CBI

CBI RESPONSE

OECD PUBLIC CONSULTATION DOCUMENT – ADDRESSING THE TAX CHALLENGES OF THE DIGITALISATION OF THE ECONOMY

Published: 13 February 2019; Closing dates for comments: 6 March 2019

Background

As the UK's leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce in the UK, covering the full spectrum of business interests both by sector and by size. Members include those in the new "digital economy" as well as more traditional businesses.

We welcome the progress the OECD has made on this matter and the opportunity to provide input into your policy making process on proposals to address the tax challenges arising from the digitalisation of the economy. We continue to support the OECD as the right body to lead reform in addressing the tax challenges of the digitalisation of the economy. Businesses, and the millions of customers they serve, need to have a stable and consistent framework for raising tax in a broad based and non-distorting fashion in the many jurisdictions in which they operate. In light of the complexity of the issues at hand, the OECD consultation document represents an important step forward.

We have structured our response to set out initial comments on the consultation before responding to questions raised within the document. We have taken this approach because we believe there are some overarching points in relation to the proposals, which should be considered prior to delving into the specific detail on each individual proposal.

If you have any questions or would like any further detail, please do not hesitate to get in touch. We look forward to continuing to work with you as your work in this area progresses.

Key points

1) The OECD is the right body to lead this reform

We support the need for reform to the international tax system, in particular to address the political momentum for governments to adopt unilateral measures in response to the impacts of digitalisation. These uncoordinated unilateral measures create economic distortions, reduce investment and growth and significantly increase the risk of double taxation and uncertainty for business.

We consider the OECD the right organisation to lead this reform and welcome the progress that has been made on this matter in outlining what long-term solutions may be, whilst recognising that each of these individual proposals comes with associated challenges. These challenges are not insignificant and would need to be addressed if any of the proposals are to represent long-term sustainable reform, for both governments and business.

In developing the detailed design of these proposals, we encourage the OECD to remain focused on the opportunities to simplify the tax system, rather than add further complexity. We have included a number of principles within the detail of our response that we believe will help to achieve this. The CBI and its members remain committed to working with the OECD to consider and constructively contribute to the proposals as they develop.

Any new set of rules must be proportionate, neutral, equitable, and enforceable for all governments. We consider that the following principles will be critical in achieving this;

- Tax transparency and equality of application for jurisdictions and taxpayers
- Cohesion with the existing international tax framework (including respect for the arm's length principle)
- No double taxation and unintentional non-taxation
- (Administrative) efficiency and enforceability
- Consistency across jurisdictions
- Certainty and simplicity (including predictability)

2) Cohesion with existing international tax framework

It is critical that any new proposal is complementary to the existing international tax framework, rather than contradictory to it. The arm's length principle, in particular, is an internationally recognised approach which has been further reinforced by the output of the Base Erosion and Profit Shifting (BEPS) project (as noted in the consultation document). Any approach to dealing with the digitalisation of the economy which contradicts or undermines this will create a disjointed framework, leading to uncertainty and instability.

The interaction with the existing BEPS framework is key. Significant work by both tax authorities and taxpayers has gone into developing the framework and the behavioural changes this has already driven are noted. However, we are concerned that some of the proposals are not only seeking to address different challenges but are also going directly against consensus previously agreed under the BEPS Actions.

As currently presented, each of the proposals will represent an overlay to the current international tax framework, which will add further complexity to a system that is already difficult for governments and businesses to administer. Our members are concerned that this overlay will create greater uncertainty, leading to additional compliance costs and double taxation. It is therefore essential that these risks are considered in any proposal taken forwards and safeguards are implemented to minimise these.

Some of our members also question whether a more comprehensive review of the tax system is necessary, rather than a piecemeal approach adopted by the proposals in the consultation document.

We recognise the importance of the OECD demonstrating progress in this area (as noted above, particularly due to the growing political momentum for individual countries to adopt unilateral measures). The proposals in the consultation document represent an important step forward. However, we consider there is still a long way to go to reach consensus on both the principles underlying any changes to the current international tax framework and the detailed policy design. Any change will need to overcome significant transitional challenges - both in terms of practical difficulties and due to the likelihood of inconsistencies with some aspects of the current framework. Therefore,

a balance needs to be struck between action which reverses the growing trend for individual jurisdictions to implement unilateral measures, whilst ensuring any proposal adopted represents sustainable long-term reform that is acceptable to all businesses as well as tax administrations.

All the proposals presented in the consultation document will take time to implement, including the need for changes to domestic law as well as treaty changes and potentially conflicting aspects of existing international provisions. Some of our members question whether a more pragmatic solution would be a two-step approach;

Step 1) Enhancements to the current TP framework (rather than relying solely on a residual profit split), to address some of the initial concerns, by allocating a portion, if any, of non-routine marketing intangible returns to a destination market jurisdiction (for instance, this could be achieved through using an additional mark-up within an acceptable benchmark range to attribute a non-routine marketing intangible return to the Limited Risk Distributor (LRD) functions in the destination market).

Step 2) Further targeted consideration of comprehensive long-term reform in response to the challenges associated with the digitalisation of the economy. This should follow detailed review of the impact of the BEPS recommendations and the outcomes of the changes under step 1.

However, to address the following risks this two-stage approach would require significant consideration to determine the extent of any additional mark-up that may be allocated to the destination market jurisdiction under step 1;

i) The increased non-routine marketing intangible return, if any, allocable to the destination market countries suggested under step 1 must not restate the "status quo", should respect the arm's length principle and DEMPE (development, enhancement, maintenance, protection and exploitation) functions and therefore, should not lead to the opportunity for a further increased profit allocation to the destination market under any step 2 long-term reform.

ii) Our step 1 proposal should not further instigate a growing trend of additional mark-ups being allocated to a broader range of transactions (outside the scope of these non-routine marketing intangible returns). This would significantly undermine the arm's length principle, which must remain an important pillar of the international tax framework.

Furthermore, as described further within our response corresponding changes may also be needed to any royalty withholding tax provisions in domestic law or treaties to the extent of any inconsistency or conflict with current provisions.

Some CBI members are supportive of a two-step approach if it provides a pragmatic solution to stop the current wave of uncoordinated unilateral measures being implemented. However, given the risks listed above, and the potential to prolong uncertainty, some CBI members have reservations about implementing a two-step approach. This group includes those members who consider that this approach undermines the arms' length principle. They view the additional allocation of taxing rights to marketing intangibles as effectively a market access fee which has the potential to create economic distortions. Specifically, the proposals risk favouring large countries that consume the outputs of innovation to the detriment of small open/innovative economies (this subset of members have equal concerns with the marketing intangible proposal).

3) International consensus on underlying issue to be addressed

Digitalisation is fundamentally changing the way all businesses operate. Some business models are more advanced than others in this regard, but all are heading in the same direction. This is to the ultimate benefit of everyone, as the knowledge transfer, innovation and connectivity facilitated by

digitalisation will promote global growth and development and facilitate more choice and options for consumers.

Against this backdrop it would be inappropriate for any changes in approach to be ring-fenced to certain business models. However, it is equally inappropriate for the changes to apply indiscriminately and impact other business models which are already adequately dealt with under the existing international tax framework. Any changes should be broad based, to avoid discriminating against different sectors of business unfairly, and should be sensitive to the interaction with the existing international tax regime, which has been developed through decades of hard intellectual work.

We are aware of the public scrutiny of multinationals and the (real or perceived) means by which digitalisation may facilitate businesses avoiding paying their "fair share" of tax as viewed by the public or governments. There is a need to address these issues and ensure that concerns are dealt with. However, it is important that any action taken reflects fiscal and economic reality, rather than misconceptions, and is not to the detriment of the wider international tax framework by seeking to address broader issues to which tax allocation is merely a symptom, rather than the underlying concern. Such changes have the potential to create distortions and/or negatively impact growth, investment and cross border trade.

We understand that there is no consensus between all governments on a specific set of underlying issues brought about by the digitalisation of the economy that are intended to be addressed by the proposals. Without clear articulation of the key issues that the project seeks to address, it is challenging to provide constructive feedback on how each of the proposals would fare in addressing them. Consensus on clear policy objectives will be necessary to design international tax reform that is effective and can be sustained in the mid-to-long term. We consider in particular that the following questions should be asked and concluded on by the members of the Inclusive Framework;

- Whether the primary purpose is to change the allocation of taxing rights between jurisdictions or to introduce further anti-avoidance rules on the assumption that the BEPS package has not been fully effective to date?
- Whether the purpose of these proposals is to introduce new rules to address the specific issues arising from new business models as a result of the digitalisation of the economy i.e. where digitalisation is perceived to facilitate companies generating value in a territory without a local taxable presence (whether this presence arises from either a connected company/permanent establishment or a third-party distributor)? Or as part of reform of a more fundamental nature, driven by a need to change how traditional businesses are taxed too?

4) No Double Taxation

CBI members recognise that the digital revolution is not without its challenges and the public perception that the tax system is one area that requires modernisation to ensure it remains effective. Members support action to address these concerns. However, it is of fundamental importance for all our members in the design of any change to the international business tax framework that it must be a tax based on profits, not revenues, and must only subject those profits to tax once. For every £1 of profit that is allocated to a market country, there must be an equal and opposite adjustment by another country to relinquish taxing rights over the same profits. It also follows that all business

expenses are deductible in arriving at the calculation of profit. This is critical to ensuring there is not double (or multiple layer) taxation.

i) Effective Dispute Prevention and Resolution Mechanisms

The importance of effective dispute resolution cannot be underestimated. The proposals being considered are anticipated to result in changes in relative country taxing rights – which may significantly change countries' relative fiscal positions - with this comes the increased risk of disputes arising. It is therefore essential that alongside any new rules must sit effective prevention and dispute resolution mechanisms, which will be essential in eliminating instances of double (or multiple layer) taxation and providing taxpayers with certainty.

We consider this an opportunity to rethink how international dispute resolution can be reformed to avoid double taxation so as to remove the risk of a potential disruption of international trade – via introducing a new required minimum standard to be adopted for dispute resolution. Whilst we support the current Mutual Agreement Procedures and International Compliance Assurance Programme (ICAP), they are unlikely to be sufficient for these proposals. Effective dispute resolution should include the following;

- ***Mandatory binding arbitration adopted on a multilateral basis with peer review –*** Given the multilateral nature of these proposals it's likely those disputes that arise will span multiple countries and therefore bi-lateral dispute resolution will be ineffective. This could be overseen by a panel of member countries (similar to the procedures outlined in Part VI of the Multilateral Instrument) or overseen by a recognised independent global body.
- ***Timely dispute resolution –*** There must be a clear pathway agreed for effective multilateral dispute resolution within a reasonable timeframe. Alongside this, mechanisms should be in place to incentivise the timely resolution of disputes. Payment of double taxation upfront whilst disputes are taking place significantly penalises business (especially in countries where inflation is high). Therefore, one incentive mechanism for timely dispute resolution could be delaying the payment of double tax whilst disputes over double taxation are ongoing.
- ***Certainty –*** Mechanisms should be included to provide taxpayers with upfront certainty, which would be beneficial for both taxpayers and governments to avoid future lengthy and costly disputes. Dispute prevention could be further enhanced by providing advance certainty, for instance via safe harbours, agreed definitions, examples, methodologies, as well as advance agreements. Upon resolution of disputes, the facts and circumstance of the dispute and the conclusion reached should be published on an anonymised basis to promote consistency of approach by jurisdictions.
- ***Accountability and transparency -*** Similar to the OECD peer review and monitoring process on BEPS, similar information should be published by the OECD on dispute resolutions to ensure governments remain accountable. This published information should include whether a jurisdiction is in line with international standards, the number of ongoing disputes, number of resolved disputes and average timeframe in which disputes are resolved per jurisdiction.

ii) Global Consistency of Measurement

Alongside effective dispute resolution, to minimise instances of double (or multiple layer) taxation which are the source of disputes, international alignment in measuring the tax base and

consistency of approach on a global basis will be of significant importance. If each jurisdiction applies a separate set of rules this will increase the likelihood of double (or multiple layer) taxation.

