to tax administrations. This reflects the economic realities of the controlled taxpayer's particular facts and circumstances and adopts as a benchmark the normal operation of the market.

Therefore, although some doubts about the ALP existed, in the BEPS project the OECD opted to focus on a stronger and more detailed guidance on its application[15].

Although both the OECD and the EU Commission are reconsidering the ALP in their ongoing working projects on taxation of the digital economy and CCCTB – looking at solutions going beyond the ALP – we still believe that the path traced by the OECD in the BEPS project must be followed.

This means that further guidance on the application of the ALP is required. This is the best solution to grant: (a) consistency with the principles applied to date, otherwise the discontinuity with the ALP could lead to inappropriate results. This is the case, for instance, of a principal operating model in which, assuming the framework of BEPS Actions 8-10 is met, the principal should have borne the losses related to the start-up period of the markets where the LRD operates. Under the new framework proposed by the Report, however, the extra profit should be attributed to the local presence that is assumed to have developed the marketing intangibles. It is clear that this outcome generates, at a MNEs group level, economic double taxation to the extent that the extra profit cannot be offset against the losses; (b) coherence among all the industries, otherwise there is a high risk that new frameworks for specific industries will significantly increase; and (c) less complexity, since several MNEs are running both a traditional business and highly digitalised business. In this situation it may not be manageable to differentiate between the two. Therefore, either a significant departure from the ALP for all the industries is to be made (but this would be incoherent with the position taken by the OECD in the BEPS project) by creating also a strong dispute resolution mechanism to balance the past situation (within the boundaries of the statute of limitations rules, which differ among the countries) or

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[15] In fact, the main outcome of the BEPS project is that, although the OECD spent considerable time and effort analysing the application of the ALP, the 2010 version of the TPG did not provide enough guidance on how to apply the ALP. The BEPS project identified that the existing international standards for transfer pricing rules can be misapplied so that they result in outcomes in which the allocation of profits is not aligned with the economic activity that generated them. The work under Actions 8–10 of the BEPS project targeted this issue to ensure that transfer pricing outcomes are aligned with value creation.

work needs to be continued on the application of the ALP. The latter is the best solution and certainly meets the aim of reducing complexity.

With reference to the development of a fractional apportionment method as envisaged in the Report, we believe that the concerns outlined by the OECD in section C of Chapter I of the TPG are still relevant. In particular, although the aim of capturing the value of the market/users represents one of the main critical success factors of the groups, it is not possible to totally ignore the extensive investments in intangibles by highly digitalised business that form the main value of such groups. The challenge of finding appropriate allocation keys to take into account both contributions could lead to a result not aligned with the effective value creation.

II.C.3 Would the RPSM reduce complexity?

In our experience, the profit split method seems, at first glance, always (or almost always) the most appropriate method. This is mainly because: (a) MNEs tend to be integrated[16]; (b) associated enterprises may engage in transactions that independent enterprises would not[17]; (c) the functional profiles of the local entities are, in fact, complex (due to the existence of strategic functions also in the case of LRDs and contract manufacturers); and (d) very reliable comparables are difficult to be found. However, in practice, profit split is often not selected due to its several peculiarities leading to complexities (e.g., common accounting standards for determining the consolidated profit, selection of the value drivers, and practical application), and results that can be unaligned with value creation (profit split could apply in absence of comparables).

With reference to the complexities, para. 2.123 of the TPG (as amended by 2018 Revised Guidance on the Application of the Transactional Profit Split Method) provides a good overview of some of the practical issues to be addressed:

> 2.123 A weakness of the transactional profit split method relates to difficulties in its application. On first review, the transactional profit split method may appear readily accessible to both taxpayers and tax administrations because it tends to rely less on information about independent enterprises. However, associated enterprises and tax administrations alike may have difficulty accessing the detailed information required to apply a transactional profit split method reliably. It may be difficult to measure the relevant revenue and costs for all the associated enterprises participating in the controlled transactions, which could require stating books and records on a common basis and making adjustments in accounting practices and currencies. Further, when the transactional profit split method is applied to operating profit, it may be difficult to identify the appropriate operating

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[16] See para. 1.10 of the TPG.