In determining the tax base, the following should be considered;

- Given that the proposals under Pillar I contemplate that the residual profit is allocated amongst various jurisdictions, there needs to be a globally consistent view on what that global residual profit is. Allocation based on this system is likely to trigger various timing considerations given that multinational enterprises may not have certainty over the quantum of their residual profit for several years until tax enquiry windows have passed and any open enquiries are closed.
- In reaching this global consistent measurement of tax base, a tax deduction for all business expenses should be allowed otherwise this could result in double (or multiple layer) taxation and tax uncertainty for business. This is particularly important for new business models enabled by digital capability which now allow for the centralisation of support activities in lower cost countries. These costs still need to be deducted from taxable income. It should be acknowledged that whilst on the one hand these new business operating models have driven down global operating costs, they have also facilitated a significant expansion of employment opportunities in lower income countries.
- The underlying principle should be that the required financial data is simple for companies to collate and ideally should be readily available to minimise the administrative burden for business. All the proposals seem to necessitate creation of (new) data sources and streams that do not naturally exist. The new rules should not require bespoke financial information to be prepared, nor force companies to bifurcate financial data into arbitrarily designed segments.
- The financial data should be subject to statutory audit to reduce the scope for disputes. However, consideration would need to be given to the extent to which the determination of the tax base is dependent on a starting point of an accounting measurement of profits. Whilst there is an increasing level of convergence in International Accounting Standards, we are not yet at a position where global consistency in the accounting measurement of profits can be assumed.

iii) Losses and transition issues

Allocation of losses (as well as profits) needs to be considered in detail, including consideration of how historic investment is treated. Any proposal would also need to consider the tax treatment of transition (including exit charges) and consideration should be given to transitional relief (please see our comments in section 6 below).

5) Requirement for further consultation with relevant stakeholders

We note the timeline for comment to this consultation is very short and the consultation document focuses on the proposals at a high level only, our comments should therefore be considered in that context and treated as initial observations. In order to ensure that any long-term reform to the international tax system is effective and sustainable, the proposals should be developed in partnership between members of the Inclusive Framework, business and other relevant stakeholders. Ahead of

any conclusions being reached, in-depth consultation should take place to ensure that multinational businesses have time to consider and constructively contribute to the proposals as they develop.

Given the breadth and potential significance of many of the proposals, active input should be sought from all businesses, not just those viewed as "digital" businesses. Many of the CBI's members outside the digital sector have not been closely following the progress of the OECD on this matter. For these businesses, the proposals present new and complex concepts with the potential to fundamentally reform the international tax system. It is therefore necessary to provide all businesses with the opportunities and time in which to evaluate the proposals and provide full comments.

We consider that a further consultation should take place as soon as the Inclusive Framework can provide further detail on the design and implementation of the proposals. This consultation should include worked examples of the application of the proposals and a detailed economic impact assessment. This will be necessary for businesses to fully evaluate the application of each proposal, alongside identifying where significant issues may arise to suggest improvements. We hope the comments provided in this response will be of assistance in highlighting those areas which need to be considered as part of a further detailed consultation process.

6) Areas for further consideration

As outlined above, we consider that these proposals should be used to ensure simplification of the international tax framework rather than adding another layer of complexity. In this respect there are the following areas which need consideration in the development of the proposals.

i) ***Interaction with withholding taxes on interest, royalties and technical service fees***: These proposals will require a re-think of the role and purpose of withholding taxes otherwise significant distortions could occur. The proposals on the table could have a fundamental impact on how different parts of a multinational business transact with each other to give the desired policy outcome. For example, if there is an intention for more profits to be taxed in 'source' states, then that could reduce the volume of payments made to 'residence' jurisdictions, having a knock-on impact on the withholding tax collected in the 'source' state. The policy intention should be made clear as the options are further developed.

   We would also note that withholding taxes are noted as a possible collection mechanism and enforcement tool in the consultation document[1], further clarity would be welcome on how this will interact with the current system and full consideration of the process for timely refund of excess withholding taxes.

ii) ***Interaction with indirect taxes:*** Consideration should be given to how the OECD will co-ordinate its approach with how indirect taxes (in particular import taxes/tariffs) are applied to multinationals. Many customs' authorities currently don't accept that the arm's length principle can be used to evidence the import value of a product or raw material (under the 'transactional

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[1] Para 55 states "the [significant economic presence] proposal also contemplates the possible imposition of a withholding tax as a collection mechanism and enforcement tool. In this context, consideration could be given to a gross-basis withholding tax at a low rate on payments to an enterprise with a significant economic presence, with the enterprise having the right to file an income tax return and seek a refund if the withheld amount exceeded the enterprise's income tax liability."
Para 57 states that all the Pillar 1 proposals could include the "possible use of a withholding tax as a collection mechanism or enforcement tool".

value method') and reject it out of hand in favour of other methodologies that result in higher tax receipts.

In adopting proposals that result in greater profits being taxed in source countries, the valuation for indirect taxes should reduce. Therefore, careful consideration will need to be given to the delivery mechanism, and its impact on other tax types. We have provided case studies in our responses to the marketing intangibles proposal that draw out these issues in further detail. Importantly, the allocation of profit to a market country should not create a fixed establishment for VAT purposes. This should be clearly agreed to by all countries.

iii) ***Capital gains on transfer of intangibles:*** If the right to tax profits is allocated between jurisdictions in a different manner to capital gains, there will be significant asymmetry in the tax systems. The interaction of current year allocations of taxable income with one-off taxing events (such as acquisitions and disposals) needs to be fully considered. For example, with reference to the marketing intangible proposal, policy and design questions include whether there should be transition rules as many intangibles may be being amortised for tax purposes. A further example would be whether on implementation of the new proposals there will be exit taxes referenced to the fall in value of the marketing intangibles in the current country of ownership and a corresponding amortisable tax base in the country to which the marketing intangibles have been transferred. Exit taxes arising within a multinational group impose a significant cash burden that reduces capacity for future investment.

Consultation question response

Revised Profit Allocation and Nexus Rules (Pillar I)

Q1: What is your general view on those proposals? In answering this question please consider the objectives, policy rationale, and economic and behavioural implications.

The 'user participation' proposal

The scope of the 'user participation' proposal (which is premised on the position put forwards by the UK Government[2]), seeks to capture the same business models - search engines, social media platforms and online marketplaces - as the UK's proposed Digital Services Tax (the UK DST). The CBI has been actively involved in considering the UK DST and we highlight the following concerns that have arisen through discussions with business on this approach (we also attach as an Appendix an extract from our full response to the UK Government's consultation regarding the design of the UK DST, which provides further detail on each of these points);

1) Boundary issues in ring-fencing the digital economy

In line with the OECD's Interim Report[3] we do not consider that it is possible or desirable to ring-fence the digital economy. Many companies undertaking predominantly digital activities also

[2] UK HM Treasury position paper entitled 'Corporation tax and the digital economy: Position paper update' March 2018

[3] OECD Inclusive Framework on BEPS report entitled "Tax Challenges Arising from Digitalisation – Interim Report 2018"

show elements of "traditional business", such as storefronts, warehouses and assembly plants, and all companies are adopting new technology and becoming increasingly digitalised.

The proposal which is premised on modifying the current profit allocation rules for certain businesses[4], would require these business models to be defined. This is an entirely novel approach that has not been successfully implemented before. There are both conceptual challenges as to where the boundary falls and practical difficulties with applying it. Over time we expect these difficulties to increase further as businesses become increasingly digitalised. Therefore, we do not consider this a sustainable long-term proposal.

2) *Income and overhead apportionment*

Many businesses will have both in and out-of-scope business models, the proposal will therefore require profit to be attributed to the in-scope business model. This will be particularly difficult in highly integrated business models, and where an in-scope activity may represent an auxiliary function, which does not directly generate revenue.

Many "traditional" businesses will find they have in-scope activity, even if it is auxiliary to the core business. For example, many businesses have a "social media" platform as part of their engagement strategy with their customers. This may take the form of online communities, Q&A sections of websites where users can share knowledge regarding the product offering. These (free) "social media" functions are not monetised via advertising but form part of a wider offering and create brand awareness. We observe from a CBI business survey that businesses undertaking such activities are common and we only expect this to increase over time as businesses become increasingly digitalised and respond to consumer trends. [5]

3) *Attributing profits in line with value created*

A fundamental component of this proposal will be identifying how much of the residual profit might be attributed to user participation. A question remains over what this will be and is necessary to fully evaluate the economic impact of this proposal. This determination should be built on evidence from economic studies.

4) *Legal/ethical issues with tracking users*

To comply with this proposal, it will be necessary for business to track the location of their users to enable them to allocate profit between jurisdictions[6]. There is an ever-growing spotlight on technology businesses regarding the level of data they store on their users. Tracking user locations is increasingly being seen as ethically wrong, and in some cases legally wrong (as a result of EU General Data Protection Regulations and similar rules in other jurisdictions).

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[4] Para 28 states "It is proposed that the approach would be targeted at highly digitalised businesses for which user participation is seen to represent a significant contribution to value creation. That would include, and perhaps be limited to, social media businesses, search engines and online marketplaces."

[5] The CBI conducted a survey between 9 January 2019 and 25 January 2019 to understand the wider impacts of the proposed UK digital services tax. The survey had 210 respondents. 9% of respondents said that some of their activities would fall within the social media definition and 16% said some of their activities may fall within the social media definition outlined in para 3.14 of the consultation document.

[6] Para 24 (3) states that the envisaged mechanics will be that profits are allocated "between the jurisdiction in which the business has users, based on an agreed allocation metric (e.g. revenues)."

Determining user location also poses some complicated technical questions. We observe that there will be an increased burden on businesses to identify and try to collect this data, many of whom do not currently record this data either because it is simply not relevant to their business or due to the complex and technical obstacles surrounding identifying user locations and ultimate users. These issues will be unique to any other compliance requirements for tax matters (such as identifying jurisdiction for VAT purposes) given that this proposal requires user location to be tracked where the user is not also a customer. In these instances, users will not often be providing the platform with any information on their location (i.e. billing information), therefore the only means to identify user location will be via reference to the user's IP address.

The use of virtual private networks (VPNs), proxy servers and anonymity servers (such as 'Tor') all seek to mask a user's location. The use of these are widespread and therefore, in some instances businesses will simply be unable to determine the location of users by reference to their IP address, or it will provide an incorrect determination.

YouGov research undertaken in 2017[7] found that 16% of British adults had used a VPN or proxy server, with the main motivation (48%) being to access regional based content which would not otherwise have been available, followed by 44% of VPN users citing security reason. This research evidences that there is a not insignificant proportion of the British population actively seeking to ensure their location remains undetectable. We understand that in some other countries the use of VPNs may be even more prevalent (e.g. owing to the desire to access country-restricted websites).

In reality we believe this may be an underestimation as many users are likely to unknowingly have their location masked. For example, many multinational enterprises have a single server for operations spanning several countries. When these users engage with in-scope activities via their work computers, reference to IP addresses will also provide an incorrect determination of user location.

We observe that there are specific difficulties for advertising revenues to be tracked based on user location. As part of a CBI business survey[8] we asked businesses who earn revenues from advertising to customers/users based on their location through one of the in-scope business activities (i.e. search engines, social media platforms or online marketplaces) whether they currently track those revenues based on the location of the customers/users. 62% of those businesses surveyed that do earn such revenues responded that they currently do not track/split out advertising revenues based on the location of customers/users or they do hold some data on the location of customers/users but would face difficulties in accurately splitting out the advertising revenues based on customer/user location.

'Marketing Intangibles' Proposal

Unlike the user participation proposal, the marketing intangibles proposal does not explicitly ring-fence the digital economy and therefore we recognise the potential for it to represent long lasting reform that could be applicable to all industries and business models and may also be durable to

[7] https://yougov.co.uk/topics/politics/articles-reports/2017/05/17/almost-half-vpn-users-are-accessing-region-based-c

[8] The CBI conducted a survey between 9 January 2019 and 25 January 2019 to understand the wider impacts of the proposed UK digital services tax. The survey had 210 participants.

evolve as new business models develop. However, there is potential it could disproportionately apply to consumer-facing businesses (which may or may not include some highly digitalised businesses) – see below for further details. We consider that considerable further work would need to be undertaken to establish how this proposal would work in practice. As with all the proposals, we consider there are a number of challenges in design that would need to be addressed. We highlight some of those in the following sections.

Whilst the marketing intangible proposal does not ring-fence the digital economy, consideration should be given to its equality of application across all businesses. A number of members are concerned that the marketing intangible proposal would have a disproportionately varied impact across businesses and sectors - as outlined in our comments under 'Key Points – 1) The OECD is the right body to lead this reform' we consider that any new set of rules must be equitable to both governments and taxpayers. Different businesses invest in different types of Intellectual Property (IP) in different ways. Brand owners will typically invest in a wide range of marketing intangibles and trade intangibles, but the relative value of each business' investment in "marketing" to "trade" intangibles will differ significantly between businesses and sectors. By drawing a distinction based on "marketing" some members are concerned that the proposal has the potential to apply disproportionately to those businesses which invest heavily in consumer brands, resulting in distortive economic effects. Given the short period of time in which to comment on this proposal we have not been able to reach a consensus among our membership on this point and we consider that the OECD should give further consideration to this in collaboration with stakeholders.

1) *Marketing intangible profit to be allocated to the market jurisdiction*

There needs to be a clear consensus as to what this proposal is trying to address that is not already covered by the arm's length principle[9]. The arm's length principle is the cornerstone of the international tax framework and therefore any divergence risks undermining it, so it is essential that any such divergence is supported by a strong principled rationale and is as limited as possible.

The consultation document notes that there is a preliminary need to distinguish between trade intangibles and marketing intangibles (see comments above). Further consideration is also needed concerning the quantum of marketing intangible profit that should be allocated to the destination market jurisdiction under this proposal. This should be justified by reference to value creation principles and any proposed divergence from the arm's length principle explained and supported. It simply cannot be the case that the destination market jurisdiction develops or maintains all the marketing intangibles and therefore should be allocated the entirety of any associated profit. Otherwise, why would there be observable transactions between third parties for the acquisition and disposal of trademarks without any of the underlying business operations?

Instead an allocation should take the diverse contributions of participants in a digitalised economy into account, including innovation, production, strategic decisions, financing, current and historic investments, risk taking and the contribution of assets. A framework that does not adequately reflect all such contributions would be distortive and may undermine countries' broader objectives, e.g. their support in R&D to generate high-value jobs and spill-over effects arising therefrom, which themselves contribute to economic growth and cross-border trade and investment.

[9] See in particular examples 8-13 to Chapter VI in the Annex to the OECD Transfer Pricing guidelines.

If the proposal is to represent a sustainable long-term proposal, it is also important to strike a balance in the design of any proposal on the resulting impact to the tax revenues of net-exporting and net-importing countries. This proposal will inevitably result in certain countries being adversely impacted (i.e. surrendering part of their tax base), in particular in the case of exports - where a large element of the value is derived from R&D – net export countries would lose considerable tax revenues if the residual profit was allocated, in full or partly, to market countries. The costs for innovation and development would likely remain in the exporting country while future profits would, at least partly, be taxed in other countries, without proper recognition of the initial investment costs. We would recommend that a comprehensive economic impact assessment is undertaken to determine the impact of the proposals and ensure a consensus-based balance can be reached.

2) Scope of proposal

The consultation document outlined the three characteristics identified in the OECD Interim Report[10] that "enable highly digitalised businesses to create value by activities closely linked with a jurisdiction without the need to establish a physical presence", being scale without mass, a heavy reliance on intangible assets, and the role of data and user participation. However, this proposal appears to go further than what is envisaged here, and we would refer back to our comments we make above in respect of 'international consensus on underlying issue'.

It is vital that the scope of what is included under this proposal and in particular what is defined as *"to participate actively* in remote user or customer markets in a way, or to a degree, that was not possible before the rapid technological advances that have taken place in recent decades" is clarified. Unless there is clear definition over what is included/excluded and how this interacts with existing taxes, this proposal could lead to some unwanted situations and there are a number of detailed design considerations - we set out some examples to illustrate:-

Case Study 1 – Consumer Goods

Scenario 1– Limited Risk Distributor (LRD) Model

XCo Group is a branded consumer goods multinational. Its international brands are owned by entrepreneurial entities where substantive global brand-related DEMPE functions are carried out (including the development of global Advertising & Promotion (A&P) campaigns and strategies). The IP owning entities undertake technical innovation/R&D work (which they may also partly outsource to other related party entities) to further develop or extend their existing portfolio of brands/products. XCo Group predominantly distributes its products through related party Limited Risk Distribution entities that purchase finished goods for resale to their customers. The following factors are relevant;

- The LRDs pay for various support services provided by related party entities on a cross-border basis (legal, accountancy, shared services, commercial, marketing support etc.).
- The LRDs 'activate' the global marketing campaigns and strategy for the local markets and incur local in-market A&P costs to customise for the local market.
- The import prices of finished goods are set in such a way as to target an arm's length operating margin based on a transfer pricing comparables benchmarking search.
- The LRD pays import duties on the finished goods purchased on a cross border basis.
- Upwards or downwards Transfer Pricing adjustments may be made during each financial period to ensure that the LRDs achieve a return that is consistent with the arm's length range.
- The LRD also sells to a third party in a neighbouring market, i.e. there is no LRD in place in the neighbouring market.
- There are technical challenges in determining whether such Transfer Pricing adjustments should be subject to VAT.
- Residual profit is realised by the IP owning entities that also manufacture the finished goods

Scenario 2 – Royalty Distribution Model

The facts and circumstances are similar to the situation described above. However, in this example, no finished goods are imported into the market territory although some raw materials including commodities are imported from related parties. In this instance, the in-market company manufactures and distributes the branded products, paying the relevant IP owning entity a royalty for the legal right to manufacture and distribute its branded goods. Additional royalties or technical service fees may be paid to other related party entities for the use of/access to other trade/production/technical IP (non-marketing IP). The following factors are relevant:

- The in-market manufacturing/distribution entity pays for various support services provided by related party entities on a cross-border basis (legal, accountancy, shared services, commercial, marketing support, procurement fee etc.).
- The in-market manufacturing/distribution entity will 'activate' the global marketing campaigns and strategy for the local markets and incur local in-market A&P costs to customise for the local market.
- The import prices of the raw materials are pegged to arm's length benchmarks (or priced on a cost-plus basis if such benchmarks are not available). The centralised procurement function is compensated with a benchmarked fee.
- The royalty rates are benchmarked against internal or external CUPS depending on the quality and availability of data.
- The in-market manufacturing/distributor must deduct withholding taxes from the cross-border royalty payments made to related party entities.
- In certain cases withholding taxes are applied to the payments for cross-border support services
- At most, only upwards Transfer Pricing adjustments may be made during each financial period to ensure that the in-market manufacturing/distribution entity achieves a minimum level of return that is consistent with the arm's length (benchmarked) range. Although in many arrangements of this type, no adjustments are made and all up-side and down-side is left in-market.
- There are technical challenges in determining whether such Transfer Pricing adjustments should be subject to VAT.
- Residual profit is realised by the IP owning entities <u>and</u> by the in-market manufacturing/distribution entity.

Cont……………

The above case studies draw out the following areas which need to be considered;

1) The stated objective of the proposal is to recognise value created by a business's activity or participation in user/market jurisdictions that is not recognised in the current international tax framework. Increasing the level of profitability of an LRD or an in-market manufacturing/distribution company will decrease the import price of the finished goods or the royalty respectively. This will potentially have two impacts i) increasing the level of profitability of an LRD will reallocate income away from jurisdictions which invest in research and development and ii) decrease the import price of finished goods or royalty respectively, will tax authorities in the local market respect these new prices when assessing import duties and royalty withholding taxes? Depending on profitability it would seem that the tax take locally could reduce rather than increase.
2) ***Interaction with other indirect taxes***, including if transfer pricing adjustments are required to up-lift profits, will such payments be subject to VAT or considered 'dutiable' where finished goods are imported.
3) ***Requirement to reflect Transfer Pricing in Financial Statements:*** Will transfer pricing adjustments also require corresponding financial statement adjustments to be made (which will affect the reporting of distributable reserves) and to be settled in cash? This may also pose concerns for non-wholly owned businesses, and fiduciary obligations toward them.
4) ***Tax Base*****:** Double taxation arises today under both case studies with respect to the full recovery of the cost of centralised support services. As more activities are centralised to drive consistency and efficiency, this is an increasingly important problem. Any re-allocation of profits therefore needs to take into account the full global cost base.
5) ***Alignment of TP and capital gains taxation***: If the returns from the marketing IP are to be reallocated to a different country (away from where DEMPE functions and/or control may be undertaken), does it follow that the value of the marketing IP in the country where the returns are correspondingly lower must be reduced? If yes, when a trademark is sold to a 3rd party will the taxation of the capital gain on the marketing intangible follow the TP allocation of marketing intangible income or will there be an earlier taxing event in the form of an exit tax when the TP changes are implemented?
6) ***Alignment of TP and withholding taxes***: In the second case study any downwards TP adjustment to the royalty or cross border services should also be reflected in a reduced tax base for withholding tax purposes and corresponding adjustments made. Is this the intention ?
7) What if the MNE also licences out trademarks to 3rd parties with the same allocation of A&P expenses as for the related party scenario ? Will there still be a transfer pricing adjustment for the related party transactions, and what would be the technical basis for this ? Will tax authorities require similar transfer pricing adjustments for the third-party arrangements?
8) Will tax authorities in the neighbouring market be able to assert local marketing intangibles and attribute a return to the local market, despite a third party being used?

Case Study 3 – Sales made through third party distributors

A supplier group has a valuable consumer goods brand. The supplier entity in Country A sells to a third-party distributor in Country B. The distributor sells the goods to customers in Country B and also to unrelated customers in Country C.

The above example draws out that clarity is required as to who has a local marketing intangible in Country C? The Country B third party distributor, the supplier group in Country A (which invests centrally in the brand and technology), or both?

4) Other Design Considerations

- ***B2C and B2B transactions***: At this stage the marketing Intangibles proposal would apply to business to business (B2B) and business to consumer (B2C) transactions however, para 61 of the consultation document questions whether business to business transactions should be included.[11] Further consideration would be required in determining any new nexus requirement for the purposes of the marketing intangible proposal, which considers the following;
  - Whilst this proposal does not ring-fence the digital economy, there are concerns that by focusing on customer interaction and attributing profit to the destination market jurisdiction, the proposals appear to only naturally apply to business to consumer transactions. It should also be noted that currently many fast-moving consumer goods companies do not sell direct to consumers but to third party distributors and retailers, which in turn sell to consumers - this is however beginning to change with the increasing importance of e-commerce and subscription models.
  - B2B models encompass a very wide spectrum of activities, from "traditional" B2B models – e.g. sale of raw materials to a manufacturer to those that raise revenue from advertising.
  - Taking the example of business to business sales of raw materials, component parts, services and other items consumed in production, consideration needs to be given to the practical difficulties in applying the proposal. Substantial technical issues may arise for these businesses in tracking the destination of consumption, as for these businesses the transaction ends when they make the sale to the unrelated party and don't have the ability to track the final destination. Allocating the marketing intangible residual profit to the locations where the seller enters contracts with business buyers could make the proposal administrable, but at the cost of undermining the core rationale of moving profit from the "origin" of production to the less mobile "destination" of consumption.

- ***Definition of a 'routine marketing function':*** This definition would require further consideration to provide a better understanding of the application of the proposals, including whether the OECD would be expecting business to use the current economic analysis (i.e. arm's length principle) to determine what is or isn't routine, or whether an alternative approach would be required (i.e. the OECD developing a more functionary list of typical activities which would determine pricing and tax treatment).

- ***Allocation of a pool of residual profits between different value driver components***: Consideration needs to be given to how any business measure accurately, year on year, what the relevant contribution is of the management of local marketing intangible DEMPE functions vs. the value created by other DEMPE activities. This would likely result in most multinational companies developing their own (predominantly formulaic) response to deal with this, which could be challenged by many tax authorities. The proposals discussed at a high-level in paragraph 47 would seem to create more possibility for a pragmatic approach but would require tax authorities and businesses to work with each other to determine a more formulaic approach that would be respected on a consistent basis across borders. Given the way each multinational operates is

[11] Para 61 of the consultation document states "There is also a question as to whether the justification is of equal relevance to companies that sell business-to-business, such as industrial goods and professional services companies, that may have substantial marketing expenditure and valuable trademark brands, or goodwill but may not leverage digital technology and customer data in delivering highly targeted/personalised marketing in the same way as consumer facing businesses'

significantly different, it is unlikely that one pre-determined formulaic approach will produce the intended policy goals for all businesses. The idea to determine routine returns for all underlying activities on a more formulaic/practical basis would also be attractive to many tax departments (given the complexity driven by the existing transfer pricing framework), however, this again would require pragmatism and collaboration between governments. For example, if all 'routine' activities were to be rewarded on a cost-plus basis, would all governments agree to the application of the same mark-up, or would they expect to see different mark-ups for different functions, or by country, or something different altogether. Also, what would be the outcome if there were insufficient profits in the group to cover the mark-up element of all the routine functions in a given year?