[17] See para. 1.11 of the TPG.

> expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities. Identifying the appropriate profit splitting factors can also be challenging. Given the necessity of applying judgement in determining each of the parameters for the application of the transactional profit split method, it will be particularly important to document how the method has been applied, including the determination of the relevant profits to be split, and how the profit splitting factors were arrived at. See sections C.4 and C.5.

For this reason, profit split, in its general use, could be more appropriate as a sanity check when the primary method could lead to unreliable results (although sanity checks are not mandatory) [18].

With reference to the issues addressed in the Report, it is worth remarking that the solution to address the tax challenges of digitalisation should be suitable to achieve a result aligned with value creation, and not overly complex.

We believe that the issues outlined in para. 2.123 of the TPG completely fit to the case of highly digitalised business.

It is particularly noteworthy that highly digitalised businesses are usually carried out by MNEs with: (a) diversified business (i.e., also traditional business) and (b) a complex and structured organisation.

With reference to diversification, to be able to apply the profit split method reliably, the traditional business accounts should be segregated in order to have the consolidated accounts of only the highly digitalised business.

This would create complexity and subjectivity because it will be impossible to rely on public accounting data, and, therefore allocations should be performed.

The second issue regards the organisational structure of MNEs engaged in highly digitalised business in which the following usually co-exist: (a) top holding, (b) global and regional headquarters, (c) entities devoted only to specific brands/products/activities, and (d) local entities. To apply a profit split in these cases would be extremely complex since several consolidations (among the entities) and segmentations (for splitting the results of the markets) should be applied.

In addition, more concerns exist on how to split the consolidated profits among the local presence and the unique contribution of the other group entities. In particular, it is extremely difficult to envisage one or more allocation keys for obtaining a reliable attribution of profits among the various entities.

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[18] See para. 2.12 of the TPG.

This is because the existing possible allocation keys do not seem to properly capture the added value generated by the different contribution, e.g.:

(i) Asset based: these can be used when there is a strong correlation between tangible or intangible assets or capital employed and creation of value[19]. The local presence does not contribute any significant assets to the business; therefore, this kind of allocation key is inappropriate;

(ii) Cost based: an allocation key based on expenses may be appropriate when it is possible to identify a strong correlation between relative expenses incurred and relative value added[20]. Cost-based allocation keys seem inappropriate since, in a digitalised business, people functions are not the primary factor in generating the combined profits. In addition, in the case of a SEP, there is a concrete risk that only few costs are attributable to it;

(iii) Headcounts: also this kind of allocation key is irrelevant due to the possible marginal local presence; and

(iv) Users: it would not capture the value of R&D functions.

Therefore, the selection of the profit split would lead to an outcome that: (a) is too complex, due to all the accounting adjustments and information required, (b) is too burdensome, and (c) provides results that do not gather the real contribution to value creation.

Indeed, the practical difficulties of the application of the profit split to highly digitalised business derives from the heterogeneous nature of each party's contribution. These could be solved, at the end of the day, applying a one side method, whereas finding a common allocation key for capturing such a different contribution would lead to a subjective exercise, with the increasing risk of cross-border disputes.

II.C.4 The importance of confirming the DEMPE analysis

The OECD's second proposal relies on the concept of marketing intangibles as defined in the Glossary of the TPG. First of all, it is important to remark that this proposal may have a wider impact than the user participation one since it may potentially

[19] See paras. 2.179 and 2.180 of the TPG (as amended by 2018 Revised Guidance on the Application of the Transactional Profit Split Method).

[20] See para. 2.181 of the TPG (as amended by 2018 Revised Guidance on the Application of the Transactional Profit Split Method).

affect the digitalisation on the economy (also including traditional business). The underlying reason supporting it is that "It sees an intrinsic functional link between marketing intangible and the market jurisdiction" given that it moves from the assumption that the "intrinsic functional link" may be manifested either through favourable attitude in mind of customers or from activity targeting the users in the market jurisdiction.

In light of its wider scope, we believe that the proposal should be more focused on the actual activities that may create nexus (i.e., whether a significant role in the marketing and sales function exists) rather than assuming the existence of a nexus on the basis of marketing intangible disregarding completely the current framework of the DEMPE analysis.

For example, if we examine para. 30 of the Report, the first critical point is to assume that the local presence "develop[s]" a marketing intangible. The use of the term "develop" is inconsistent with what is stated in paras. 6.76−6.78 of the TPG, where the DEMPE functions attributed to the distributor is the enhancement.

The second point is the "intrinsic functional link between marketing intangibles and the market jurisdiction", a concept which seems: (a) not fully clear; (b) inconsistent with para. 6.31 of the TPG; and (c) theoretically applicable to all kinds of business (so also to traditional business).

Furthermore, the clarification provided under para. 31 of the Report on the "functional link" does not shed any light on the application of the concept mentioned above.

Indeed, on the one hand it is difficult to understand where the "favourable attitudes in the minds of customers" differs from the market specific characteristics addressed under section 6.31 of the TPG (which does not lead to any intangibles). For example, the digitalisation of a certain country (deriving from local policies) is a form of market characteristic not governable by the MNEs that impacts the attitude of the customers. The same could apply to any other industry (e.g., a favourable welfare regime that could impact on the consumer of drugs). With reference to the second sentence of the paragraph under analysis, the elements mentioned constitute the results of distribution/marketing activities also performed by local comparables. It is therefore difficult to understand whether those represent unique and valuable intangibles:

> 6.11 Care should be taken in determining whether or when an intangible exists and whether an intangible has been used or transferred. For example, not all

> research and development expenditures produce or enhance an intangible, and not all marketing activities result in the creation or enhancement of an intangible.

Therefore, the market characteristics should be captured through the selection of appropriate local comparables.

Moreover, we further disagree with the starting point of the marketing intangible approach, which is stated under paras. 36 and 37 of the Report:

> 36. Importantly also, the proposal maintains that the implications of BEPS Actions 8-10 are different for marketing and trade intangibles. The proposal is premised on the view that MNE groups now have less ability to shift profits attributable to trade intangibles, which generally arise from substantial, observable activities arising in a specific location. In contrast, the proposal contemplates that the situation is significantly more challenging with respect to marketing intangibles, where the link between specific and substantial activities and the return is less readily apparent. Similar considerations also influenced the decision in the context of BEPS Action 5 to permit certain incentive regimes for trade intangibles but not for marketing intangibles. [emphasis added]

This statement is inconsistent with the founding principles of Chapter VI of the TPG which clearly refrain from creating an a priori definition for transfer pricing purposes of the meaning of the intangibles[21]. The approach suggested by para 36 of the proposal, deviated clearly from the solution endorsed by para 6.15 and 6.16 of the TPG "where it clearly states that the approach provided does not apply differently for the category of intangibles".

In particular, the methodological approach designed by Chapter I and VI of the TPG (which is based on the analysis of the actual contribution in terms of functions, risks and assets of the different parties of the transaction) allows already to properly identify who is the owner for transfer pricing purposes of the marketing intangibles. This derives from the first key point, i.e., legal ownership serves simply as reference point[22] where the remuneration will be attributed based on the contribution to development, enhancement, maintenance, protection and exploitation (DEMPE functions)[23].

Moreover, we believe that the reference to BEPS Action 5 to the existence of a "link between specific and substantial activities" may be misleading given that the approach chosen by BEPS Action 5 clearly departs from the ALP and is based on the "nexus approach" which requires a link between a tax benefit and the expenditure that

[21] See in this respect, para. 6.6 of the TPG where it is stated that "[…] to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."

[22] See para. 6.43 of the TPG.