- ***Cross-sectoral issues***: Consideration will need to be given to the application of any new proposal(s) to specific industry sectors, for example;
    - ***i) Bespoke industry specific tax rules*** - for example those companies taxed on a ring-fence basis, such as the extractive industries that are subject to production sharing agreements with governments, or with specific tax regimes such as global shipping taxed on a tonnage tax basis.
    - ***ii) Highly regulated industries*** – we would draw the OECD's attention to the need to cater for industry specific considerations, in particular highly regulated industries and that strict regulation means there is relatively little scope to generate customer-related intangibles. The financial services industry would be an example of this for which we would recommend consultation with regulatory bodies such as the European Securities and Markets Authority and the Financial Conduct Authority in the UK.
    - ***iii) Business sectors where the contribution of marketing intangible is not substantial and whether these should be outside the scope -*** There are situations in which businesses supply their products based on customer list (for example in the trading of commodities or other wholesales businesses) and hence, in theory, a marketing intangible arises within the current proposed definition of a marketing intangible. However, in these scenarios reliance on or value attributed to brand or other marketing intangibles is likely to be insignificant, for example in the instance of commodities if customers are well known utility companies or national energy companies. Consideration should be given to the value (if any) that would be attributed to the marketing intangible in these instances.

Significant economic presence (SEP)

We observe that there is currently a need for further consideration of this proposal, understandably as it is a relatively new proposal being explored by the Inclusive Framework the consultation document is light on detail. However, we make the following initial comments;

- ***Breadth of proposal***: This SEP proposal appears to have the broadest application, with the potential to fundamentally change the basis of taxing rights over **all** income allocated between jurisdictions. This would represent a significant shift away from the current international tax framework and we question whether such a fundamental reallocation of taxing rights is required. We refer back to our comments on the necessity for 'International consensus on the underlying issued to be addressed' and also the principles set out at point 1 above that should guide any international tax reform.

- ***Distortive economic implications:*** This proposal is likely to drive behavioural change i.e. some companies may decide to withdraw from a market altogether if the scale of their business there is small and the value of having a presence in the market is outweighed by the tax compliance burden of having to file tax returns. This will be most pronounced where businesses make losses or low margins, but fractional apportionment would result in artificially high allocation of taxable profits to that market. This measure may therefore prove not to be in the longer-term interests of smaller markets.

Q2: 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?

Please refer to comments above.

Q3: 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?

1) No double taxation

As outlined in the 'common design issues' section of this response a fundamental principle in the design of any new proposal is that all businesses are taxed once on their global profits (allowing a full deduction for all business expenses). To achieve this, a consistent global approach should be adopted on measuring those profits subject to tax (taking into account **alignment of tax base** and **tax deductions for business expenses**), alongside **effective dispute resolution mechanisms**.

2) Advance pricing certainty

The adopted proposal(s) are envisaged to have an impact on the allocation of taxing rights which could result in a significant change to where any one multinational pays tax on its profits. In the past, for businesses to achieve certainty on transfer pricing issues, they have been required to pursue Advanced Pricing Agreements on a bilateral or multilateral basis with relevant governments. A significant change to the allocation of taxing rights could also provide an opportunity to re-think how tax authorities and businesses can work together, proactively, on a multilateral basis, to achieve tax certainty up-front. This would be especially important if profits are being allocated based on a formula basis between a large number of jurisdictions. There is also an opportunity to simplify the tax system to make it more practical to administer for tax authorities and taxpayers alike.

3) Treatment of losses

Allocation of losses (as well as profits) needs to be considered in detail, including consideration of how historic investment is treated.

For example, under the marketing intangible proposal, where the intention is to tax 'non-routine' profit associated with marketing intangibles, then the marketing intangibles should only be compensated if non-routine profits remain after other relevant functions/assets/risks have been compensated (potentially also on a routine basis as is suggested by the OECD). If no such non-routine profits exist within the supply chain (for a particular product/division etc.) then no additional profit should be allocated to the market jurisdiction. It will be important for tax authorities to respect how businesses collate and use data to determine system profits, also noting that many multinationals may encounter difficulties in tracking this type of data on a very granular basis.

4) Thresholds

The proposals are expected to add a significant additional compliance burden for business. This will be particularly relevant where the application of any proposal(s) gives rise to tax compliance obligations for business in a jurisdiction where it currently has no taxable presence. This may deter business from operating in smaller markets, leading to limited consumer choice in these jurisdictions. It is therefore important to minimise the compliance burden of any new proposal in the first instance. However, as the compliance burden may be disproportionately higher for those jurisdictions in which countries have minimal sales, we question whether it would be necessary to include within the policy design thresholds (i.e. revenue) before businesses come within the scope of any new rules.

We consider that this is an area that requires further consideration and the CBI recognises the balance that needs to be met between the benefits of establishing thresholds for efficiency reasons, whilst maintaining the ability for lower income countries to assert their taxing rights on multinationals operating in their jurisdictions. In the decision to implement thresholds, and if so the design of these, consideration should be given to the following;

i) Some members consider that such rules are necessary for small and medium sized enterprises (SMEs) to reduce the significant (and potentially prohibitive) compliance burden of operating in some jurisdictions however, other members consider this would create market distortions and an inequitable playing field.

ii) If a threshold is applied, it should be on a 'country-by-country' basis in order to address the risk that the additional compliance burden associated with the proposals could lead to it being uncommercially viable to operate in a country.

iii) Care would need to be taken when designing a threshold that it does not create market distortions, nor an inequitable playing field by drawing an artificial line between those businesses that are in or out of scope. Applying thresholds on a country basis (rather than at a consolidated level) would reduce the risk for large groups (globally) operating in small markets and consideration could be given to implementing both relative and absolute thresholds.

iv) In implementing thresholds, parallels could potentially be drawn with the European Commission Electronically Supplied Services ("EC ESS") VAT rules, where a de minimis is set in some countries and not others. If a similar threshold approach was adopted,

consistency should be maintained with the existing thresholds set for EC ESS VAT rules, which would ease the administrative burden on business to a degree.

v) Learnings should also be taken from the EC ESS VAT rules, in particular that no fiscal representative, which shares joint and several liability is required, as for large businesses there will be practical difficulties in appointing a fiscal representative which would be required to share liability.

5) **Interaction with other taxes**

As discussed above, the interaction with VAT, customs duties, withholding taxes and capital gains needs to be part of any proposal to reform the international tax system in a holistic way.

Q4: What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

Members consider the following will be essential for providing businesses with greater stability, predictability and simplicity in the tax system;

1) Effective Dispute Resolution and alignment of tax base

Of fundamental importance is that businesses are only taxed on their profits once and there is a deduction for all business expenses. Effective dispute resolution and the alignment of tax base will be key in ensuring that this is the outcome of the implementation of any new proposal. We refer to our comments in the 'Key Design Features' section of this response and our comments on how we consider this an opportunity to rethink how international dispute resolution can be reformed – via introducing a new required minimum standard to be adopted for dispute resolution.

2) Interaction with existing tax framework

As outlined in the 'areas for further consideration' section of this response, each proposal needs to consider how it will interact with the existing tax framework. In addition to our comments above the following should be considered;

- That the creation of any new market country nexus is for corporate income tax purposes only and does not create a fixed establishment for VAT purposes.
- Any reallocation (to market) should not result in any deemed payment or a characterization of a payment which could be subject to withholding tax or local book-tax adjustments in any country.
- The interaction with VAT, customs duties, withholding taxes and capital gains needs to be part of any proposal to reform the international tax system in a holistic way.

3) Clear timeline for implementation and administrative simplicity

These proposals have the potential to represent significant international tax reform and the novel nature of the proposals will give rise to new compliance and reporting requirements. It is therefore essential that business (and governments) are provided with a clear timeline and roadmap for

implementation, allowing sufficient time between the detailed design being established and implementation.

Businesses do not stand still and there will inevitably be a need for business restructuring for commercial reasons in the period leading up to any implementation date of significant international tax reform. Equally, acquisitions and disposals activity and valuations will be impacted by any significant changes in the valuation and location of intangibles and post-tax operating cashflows. Therefore, businesses value clarity and as small a period of uncertainty as is reasonably possible.

The proposals should be easy to comply with and provide transitional relief. We would recommend simplified / standardised filings for any new nexus (or ability to allocate additional profits to an existing local entity where a business already has an entity to avoid additional filings).

In countries where businesses have only a very small level of activity/sales, the administrative cost may be disproportionate to the additional tax collected and from the point of view of business may outweigh in certain scenarios the benefit of being in that market at all. Thresholds may to some extent address this and please refer to our comments above in respect of this.

Global Anti-base Erosion Proposal (Pillar II)

Q1: What is your general view on this proposal? In answering this question please consider the objectives, policy rationales, and economic and behavioural implications of the proposal.

The consultation paper indicates that BEPS has not been fully effective[12]. However, implementation of the BEPS package is ongoing and not all of BEPS has been fully implemented yet. We therefore consider it premature to conclude at this stage that there remain BEPS issues which cannot by fully addressed by the current package.

Significant work has taken place to ensure that taxation is aligned with value creation, by ensuring that taxing rights are in line with where substance is located, and these proposals run contrary to this. We do not consider that it still remains possible to shift profits to low (or no) tax territories without a significant value creating presence if BEPS Actions 8 – 10 are being applied correctly. It is true that value can be created by a small number of roles exercising the DEMPE functions, but this was also the case when the original BEPS changes to the transfer pricing guidelines were made.

We consider that this proposal should be excluded from the current OECD workstream on addressing the tax challenges arising from the digitalisation of the economy and be put on hold until further empirical analysis is undertaken to assess the post BEPS issues.

Following this, if the OECD and the Inclusive Framework believe BEPS has not been effective, the first response should be to improve measures and recommendations already made (e.g. BEPS actions 2, 3, 4, 5). If that is not adequate, the minimum tax proposals from Pillar II should not add another layer of complexity to what are considered ineffective measures. Rather, the OECD should recommend

[12] Para 89 of the consultation document states that "certain members of the Inclusive Framework consider that these [BEPS] measures do not yet provide a comprehensive solution to the risks that continue to arise from structures that shift profit to entities subject to no or very low taxation".

repealing certain complex BEPS measures and replace them with more comprehensive, yet simpler minimum tax proposals.

Impact on tax sovereignty

The question of what "low" and "minimum rate" could be is not addressed in the consultation document. Determining the "low effective tax rate" under the income-inclusion rule and the "effective tax rate at or above a minimum rate" under the base-erosion rule will represent a fundamental issue of design of this proposal. This should recognise effective tax rates adopted currently (i.e. US rates are now 21%. the UK will be 17% from 2020 and the Irish rates has been 12.5% for a number of years now).

The global base erosion proposal should not be used as an indirect method of driving up corporate income tax rates and therefore the starting point should be that "low" and "minimum rate" are considerably lower than these rates.

Q2: What would be the most important design considerations in developing an inclusion rule and a tax on base eroding payments? In your response please comment separately on the undertaxed payments and subject to tax proposals and also cover practical, administrative and compliance issues.

1) Alignment of tax base

We refer to our comments above in the need for global alignment of the tax base which will be equally important for this proposal. In addition, it is necessary that safeguards are put in place to prevent countries from manipulating their tax base (i.e. by not taxing certain payments) as this will result in the minimum tax rate not having a meaningful impact.

For example, we are concerned that this could motivate some jurisdictions to provide a cash payment or other "above the line" incentives for research and development rather than providing relief through the tax system. If the proposal is to address incentives provided by governments more broadly then all forms of government support would need to be considered as part of the effective minimum tax rate. We would also question how this proposal would interact with BEPS Action 5 compliant regimes and whether such regimes should be excluded?

Losses should also be considered as countries have very different rules about the manner and timeframe in which losses can be utilised.

There is an assumption that the Global Anti-Base Erosion Proposal (Pillar II) can be implemented in conjunction with changes to the allocation of income (Pillar I). We would challenge this assumption as the changes under Pillar I are likely to multi-lateral and the final position not known for a number of years. This would create significant practical issues with the administration of an additional Pillar II type of proposal which seems envisaged to apply bilaterally.

2) ***Issues for further consideration***

The consultation document in para 95 identifies a number of broader questions that may need to be considered as part of this proposal, we emphasise that it is essential that these broader

questions are addressed along with consideration of existing measures that can be repealed to simplify anti-avoidance rules e.g. anti-hybrids, Controlled Foreign Company (CFC) and interest restriction rules to ensure that opportunities are not lost within this reform to simplify the tax system.

Specific comments: Tax on Base Eroding Payments

3) Timing

Timing of introduction would be very important to make this manageable for business. If suddenly all expenses paid to certain territories, with which specific industry sectors have strong connections, were to be disallowable this may have a significant impact on global trade flows.

4) US Base Erosion and Anti-Abuse Tax (BEAT) rules on a gross basis

Our members note that there are significant practical challenges with the operation of the US BEAT rules on a gross basis. So, for example, a payment made for group services cannot be offset against income received for group services. This leads to some very unfair outcomes which could be solved by considering related party payments on a net outflow basis.