[23] See para. 6.45 of the TPG.

contributed to developing the intangible. It is clear that in the context of BEPS Action 5, the selection of an approach different from transfer pricing (aimed at granting that IP holding company performs substantial activity) was acceptable to the extent that it was limited to counter harmful preferential tax regime. We believe that to borrow this principle to tackle situation concerning marketing intangible may create potential disputes and uncertainty given that: (a) the identification of marketing intangible is an exercise that may involve a discretionary approach in evaluation of facts and circumstances; (b) may create a dangerous overlap between intangibles and comparability factors; (c) systematically authorises tax authority of the "market jurisdiction" to apply an aggressive approach.

Furthermore, the statement under para. 37 of the Report is not fully clear, since a proper application of the DEMPE analysis would avoid any shift of remuneration related to marketing intangibles. Indeed, a proper application of the DEMPE approach would avoid the shift of marketing intangibles in the absence of a transfer of functions, assets and risks, whereas in the past the mere legal ownership transfer (or the misuse of cost contribution arrangements) led to a shift of profits to (also) low tax jurisdictions in the absence of any effective control over DEMPE functions[24].

In addition, with reference to marketing intangibles, we have to point out that: (a) significant strategic activities are required even though the asset intensity is different from that required to develop trade intangibles, and (b) a strong interrelation exists between marketing and trade intangibles in several types of business, which renders any form of segmentation artificial.

With reference to point (a), marketing intangibles currently constitute one of the main assets of MNEs. This is true also for highly digitalised business, as confirmed by the fact that six of the top ten brands in Forbes' annual ranking are from MNEs in the technology business[25]. This value is certainly generated by the strategic decisions taken at the level of headquarters (brand image, naming, logo identification, communication strategy, purpose, etc). Looking at the luxury business, the design activity for a new fashion show, the selection of ambassadors and testimonials, the framework and theme of the windows of the retail shops, and the pricing of the products, are all

[24] "37. While MNE groups for a long time have had the ability to capture marketing intangible profits outside the market jurisdiction in low tax jurisdictions, recent developments have enhanced their ability to do so which in turn justifies taking a fresh look at this point in time".

[25] https://www.forbes.com/powerful-brands/list/#tab:rank.

elements defined at central level and impact the DEMPE functions regarding marketing intangibles.

With reference to point (b), the interrelation between marketing intangibles and trade intangibles renders a split between those artificial in several types of business. Indeed, it is extremely difficult, from an economic standpoint, to understand where the brand value ends and the technology value begins. This applies equally to traditional business (the value of a luxury automotive brand is interrelated to the one of the patents and know-how embedded in the cars) and highly digitalised business (how does one split the value of the brand of the most important marketplace platform with the one of the algorithms and software used to carry out such business?).

We indeed believe that the concerns of the OECD outlined under paras. 36 and 37 of the Report may be appropriately addressed through: (a) an in-depth DEMPE analysis, and (b) a search for local comparables.

II.C.1 Approach proposed

As outlined above, the first issue to be addressed is the characterization/nexus of the local activities. In this respect, and taking into account the peculiarities and the value chain of highly digitalised businesses, we believe that both the physical and SEP should be characterised as marketing operations.

Then, the mechanics for attributing profit to the local presence should be the same for both (a) physical presence and (b) SEP by applying a single taxpayer approach (i.e., in case of physical presence, also the activities generated by a SEP should be attributed to it). In our view, this approach should rely on the ALP in order to grant: (a) avoidance of the double taxation; (b) consistency with the principles applied so far; (c) coherence among all the industries; and (d) less complexity.

The characterization of the local presence as marketing operations leads to the application of methods based on a return on turnover. This, as outlined under para. 6.78 of the TPG, would allow to capture the market penetration through a remuneration that would benefit from: (a) the turnover generated and (b) the market share:

> 6.78 […] For example, a distributor may have the ability to obtain benefits from its functions performed, assets used, and risks assumed in developing the value of a trademark and other marketing intangibles from its turnover and market share when it has a long-term contract providing for sole distribution rights for the trademarked product.[..] [emphasis added]

The application of a resale price/TNMM selecting local comparables should allow to obtain a remuneration aligned with the value created on the market and the related functional link with the market jurisdiction. In absence of reliable local comparables, a reliable adjustment should be applied (a possible approach would rely on regional comparables with market adjustments).