Q3: What, if any, scope limitations should be considered in connection with the proposal set out above?

Whilst further detail is required to determine the necessary scope limitations, the OECD should consider cross-sectoral issues. The following list is in no means comprehensive but highlights some of the areas for further consideration;

- ***Businesses subject to specific tax regimes*** – Global shipping has a specific tax regime and there are other examples of businesses that are ring fenced under existing international frameworks such as the extractive industries that are subject to production sharing agreements with Governments and other highly regulated environments such as the financial services sector. The particular position of these businesses requires detailed consideration in order to avoid the risk of significant double taxation and market distortions.
- ***Collective investment vehicles*** – The anti-base erosion principal should consider the investment funds industry (due to the need for tax neutrality). Investment funds operate as conduits for investors and they are generally tax exempt/subject to zero tax regimes as a matter of policy.
- ***Hedging –*** For businesses that hedge pricing exposures through the use of financial derivatives, it is imperative that the tax treatment applied to the profit or loss arising from those financial derivatives is treated the same way as the profit or loss arising from the associated physical transactions.

Q4: How would you suggest that the rules should best be co-ordinated?

We strongly recommend that the Global Anti-Base Erosion Proposal should be considered only once there is consensus on the way forward under Pillar I. It will become much more apparent at this point in time whether there are any remaining concerns with base erosion that require further remedies. At a later point in time there will also be further empirical evidence available as to the effectiveness in practice of the BEPS changes already implemented.

Q5: What could be the best approaches to reduce complexity, ensure early tax certainty and to avoid or resolve multi-jurisdictional disputes?

Of fundamental importance is that businesses are only taxed on their profits once and there is a deduction for all business expenses. Effective dispute resolution and the alignment of tax base will be key in ensuring that this is the outcome of the implementation of any new proposal. We refer to our comments in the 'Key Design Features' section of this response and our comments on how we consider this an opportunity to rethink how international dispute resolution can be reformed – via introducing a new required minimum standard to be adopted for dispute resolution.

Appendix

CBI Response to the UK Government Consultation Document regarding a Digital Services Tax

28 February 2019

CBI RESPONSE

HMT and HMRC CONSULTATION DOCUMENT – DIGITAL SERVICES TAX

Published: November 2018; Closing dates for comments: 28 February 2019

Background

As the UK's leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

We welcome the opportunity to provide input into your policy making process for the introduction of a Digital Services Tax (the DST).

We have structured our response to set out initial comments on the consultation before responding to questions raised within the document. We have taken this approach because we believe there are some overarching points in relation to the introduction of the DST, which should be considered prior to delving into the specific detail on the scope, design and administrative requirements.

If you have any questions or would like any further detail, please do not hesitate to get in touch. We look forward to continuing to work with you as your work in this area progresses.

Key points

OECD Progress

The CBI understands the political desire to make progress on the question of how to reflect the increasing digitalisation of the global economy in the tax system, but we do not support the UK Government implementing unilateral measures at this stage. Whilst some members, that have limited, or no online presence, support action by the Government to level the playing field between wholly online and more traditional business models, the majority are opposed to this issue being addressed via unilateral and uncoordinated measures, including the introduction of the DST. Such measures risk creating a complex patchwork of tax policies that increase compliance burdens, uncertainty over tax positions and ultimately damage global trade, cross-border investment and growth. Therefore, it is the CBI's view that such measures should be avoided.

There is widespread consensus that the OECD is the right organisation to lead reform in addressing the tax challenges of the digitalisation of the economy, which is a view shared by both the UK Government and the CBI. The recent progress at the OECD[13], demonstrates a clear political commitment from the 127-member countries of the Inclusive Framework to work towards reaching a consensus on global long-term reform. We consider that the timeline set by the OECD (to achieve a consensus by the end of 2020) is necessary to ensure that time is spent on the important detailed work underpinning a sustainable solution. We would urge the Government not to lose sight of this and believe that the Government should postpone unilateral action at this time. Instead all efforts should be focused on the work being undertaken by the Inclusive Framework to reach sustainable long-term reform at the level of OECD.

Need for economic impact assessment

Revenue-based taxes are economically distortive and have many shortcomings - given the (potentially) distortive nature of the DST, it's important that the Government undertakes a thorough economic impact assessment on the introduction of the DST, including on the wider impact of the tax on the rest of the UK economy. We believe the following are fundamental areas of weakness with this proposal rather than simply questions of design which need to be considered in any impact assessment;

- ***Spill-over effects:*** The introduction of the DST not only impacts those businesses that fall within the scope of the DST, it will also impact those businesses that interact with or rely on in-scope business activities for their own business activity. For example, a business might advertise via a search engine, buy data from a social media platform or sell its products via an online marketplace. The CBI conducted a business survey[14] to examine this in more detail. It found that 51% of respondents anticipated they would be (or may be) within the scope of DST and over 80% of respondents that do not fall within the scope of the DST interact in some form with those that do.

  While there is not enough evidence from the survey to understand exactly what the pass on rate will be to consumers, there is evidence to suggest that in some cases there will be pass-through. In conjunction with evidence suggesting a large number of businesses, including SMEs, rely on in-scope business activities. This indicates that the indirect impacts on both businesses and on consumers could be fairly significant, and there could be distortions created across sectors where reliance is higher. We provide further detail on the results of the survey and the potential associated economic impact in response to question 28.

- ***Impact on UK Consumer Choice:*** Proposals based on taxing turnover create distortions in businesses' decision making which could damage growth. In addition, this proposal represents an increase in both potential reporting obligations and costs for companies making sales to UK customers in those instances where they are unable to pass on the cost of the DST to consumers. Consequently, we believe this could be damaging to UK consumer choice and could discourage multinational groups from operating in the UK, where there is the option for supply chains to be reorganised such that UK sales can be minimised.

[13] Including the OECD policy note issued on 29 January 2019 and the OECD public consultation document issued on 13 February 2019, both entitled 'Addressing the Tax Challenges of the Digitalisation of the Economy'

[14] The CBI conducted a survey between 9 January 2019 and 25 January 2019 to understand the wider impacts of a digital services tax. The survey had 210 respondents.

- ***Impact on UK exports:*** Proposals based on revenue taxation set a precedent for other countries to follow suit with the potential to damage the competitiveness of UK businesses operating overseas. There is no reason to believe that another country choosing to implement a unilateral solution would apply the same scope and thresholds as the UK, meaning the impact has the potential to be much wider in these countries (i.e. these unilateral measures could impact more than just technology based and digital activities).
- ***Potential for retaliatory action***: Interim solutions that are adopted by individual countries also risk prompting retaliatory action which could damage global trade and growth. There are specific concerns that the US has been very vocal in its opposition of unilateral digital service taxes[15] - viewing them as targeted at the US technology sector. Some specific concerns by members in this regard are as follows;
  - UK-US relationships are currently particularly relevant in light of the fact that the US would be one of UK's priorities for a free trade deal post-Brexit and implementing a tax of this nature may make negotiations more difficult and less advantageous for the UK.
  - The UK is in a position, that as a result of the decision to leave the EU, UK headquartered groups will no longer be able to rely on the Limitation of Benefits article in the US - European double tax treaties. Resolving issues such as this bilaterally with the US will be made more difficult by the introduction of the DST and the consequence of progress on this issue being delayed is the risk of UK headquartered groups suffering significant withholding taxes costs on dividends, interest and royalties.

Signals sent re. Technology

The Government's Industrial Strategy and its Digital Strategy "set a path to make Britain the best place to start and grow a digital business".

We consider that the DST proposal is not aligned with this broader objective. We consider these proposals could therefore have unintended negative consequences in light of innovation across the

[15] Comments made from US official condemning unilateral digital taxes include;

- On the 29 January 2019, the Chairman (Charles Grassley) and a Ranking Member (Ron Wyden) of the U.S. Senate Committee on Finance wrote to Secretary Munchin (U.S. Secretary of the Treasury) and cc'd Robert Lighthizer (United States Trade Representative) to express their "serious concern regarding unilateral action by foreign countries to establish digital services taxes designed to discriminate against U.S.-based multinational companies.". The letter also references that a multilateral solution is needed "that does not create a new transatlantic barrier to trade".
- Chip Harter (a senior U.S. Treasury Official) at an event on digital taxation held in Washington on 3 December 2018, explicitly criticised the UK approach on user participation and also made comments that the US would regard the UK DST as being a covered tax under the treaty. The impact of this would be that US companies would not get any expense relief for the DST and so would be deliberately discriminatory to US companies.
- On 25 October 2018, Steven Mnuchin (U.S. Secretary of the Treasury Treasury), issued a press release condemning the proposals for a specific tax on digital companies. "I highlight again our strong concern with countries' consideration of a unilateral and unfair gross sales tax that targets our technology and internet companies. A tax should be based on income, not sales, and should not single out a specific industry for taxation under a different standard. We urge our partners to finish the OECD process with us rather than taking unilateral action in this area."
- On 31 October 2019, Kevin Brady (House Ways and Means Committee Chairman) released the following statement after the United Kingdom announced plans to introduce a new tax on digital services: "The United Kingdom's introduction of a new tax targeting cross-border digital services – which mirrors a similar proposal under consideration in the European Union – is troubling. Singling out a key global industry dominated by American companies for taxation that is inconsistent with international norms is a blatant revenue grab." "The ongoing global dialogue on the digital economy through the OECD framework should not be pre-empted by unilateral actions that will result in double taxation. If the United Kingdom or other countries proceed, that will prompt a review of our U.S. tax and regulatory approach to determine what actions are appropriate to ensure a level playing field in global markets."

whole economy and would affect businesses across all sectors. The CBI acts in partnership Sharing Economy UK, the trade association for the Sharing Economy, many of the members are technology start-ups and share this concern.

Whilst the UK has many cutting-edge firms at the forefront of technology, lower rates of technology adoption by many firms is holding back the UK's potential. Digital can help the UK to tackle its persistent problem of low productivity growth. Therefore, the Government needs to encourage this in all businesses and recognise the role that tax plays in businesses' decision making and as an enabler of technology. The DST sends a message contrary to this.

Compliance/systems burden

The DST is anticipated to create a significant compliance burden for business. Due to the unique and complex nature of the DST, businesses are likely to be required to invest substantial capital spend and resource in developing systems to capture the data required to assess whether the business is within the scope of DST and if so, the DST liability itself.

We consider that this burden will not be limited to those businesses within the scope of the DST but ultimately fall also those businesses on the peripheries of being within the scope of DST (i.e. on those businesses outside the scope or those on the margins, in view of the broad-brush and highly judgemental approach proposed to defining scope and allocating revenues (which we elaborate on further in our detailed response)). This increased compliance burden placed on businesses operating in the UK may have an impact on the attractiveness of the UK as a place to do business.

This compliance burden would appear disproportionate for a tax that is intended to be temporary and another reason why we would urge the Government to consider delaying the decision to implement the DST until the OECD has concluded its work.

We would hope that following the conclusion of the OECD work there would be no need to implement the DST. However, if the Government felt determined that it should be implemented, for the reasons outlined above it is important that businesses are given sufficient lead time (following detailed legislation and guidance being published) to put in place the necessary systems to ensure they are able to comply with the DST.

GDPR and data ethics

There is an ever-growing spotlight on technology businesses, and in particular on many of the businesses which will be subject to the UK DST, regarding the level of data they store on their users. Tracking user locations is increasingly being seen as ethically wrong, and in some cases legally wrong (as a result of GDPR). Businesses will therefore be presented with a difficult challenge of balancing their obligations in respect of a UK DST alongside wider obligations on data ethics. The consultation is currently silent on these points and we consider that the Government needs to give further thought to these issues prior to implementation.

Our recommendations

Based on the evidence and views of the CBI's membership we are making the following recommendations:

1) We recommend that the Government should continue to focus its efforts on achieving long-term reform through the OECD.

2) The Government should avoid pushing forward with a solution based around the taxation of revenues unless necessary and at a minimum should delay the introduction of the DST until after the OECD has concluded its work, which may render the DST unnecessary/duplicative. The UK may wish to defer consideration of this until 2022 at the earliest. We consider this timeline would provide time for the outcome of the OECD work at the end of 2020 to be considered and following which, sufficient lead time for business to implement the required systems to enable them to comply with the DST.

3) If it is determined that the DST will continue to be implemented, in advance of the OECD conclusions, the design of the DST should be proportionate to its temporary nature and be easy to comply with. We therefore recommend the following changes to its design which would reduce some of the significant challenges we observe:

   - The scope of the DST should be refined to align the scope of the DST with those revenue streams which could foreseeably have a connection with value created by users (i.e. targeted advertising and commissions in the case of online marketplaces). This would ensure that the DST remains in line with the Government's policy objectives "to ensure tax is paid that reflects the value derived from UK users".

     We consider that this would be best achieved by a two-step definition of scope as follows;

     Step 1 – whether a business generates specific revenues streams, being targeted advertising and commissions.

     Step 2 – whether a business carries out an in-scope activity (based on refined definitions to those currently proposed) and that activity is directly monetised to generate either of those revenues outlined in step 1 on a stand-alone basis.

     Incorporated within the scope should be a further exclusion for those businesses where in-scope activities form an insignificant part of the complete business offering, that business would fall outside the scope of the DST.

     We consider these 2 proposals would simplify the compliance burden for some businesses and reduce the judgement and uncertainty in calculating the liability to DST.

   - The safe-harbour design is amended to reduce the multiplier from 0.8 to 0.02. We consider this is necessary to address the fact that the DST will be a disproportionate burden on low-margin businesses and to reduce the instances of the DST being passed-on to consumers

where low margin businesses are unable to absorb the tax. We do not consider that the current availability of the safe-harbour election to just those business models with a profit margin of less than 2.5% is sufficient to address these issues.

- A 'sunset clause' is introduced with effect from 2025. We consider that a legislated end to the DST is needed to represent a clear commitment from Government that the DST will be a temporary measure.

Consultation question response

Chapter 3 – Business activities in scope

Q1: Do you agree the proposed approach of defining scope by reference to business activities is preferable to alternative approaches?

We consider that the proposed UK approach remains broader than intended, with the consequence that in some circumstances there is a disconnect between the scope of the DST and the policy objective "to ensure tax is paid that reflects the value derived from UK users".

We observe two main concerns with the UK approach over alternatives;

- Those businesses with any in-scope activities will be more broadly taxed than under a revenue stream-based approach (such as those proposed by the European Commission and other European jurisdictions in their measures), as for these businesses the DST will apply on **all** revenue streams deemed to be derived from UK users.
- There are additional practical complexities in the design of this approach, over and above an approach that identifies specific revenue streams. These include the challenges surrounding defining in-scope actives and attributing revenue specifically to these activities (we elaborate on these complexities further throughout this consultation response). This in turn creates the potential for a significant compliance burden to be placed on business to comply with the DST, even if they ultimately pay little or no DST.

Definition of in-scope business activities

In part, these concerns arise as the defining features of the in-scope business activities, as currently drafted, can be interpreted as applying to a wide range of business models (which we elaborate further on in response to Q2 below).

User participation is not a proxy for value creation

The second main contributing factor is that, where a business has in-scope activities, the DST as currently drafted will be levied on all revenue streams attributed to that activity, irrespective of whether those revenue streams have any connection to user value. This approach oversimplifies the way in which businesses interact with their user bases and ignores the diverse spectrum and quality of user participation. It assumes where a business undertakes an activity which is heavily reliant on

user participation, this is a proxy for value created by these users. We consider that the result of this oversimplification in the application of the DST is that businesses which have in-scope activities are disproportionally taxed based on the value generated from their users. For many multinationals, users are not the key driver of value but rather other factors such as intellectual property are significant factors in attributing value.

We consider that to meet the policy objective and the DST paid reflects the value derived from UK users, it is necessary to also give consideration to the types of revenue which derive their value from user participation. In the absence of considering revenue streams, alongside in-scope activities, there will be a disconnect between revenues which are driven by user participation and total revenues which are subject to the DST. This is best explained by the following examples.

1) Where a business operates an online marketplace it may generate revenues from both commissions received for the sale of goods and delivery fees. Delivery fees relate purely to fulfilment and logistical activities, and the taxation of this auxiliary function is clearly contrary to the policy objectives of taxing those activities from which users generate value. We observe also that such fees generally represent a lower margin (and often loss making) activity and therefore when applied to gross revenues, this exacerbates the issues of the DST being disproportionately high for these businesses compared to user contribution.

2) In other businesses the in-scope activity may be auxiliary in their entirety to the core business, which is the revenue generating activity. For example, many businesses have a (free) "social media" platform as part of their engagement strategy with their customers. This may take the form of online communities, Q&A sections of websites where users can share knowledge regarding the product offering by the platform or blog features. These (free) "social media" functions are not monetised via advertising but form part of a wider offering and create brand awareness. However, this activity is an auxiliary feature rather than a fundamental part of the product offering (which will be monetised by other means). We observe from the CBI business survey that businesses undertaking such activities are common and we only expect this to increase over time as businesses become more digitalised and respond to consumer trends .[16]

Administrative burden

As the DST is based on business activities rather than revenue streams, this will add a compliance burden for all large businesses to document that they have assessed their activities to confirm whether they have any in-scope activities. There is a high degree of judgement required for business to determine whether they have in-scope activities (with reference to the key elements which would define such activities) in comparison to other alternative approaches (i.e. by reference to specific revenue streams). This issue is in some part exacerbated, by the degree of ambiguity in the proposed definitions (which we discuss further in response to Q2).

As outlined in the example above there are a wide variety of business models that can fall within the social media definition (by virtue of them having some kind of online community including users). Under the current definition of in-scope business activities, particularly the social media definition in this example, irrespective of the purpose of this online community and even though these businesses don't directly 'monetise' their users the business would appear to be within the scope of the DST.

[16] 9% of respondents said that some of their activities **would** fall within the social media definition and 16% said some of their activities **may** fall within the social media definition outlined in para 3.14 of the consultation document.

Targeting instead the advertising revenues from social media models would take these business models out of scope and save a huge administrative burden of ‘proving a negative’ i.e. that users aren’t monetised.

Secondly, where businesses have integrated in-scope and out-of-scope business activities they will be required to attribute revenue to the in-scope activities (which in some cases has substantial practical complexities and can create significant uncertainty over approach taken, as outlined further in respect to Q5). This exercise would be simplified where a business would only be required to attribute specific revenue streams to these in-scope activities.

CBI Recommendation

We consider that the introduction of an additional step in determining the scope of DST, by reference to revenue streams which generate most value from user participation would mitigate these adverse issues for some businesses. It would ensure the DST is narrowly targeted on taxing revenues which derive their value from user participation. Secondly it would ease the compliance burden for many businesses who would not have to proceed to the more complex analysis of determining whether they have in-scope activities.

Step 1: To determine whether a business has in-scope revenues, based on revenues streams that derive material value from user-participation (i.e. targeted advertising or commissions from online marketplaces). We consider that advertising should be restricted to targeted advertising only (not static) to ensure this remains aligned with the user value principle.

Step 2: Where a business has in-scope revenues, to determine whether these revenues relate to the in-scope activities (we have outlined in response to those questions raised in the remainder of Chapter 3 of where refinement is needed to the current drafting of these definitions).

We consider that by virtue of market forces there would be little scope for companies to manipulate revenues between different revenue streams in order to avoid DST. We demonstrate this through the following scenarios;

- For an online marketplace, delivery is a developed market where there is a genuine third-party pricing structure for delivery fees. It would be commercially unfeasible to manipulate the level of delivery fee charged as it would quickly become transparent to customers/sellers. In addition, many online marketplaces currently provide sellers with the choice of whether to pay for delivery/logistics or they can provide these services separately. Therefore, if the price for delivery goes beyond market norms, sellers would simply decide to undertake the activity themselves.

- For search engines/social media platforms these business models are often based on offering a free service to users and therefore businesses are unlikely to fundamentally change their business model to start charging a subscription fee to users to supplement a reduction in advertising revenue. Any business that started charging for these services, would be expected to lose market share quickly as users would simply shift to competitors who continue to offer a free service.

We therefore consider it very unlikely that businesses would look to/or even be able to change their business models to mitigate (or reduce) their charge to DST. However, the Government

could consider including a purposive anti-abuse test if they remained with concerns that there may be rare scenarios in which this could happen.

Q2: Do you have any observations on the proposed features used to describe the business activities in scope of the DST?

The definition of in-scope activities is fundamental to narrow targeting of the DST, and (just as importantly) in providing clarity to business where they are not in-scope. This clarity should be provided through well drafted and targeted legislation and supported by HMRC guidance. Given the unique nature of the DST, this will be essential for providing businesses with greater stability, predictability and simplicity in the tax system, which is an important pillar of the competitiveness of the UK's business environment.

We observe that the described in-scope activities by reference to key elements are vague and can be interpreted to apply to an extremely broad range of business models. This highlights member's concerns that the DST will not be a targeted tax as envisaged and could directly impact many businesses operating in the UK.

It is envisaged that most of these businesses will not ultimately have a DST liability however, the DST will create a substantial compliance burden for these businesses in undertaking analysis and evidencing their conclusion that they do not have in-scope activities or, reach the relevant revenue thresholds. This challenge and resource intensive burden of determining whether a business model is in or out of scope would apply equally to HMRC and our members have significant concerns that they are unlikely to have the technical/business resource to address this complex question in a timely and efficient manner to give business the necessary certainty over their tax affairs.

Social media

The definition of social media has the potential to capture numerous situations where there is not a direct link between revenues and user contributions. We observe that the current definition could capture the following scenarios;

- Platforms which provide free content (e.g. online publishers of content), if the authors of that content also happen to read content on the platform.
- Platforms used by businesses for the purposes of engagement and relationship-building with their customers, but which are peripheral to the core business and not directly monetised.
- Arrangements involving sharing or pooling of data across an industry sector via an intermediary platform owner, e.g. insurers pooling insurance claims histories or drivers contributing their own telematics data.
- Business platforms allowing customer reviews of the business's products or services in order to help promote those products/services rather than to target advertising at users.
- There is also currently uncertainty whether telecoms providers could be interpreted as a social media platform given they enable users to share media content such as photos or videos.

CBI Recommendation

We would recommend the definition of social media platform should be narrowed such that it only captures situations where users are generating content through their active participation/interaction with others on the platform **and** where the owner of the platform is able to monetise that content through advertising targeted at users.

Search engines

The proposed definition of a search engine includes "where a central part of the business offering" is to "view webpages beyond those provided by the platform itself". The current terminology with reference to "a central part of the business offering" is ambiguous and could capture external links even where they are an ancillary part of a broader website. Where a link is contained to a third-party site, in some instances it may be difficult for business to conclude this is not part of "a central part of the business offering" as an active decision will have been made to include that link. We understand it is not the policy objective to capture a substantial number of business websites, which do not operate a search engine as their core function, but the current drafting would seem to have that effect.

Furthermore, where businesses do provide links to third party sites, in most instances revenue will not be directly generated from this link. However, the requirement to attribute revenue on a 'just and reasonable' basis to this in-scope activity, will result in an administrative burden for companies to document that revenue apportioned to these in-scope activities does not exceed the revenue thresholds. As we outline further in response to Q5, where businesses have closely integrated functions this process will be highly judgemental, administratively burdensome and costly.

CBI Recommendation

We would recommend the following amendments are made to address this;

- The definition of a search engine should be refined and refer only to those businesses where the operation of the search engine is **the core function** of the business.

- The wording "it generates revenue by monetising users' engagement with the platform and with other closely integrated functions e.g. websites accessed through a web browser" is refined to just capture those instances where the search functionality links to third party sites and those links are **directly monetised** (by way of targeted advertising or commission).

Online marketplaces

We observe that the online marketplaces definition has potential to capture a wide variety of businesses. We observe three specific concerns;

- There are an increasing number of businesses which allow others to use their existing platform and customer base to sell their products, giving rise to an in-scope activity. In many cases, there is very little differentiation, if any, between customers buying products owned by the marketplace, and those owned by a 3rd party selling through the marketplace. It therefore appears very artificial to draw a line between these two activities and say one is in scope and the other out

of scope. Since marketplaces for physical goods are a low margin activity with very minimal user value contribution, we would question whether there should be a specific carve-out from UK DST of physical goods marketplaces, to ensure the DST remains in line with the policy objectives.

- The definition of an online marketplace refers to the vague concept of "indirect monetisation" which could bring into scope ancillary functions. For example, the current definition of an online marketplace may capture franchising arrangements, where it's common for a franchisor to provide a central website to sell the goods of their franchisees. This would be a central part of a business model, as it provides a cohesive brand and seamless customer experience but is not a pure profit activity.

- It will be difficult to achieve consistency in the application of the DST between online marketplaces as the impact will vary significantly based on whether they recognise total revenue from the sale of the good to the customer or they only recognise the commission element of the sale as revenue.

  As recommended in response to Q1, the scope of the DST should be narrowed only to capture those revenues connected to user participation (i.e. direct commissions earned or targeted advertising revenues). This will provide greater clarity for businesses regarding whether they have in-scope activities and target business models that actually monetise the transactions on an online marketplace.