In case the activities performed locally should also enhance the marketing intangibles, the principles provided under example 10 to the Annex to Chapter VI of the TPG should apply. In this respect, we strongly suggest to increase the remuneration via either: (a) the selection of a position in the interquartile range above the median; or (b) using a comparability adjustment by providing a mark-up on the costs of the local employees for the marketing activities.

These tailored measures should apply only in case of physical presence. Indeed, although the method (and its rationale) should be the same for physical and SEP, it is needed to differentiate the remuneration for taking into account the value provided by a physical presence (otherwise, the taxable income should be the same regardless the performance of any local activity).

III. 3. What would be the most important design considerations in developing new profit allocation and nexus rules consistent with the proposals described above, including with respect to scope, thresholds, the treatment of losses, and the factors to be used in connection with profit allocation methods?

In light of our comments above, we reaffirm that any approach should rely on the ALP. This will ensure: (a) avoidance of double taxation; (b) consistency with the principles applied thus far; (c) coherence across all industries; (d) less complexity; and (e) adoption of a multilateral solution to solve issues arising from businesses operating without a physical presence.

With reference to points from a) to d), the ALP would not only be considered correct from a technical point of view, but it would also ensure immediate certainty and avoid any need to amend the current double tax conventions.

An ALP-based approach would cover not only highly digitalised business but all business impacted by digitalisation (e.g., e-commerce carried out by traditional business).

The first key step is to perform an in-depth value chain analysis consistent with Chapter I of the TPG, in order to understand whether the local presence could be characterised as marketing operation functions.

From a quantitative standpoint, the ALP could be applied concretely by using a transfer pricing method that relies on the return on turnover (either RPM or TNMM) – this will account for the dimension/size and share of the market and the related value for the MNEs. A SEP should have a slightly lower remuneration than a physical presence in order to take proper account of the activities performed locally.

In our view, applying a profit split method might increase complexity and result in a burdensome activity for the taxpayer.

As to the threshold, we believe that both qualitative (in terms of nexus) and quantitative (in terms of volumes) thresholds should be set for SEP only.

On the other hand, we discourage thresholds on physical presence, as they could be considered inconsistent with the ALP and incoherent with the current rules generally applied to other industries.

If both physical and SEP co-exist, a single taxpayer approach should be applied to attribute the SEP activity to the physical presence.

Finally, losses should still be attributed to the entity performing/controlling all the key strategic functions (i.e., the entity that bears the key risks and contributes the key assets). This means that, in general, losses should not be attributed to the local presence.

IV. 4. What could be the best approaches to reduce complexity, ensure early tax certainty and avoid or resolve multi-jurisdictional disputes?

We believe that any amendment should be based on the ALP for both cases in which there is a physical presence and in which MNEs operate without a physical presence (i.e., through a SEP).

In our view, to reduce complexity, ensure tax certainty and avoid disputes the following should be considered:

(i) With regard to the criteria to tax highly digitalised businesses, by implementing the ALP as stated in our response to question 2, by either introducing a specific chapter to the TPG or updating the current Chapter I, III and VI of the TPG;

(ii) With regard to the implementation of the nexus for establishing the existence of a SEP (in the absence of a physical presence) by adopting a multilateral solution (such as a multilateral convention); and

(iii) With regard to the criteria to tax permanent establishments arising from changes deriving from the multilateral solution under point ii) above, to either issue a new report on the attribution of profits to permanent establishments or update the Report.

More specifically, in our view the solutions under point i) and iii) would enable immediate implementation in the OECD countries and coherence with the past.

With regard to the solution suggested under point ii), we believe that in terms of timing and efficiency the best option to avoid disputes and uncertainty would be to implement, in the context of a multilateral instrument, amendments covering new "nexus" rules for establishing a SEP.

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Please do not hesitate to contact us if you require any clarification on these comments.

We look forward to discussing any questions you have on our comments or on other specific matters raised by other commentators on the Report.

Yours sincerely

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