CBI Recommendation

We would recommend the following;

- Specific exemptions are provided for business models which are not anticipated to be in-scope of the DST but there is potential for ambiguity (we elaborate on this further in response to Q3).

- References to indirect monetisation are removed and only activities which are **directly monetised via specific revenue streams** (i.e. by way of targeted advertising or commission) are within the scope of the DST.

Legislative drafting of the key elements

Clarity is also needed on whether each of the key elements, which define each in-scope business activity, need to be met to give rise to an in-scope activity.

We would assume that to meet the definition of a social media platform, search engine or online marketplace a business would at a minimum need to meet all three of the relevant features listed in respect of delivery, functions and monetisation. Furthermore, the example provided in para 3.46 with reference to boundary issues indicates that each of the functions would also need to be met for a business to have an in-scope activity however, this is a point which requires clarification.

Q3: Do you think the approach to scope negates the need for a list of exemptions from the DST?

No. As a first priority we consider that the approach to scope should be refined to ensure the scope is narrowly targeted to only those business models where there is significant user value contribution

(we refer to our comments made in Q1 and Q2). This is fundamental as a specific exemption list is unlikely to capture every business model not intended to be captured by policy objectives of the DST. This will be particularly true in the technology sector where innovation is prevalent, and therefore any exemptions list could quickly become obsolete.

However, we do consider that specific exemptions will complement a refinement in scope and provide additional certainty to a substantial number of businesses, helping to minimise unnecessary compliance burdens. The Government should ensure that statutory powers are maintained to amend the exemption list as needed.

In drafting exemptions, the following should be considered in respect of specific business models.

Financial and payment providers

The consultation paper outlines that financial and payment service providers are not envisaged to be within the scope of the DST however, the current definition of an online market place is not precise enough to exclude financial and payment services activities. Digital activities in the financial services sector are developing all the time and it does not take a particularly broad interpretation of the definitions to catch existing financial services, in particular trading venues.

The consultation paper currently does not provide any commentary on what an exemption for financial and payment service providers would include and our members have concerns that it would be difficult to draft an all-encompassing exemption that reflects all current (and future) financial services business models. We consider that this is another example highlighting the difficulties in defining a narrowly targeted tax by reference to business models and demonstrates the potential for unintended consequences of the DST.

Whilst we don't consider that any exemption list will be sufficient enough to cover all financial services business models, we would recommend the following is included;

- The supply of regulated financial services by regulated financial entities. As is acknowledged in para 3.19 of the consultation document financial services should not be in scope as they "are not considered to derive significant value from user participation and are often subject to unique tax and regulatory regimes already." This would make the position clear and provide certainty for regulated financial entities.
- This exemption would need to include regulated trading venues (whether regulated by the Bank of England, Prudential Regulation Authority or Financial Conduct Authority etc) but unregulated exchanges (such as commodity exchanges and spot FX trading platforms, which are often unregulated) should also be included in this exemption. Many businesses, especially those which extract or deal in commodities, trade products on commodity exchanges as part of their risk management processes to reduce exposure to volatile shocks in commodity prices. This is a particular concern, as whilst the DST would be incurred by the platform (i.e. trading venue), the cost is anticipated to be passed onto the user in this scenario. This would significantly increase the cost of risk management functions which form part of good governance for these industries if only regulated exchanges were exempt.
- We consider that our suggestions in respect to Q7, to refine the definition of 'user' to just include individuals, would limit the number of financial services transactions caught by the tax as business to business transactions would be excluded.

The provision of online content

We consider that an exemption for the provision of online digital content should include the sale of software, apps, eBooks etc and be applicable regardless of whether a business owns the content. This would be necessary to include instances where software/online digital content is sold under an agency or commissionaire arrangement (or even where it is provided for free). We would note as currently drafted the example on this (example 5) is unhelpful in providing clarity on this, as it is restricted to situations where content is created or bought in by the company and thus the example would need to be updated in any future HMRC guidance.

Cloud computing

There should be a specific exemption for cloud computing in the legislation, to ensure there is no uncertainty surrounding whether the provision of such services is in the scope of the DST.

Additional exemptions needed

We consider that the following exemptions would also be required, in addition to those outlined on paras 3.30 – 3.32 of the consultation document.

- ***Pre-installed apps:*** Revenues derived in respect of certain pre-installed apps may fall within the scope of the DST currently. Pre-installed apps can be included on mobile and fixed devices (mobile phones, tablets, laptops, TV's, Cars etc).
- ***Exclusion of Telecoms providers*** – as outlined in response to Q2 above, there is currently ambiguity as to whether telecoms providers could fall within the current definition of a social media platform.
- ***Franchising arrangements –*** please refer to comments in Q2.

Role of HMRC Guidance

The legislation should be drafted in a sufficiently clear manner to remove the ambiguity surrounding the scope of the DST. Whilst secondary to this, HMRC Guidance will play an important role of complementing the specific exemptions provided by legislation. Due to the complexities and intricacies of specific business models it will be essential that HMRC draft this guidance in collaboration with businesses as specific industry knowledge will be required to ensure this is of practical relevance to business.

We would recommend that at a minimum this guidance should provide comprehensive examples of where multinational enterprises will and will not be within the scope of DST. Furthermore, it may be helpful for this legislation to provide specific exemptions for the major industry classifications, this would provide more general assistance to taxpayers in reviewing their business models.

CBI Recommendation

The CBI recommends that refined definitions of in-scope activities should be complemented with specific exemptions to ensure the DST legislation aligns with the intended policy objectives.

These legislative exemptions should be drafted in a sufficiently clear manner to remove the ambiguity surrounding the scope of DST, this legislation should be complemented with comprehensive HMRC guidance. It is essential that a collaborative approach between HMT/HMRC and business is adopted in drafting this legislation and guidance, for it to be of practical relevance specific industry knowledge will be required.

Boundary between marketplace and the selling of own goods

We observe that this boundary issue leads to concern by some members that this could create market distortions. Where businesses provide effectively the same service, how the supply chain is legally structured will determine whether revenues are subject to DST. Care would need to be taken that any approach to address this does not draw an artificial line between business models and the focus remains on the economic substance of the arrangement. This is essential to mitigate the risk of substantial distortions in competition arising.

We believe that there will be significant other challenges faced by business as a result of boundary issues, which are not easily resolved. Some of these challenges are best illustrated by an example, as in the box below.

Example: Challenges arising from boundary issues

A business has two business models:

1) It provides online content and technology tools to institutional customers by way of subscription agreements (the 'paid-for offerings'). The agreements entitle the employees and other affiliates ('users') of the customers to access the content via a platform.

2) The business also provides a separate but related platform for users to share their work, join communities and interact with one another. The business does not charge a fee or otherwise (directly) monetise this activity; rather the value to the business is in encouraging users (and therefore their employers) to maintain or upgrade their subscription agreements for the paid-for offerings.

The users of and contributors to the first platform include considerable overlap with, but are not identical to, the users and contributors to the second platform. In both cases, the business does not track where users are located, it only knows where the customers (i.e. their host institutions) are located. Nor is there any ready means of tracking which users or contributors to the first platform are also users or contributors to the second platform.

In relation to the first business model, ordinarily the business might gain some comfort from the specific exemption for online content but a) the content is not 'bought' from third parties but contributed for no fee to the platform under separate contracts between the business and the contributors and b) some of the contributors of content may – independently – also be users of the platform (though there is no easy way to track whether an individual user is also a contributor). Hence the provision of online content itself could (under the broadest interpretation) be regarded as falling within the proposed definition of a social media platform.

Cont…..

Example cont….

In relation to the second business model, it is unclear whether the platform for the provision of content/technology and the platform for sharing work, communities and interaction would be 'closely integrated functions', so that even if the former (the paid-for offerings) fall outside the scope, some of their revenues be allocated to the second platform (we elaborate on the difficulties of attributing revenues on a 'just and reasonable' basis further in response to Q5).

On one level this example seems similar in concept to other examples provided in the consultation paper, where the benefit to the business is in improving/enhancing its own product offering. However, it is unclear whether either business model described above (or a subset of either) would be regarded as a social media platform and, if it were, it is even more unclear how any revenues might be allocated to it on a 'just and reasonable' basis.

Chapter 4 – Revenues in scope

Q5: Do you have any observations on the proposed approach for attributing revenues to business activities?

The consultation paper observes that in many cases "it will be clear what revenues are generated from an in-scope business activity". Whilst we recognise and appreciate that this would be the case in some instances and therefore the proposed approach will be relatively straight-forwards, we consider that there is currently an underestimation of the complexities many businesses will encounter in this process, especially in highly integrated business models.

'Just and reasonable' apportionment

We note the merits of apportioning revenue to specific business activities on a 'just and reasonable' basis, as this will provide the most economically accurate outcome and for some business it may be simple and clear how to undertake this apportionment. However, the consultation underestimates how challenging it will be for many businesses where they may carry out in-scope activities as part of their business models (please refer to our example in Q4, which outlines the complexities that will arise in just one business model). In these instances, where in and out-of-scope activities are integrated together to form a holistic business offering, it is unlikely that the business will currently be tracking an isolated revenue stream which arises from the in-scope activity alone.

The consultation paper outlines in paras 4.8 and 4.9 that these businesses will be required to undertake an exercise to apportion revenue between in and out-of-scope activities on a just and reasonable basis. This will add a significant compliance burden for these businesses, which will have to incur significant spend and time in developing and implementing systems and processes to hypothetically allocate a portion of the revenue streams to in-scope activities. This exercise will need to be re-performed annually (or more often as business models evolve) and the subjective nature of the exercise will inevitably result in further discussions being necessary with HMRC.

Whilst not removing the administrative burden and additional complexities in entirety, we consider that the following would be of assistance to business;

- There is a refinement of scope, as proposed in our comments in response to Q1 and Q2, to narrowing the current definitions of in-scope activities and isolate specific revenue streams within the scope of DST. This will reduce the burden on business arising from these issues to a degree.

- Further examples on the application of the 'just and reasonable' criterion are provided in HMRC guidance to substantiate how this approach should be applied in practise (including a comparison of methods that would be acceptable/unacceptable). This guidance should also provide clarity of instances where no revenues should be attributed to the in-scope activity (for example cost centre activities).

- Optional mechanical rules are available for the taxpayer to elect to apply where there' just and reasonable' approach which leads to high level of uncertainty (and we discuss this in further detail in response to Q6).

Disproportionate administrative burden

It is anticipated that the process of attributing revenue to in-scope activities will be comparatively easier for those businesses that solely carry out in-scope activities. The process will be disproportionately more complex for those businesses that the DST is not necessarily intending to target (i.e. where the in-scope activities are closely integrated and do not directly drive revenue streams, it's more likely that the apportionment of revenue to in-scope activities will fall below the revenue thresholds). However, there will remain a requirement for these businesses to carry out the relevant revenue apportionment to substantiate and document this position.

We recommend that a further threshold test is included to exclude businesses from the scope of the DST where an insignificant proportion of their revenue is derived from in-scope activities. This would provide an additional safeguard to remove the unnecessary administrative burden of artificially allocating revenue to in-scope activities for businesses that do not derive a substantial part of their revenues from user participation. The level at which insignificant is set should be determined with the ultimate policy objective in mind (i.e. to link tax to values created by UK user participation). We consider that a suitable threshold would be where revenues derived from in-scope activities equate to less than 10% of total revenues. A 10% threshold allows enough margin for those business that have minimal in-scope activities to not have to undertake substantial additional work to determine if they fall below the threshold, whilst not being too high that it starts to exclude those businesses that do derive significant value from in-scope activities.

CBI Recommendation

HMRC should provide comprehensive guidance on the application of 'just and reasonable' revenue apportionment.

A further threshold test is included to exclude businesses from the scope of the DST where an insignificant portion (less than 10%) of their revenue is derived from in-scope activities.

Q6: Do you think there is a need for mechanical rules to guide apportionment in certain circumstances?

We consider that businesses should be able to elect to apply mechanical rules, to assist those businesses which may encounter significant complexities and uncertainty in applying a 'just and reasonable' approach to revenue apportionment. However, we consider that 'just and reasonable' apportionment will in most instances be the best approach and therefore mechanical rules should not be the default position.

We also observe that mechanical rules for revenue apportionment could not be drafted in a manner which provides clarity and certainty to the taxpayer, without first determining the revenue stream which should be apportioned. We therefore consider that our proposal in response to Q1, of defining specific revenue streams, would simplify the drafting and subsequent application of mechanical rules for revenue apportionment.

Chapter 5 – UK Revenues

Q7: Do you have any observations on the proposed approach to defining a user?

We observe that the definition of user in the consultation document (which includes individuals, companies and other legal persons) is broad given the basic premise is to tax value derived from users. We consider that this definition should be refined to just include individuals. This could include individuals which participate with an in-scope business activity both via a personal or business technological device.

Including companies and other legal persons in this definition creates additional complexities and uncertainties over the scope of the tax (i.e. has consideration been given to whether there is an intention to tax value derived through robots interacting with platforms which carry out in-scope activities).

Impact of the supply chain

As outlined in the 'Key Points' section of this response, the results of the CBI business survey highlight the breadth of companies that interact with businesses that provide in-scope activities and that in some instances the cost of the DST may be passed on to these businesses. This is supported by various economic studies carried out historically on revenue taxes, which find that such taxes are often passed on, in full or in majority, to the consumer or through the supply chain.[17] A detailed economic impact assessment of the introduction of the DST is needed to establish the wider consequences on the UK

[17] Besley and Rosen 1999, "Sales taxes and prices: An empirical analysis". Detailed study of the pass-thru of sales taxes to prices at the item level, for the US. Finds high rates of pass-thru.

Bergman and Hansen 2012, "Are excise taxes on beverages fully passed through to prices? The Danish evidence" Danish study which finds that excise tax hikes on alcoholic beverages are mostly passed through to prices.

Benedek, De Mooij, Wingender 2015, "Estimating VAT Pass-Thru" IMF study of VAT pass-thru in Eurozone countries, following the general framework of Poterba, and Besley and Rosen (above). Finds 100% pass-thru for changes in the standard VAT rate, lower pass-thru for changes in reduced VAT rates.

economy however, by limiting the scope of the DST to only business to consumer transactions only would limit the impact to a degree.

Application to group companies

Where in-scope activities are closely integrated within the business model and relate to ancillary or support functions, the user of the in-scope activity may often be another group company. There should be a clear statement provided in the legislation that UK DST does not apply to transactions between affiliated entities (this would be in line with the comments made in para 4.1 of the consultation document).

We would note that often in these instances where the 'UK user' is a group company, revenue relating to the functions and value of the UK company (or UK Permanent Establishment) will already have been allocated to the UK tax net under transfer pricing legislation. It therefore appears unnecessary to apply DST on intra-group transactions.

CBI Recommendation

The definition of users should just refer to individuals which participate in an in-scope business activity (both via a personal or business technological device).

Q8: Do you think the proposed approach for determining user location for the purposes of the DST is reasonable?

Determining user location for the purposes of DST poses some complicated questions. We observe that there will be an increased burden on businesses to identify and collect this data, many of whom do not currently record this data due to the complex and technical obstacles surrounding identifying user locations and ultimate users. Consideration should also be given to interaction with other data protection measures including the General Data Protection Regulations (GDPR).

It's noted that the extent to which the proposed approach is reasonable, and the complexities encountered by business, will vary across in-scope activities and the means by which these activities are monetised.

In-scope activities which are monetised through payments from users

The proposed approach may be simpler for those business models which directly monetise their in-scope activities through payments made by users (for example a purchase made via an online marketplace). It is envisaged in these instances that billing information/delivery addresses will be available to assist in determining user location. However, whilst information on user location may be more readily available in these scenarios there will remain many issues which would need to be addressed.

Administrative burden and cost

While businesses may to some extent know where their users or customers are located, there is a key distinction to be drawn between the level of data accuracy required to inform strategic decisions versus that required to be compliant with UK law in calculating a DST liability.

This burden will extend beyond those businesses which ultimately have a liability to DST. Any business on the peripheries of the scope of the DST will be required to track user location to demonstrate that revenues attributable to in-scope activities and deemed to be derived from the participation of UK users, do not exceed the revenue thresholds.

Implementing such systems to capture this data will add a significant administrative burden to doing business in the UK.

Just and reasonable approach

We agree with the outlined approach that the need for mechanical rules, which assist the taxpayer in providing certainty, needs to be balanced with ensuring that the approach for identifying UK users is just and reasonable. However, we observe that this is a difficult balance to reach.

A just and reasonable approach is appropriate where businesses currently have high quality data on user location however, there are some areas where this could create significant uncertainty for business.

One area of particular concern is where the information provided by the user may in itself be contradictory, for example if the billing address and delivery address are in different jurisdictions. The requirement outlined in para 5.16 “that the assessment is undertaken on a just and reasonable basis, having regard to the facts” places a significant burden on business to verify user location where they are presented with contradictory evidence.

In a business that undertakes millions of transactions a year, it would be overly burdensome to expect business to review data on a transaction by transaction basis and seek additional information to verify user location. It is therefore essential that clear guidance is provided on the extent of measures business will be required to take to verify user location where there is contradictory evidence. In this instance mechanical rules may assist business in determining which information should take precedence and mitigate the uncertainty of potential challenge. However, as highlighted mechanical rules may distort the true user location and therefore the application of them should always be optional.

GDPR and data ethics

There is an ever-growing spotlight on technology businesses, and in particular on many of the businesses which will be subject to the UK DST, regarding the level of data they store on their users. Tracking user locations is increasingly being seen as ethically wrong, and in some cases legally wrong (as a result of GDPR). Businesses will therefore be presented with a difficult challenge of balancing their obligations in respect of a UK DST alongside wider obligations on data ethics. Data protection points are yet to be addressed in the consultation paper.

Whilst we understand that it is assumed that the Government can legislate for companies to retain such data for the purposes of DST compliance, which in effect will override GDPR obligations, we have specific concerns with this in practise;

- The legal obligations to maintain data on users will not mitigate the perception by users that it is ethically wrong for companies to retain this data. This could have a negative impact on user perceptions of businesses required to do this and change user behaviour.

- As the DST is a unilateral measure, we understand that any override of GDPR will only apply to UK users and not to users located in EU member states or outside the EU. Consideration must also be given to data privacy regulations outside the EU. For example,
  - In cross-border transactional scenarios where there are multiple users in the same transaction, e.g. Chinese seller selling to a UK customer via an online marketplace, there will be a need to prove where the non-UK party is located for the purposes of DST, and so the UK can apply the appropriate taxation to the revenue (i.e. 50% where there are 2 users, 1 of whom is UK – see further comment below on this in Q10).
  - In an advertising scenario, impressions are often served to users in a variety of different countries accessing the same website. It will be necessary to have data on the location of those users to prove the appropriate portion of advertising revenue that relates to the UK.
  - Where users access platforms near the UK border (in particular near the border between Northern Ireland and the Republic of Ireland), in order for business to demonstrate that revenues are not in the scope of DST by virtue of them arising from a user located in the Republic of Ireland they would need to retain this data in order to substantiate this point in any future enquiry. Our understanding is that this will not be possible and therefore, we would urge the Government to confirm the legalities of this point and consider how this will be addressed.

We would welcome further consideration from Government on how businesses should deal with these challenges and obligations under UK DST interacts with legislation on data protection (including GDPR). This will require HMT and HMRC to link with other Government departments responsible for these issues.

In-scope activities which are monetized via other means

Where users do not pay the platform directly for services/goods, but the in-scope activity is monetised via other means (most commonly advertising), we observe that there will be further difficulties with the proposed approach. In a significant number of cases where the user is not entering into a transaction with the platform, they will not be required to provide details regarding their location, this will exacerbate a lot of the issues outlined above and provide additional complexities.

These issues will be unique to any other compliance requirements for tax matters (such as identifying jurisdiction for VAT purposes) given that the DST will be applied to revenue streams in the absence of the UK user making a payment for the services provided.

Use of Virtual Personal Networks (VPNs), proxy servers and other mechanisms to mask locations

Where users are not required to provide the platform with any information on their location, often the only means to identify user location will be via reference to the user's IP address.

The use of VPNs, proxy servers and anonymity software (such as 'Tor') all seek to mask a user's location. The use of these are widespread and therefore, in some instances businesses will simply be unable to determine the location of users by reference to their IP address, or it will provide an incorrect determination.

YouGov research undertaken in 2017[18] found that 16% of British adults had used a VPN or proxy server, with the main motivation (48%) being to access regional based content which would not otherwise have been available, followed by 44% of VPN users citing security reason. This research evidences that there is a not insignificant proportion of the British population actively seeking to ensure their location remains undetectable.

A separate analysis undertaken by Wombat Security[19] indicated that from 1,000 UK working adults surveyed, 44% of those surveyed in the UK use a VPN on a corporate and/or personal device.

In reality we believe this may be an underestimation as many users are likely to unknowingly have their location masked. For example, many multinational enterprises have a single server for operations spanning several countries. When these users engage with in-scope activities via their work computers, which we understand based on the proposed definition of users will be in scope, reference to IP addresses will also provide an incorrect determination of user location.

Furthermore, the introduction of DST which will require users to be tracked by organisations may, in itself, lead to increased activity by users to mask their location for reasons of online safety. Attempts to geolocate by organisations will therefore become increasingly less effective. Whilst organisations can use software to block logins that can't be tracked e.g. from anonymity software such as 'Tor', commercially this will have an adverse impact on their business.

Advertising models

We observe that there are specific difficulties for advertising revenues to be tracked based on user location. As part of the CBI business survey we asked business who earn revenues from advertising to customers/users based on their location through one of the in-scope business activities (i.e. search engines, social media platforms or online marketplaces) whether they currently track those revenues based on the location of the customers/users. 62% of those business surveyed that do earn such revenues responded that they currently do not track/split out advertising revenues based on the location of customers/users or they do hold some data on the location of customers/users but would face the following difficulties in accurately splitting out the advertising revenues based on customer/user location.

- Users do not need to provide location information when an ad impression is viewed – therefore in order to track user location, it is likely that IP address would need to be used, but this is imperfect for the reasons set out above.
- Information on the location of users is not typically provided to advertisers, often for data privacy reasons. There is no reason why these businesses would need to accurately track the location of users that view ads, and track revenues based on user location
- A number of advertising models involve facilitating the sale of advertising inventory programmatically between third parties, under a business-to-business model. In these scenarios, whilst the location of the business customer may be known, the location of the end viewer of the ad would not necessarily be known.

[18] https://yougov.co.uk/topics/politics/articles-reports/2017/05/17/almost-half-vpn-users-are-accessing-region-based-c
[19] Wombat Security Technologies- 2017 User Risk Report https://info.wombatsecurity.com/hubfs/2017%20End%20User%20Risk%20Report/Wombat%202017%20User%20Risk%20Report.pdf?submissionGuid=3b127e11-45a8-4427-a760-88a7fce9e675

Q.9: Do you think there is a need for mechanical rules to determine what is considered a UK user in certain circumstances?

Please refer to our comments in respect of Q8, which outline where we consider certain scenarios in which mechanical rules may be of assistance in providing greater certainty to the tax payer.

However, mechanical rules may distort the true user location and therefore the application of them should always be optional. Taxpayers should have flexibility to adopt their own approach if it is a just and reasonable one.

Q.10: Are there any other circumstances where the treatment of cross-border transactions needs to be clarified?

We observe that a wave of countries have followed the UK in introducing unilateral digital taxes. There is significant uncertainty as to whether DST would be considered a covered tax within the scope of the UK's tax treaties or not. Whilst the UK may consider it not to be a covered tax, this position would appear to be open to challenge, and bilateral treaty partners may not take the same view as the UK. This will inevitably lead to increased uncertainty and potential disputes.

If these taxes are not covered taxes for the purposes of double tax treaties, which serve to reduce instances of double taxation, double (and multiple layer) taxation will inevitably arise - this is a complication of revenue taxes.

In the absence of the DST being covered by the existing tax treaty framework, a separate and bespoke process will be required to ensure that double taxation does not occur and there is an appropriate allocation of taxing rights. We consider it highly important that there are dispute and resolution mechanisms integrated in any such agreement which allows for timely settlements of any disputes that arise. The current consultation is silent on what these mechanisms would look like and an area which needs further consideration. We would highlight our concern regarding the input of resource required by tax authorities to establish and negotiate with other jurisdictions on this matter, which would be highly disproportionate for a temporary measure. There is also significant concern over the timeframe it would take to achieve agreement on these matters.

These concerns will be exacerbated where the principles on which other jurisdictions calculate the equivalent digital tax differ. These differences are expected to be prevalent given other jurisdictions are focusing on revenue stream-based approaches and differing revenue recognition-based principles to the UK (i.e. a cash basis versus following accounting accruals-based principles of revenue recognition). The UK taking a significantly different approach to DST compared to other countries raises further challenges for taxpayers having to manage different incidences of DST.

We believe that double taxation is an area of weakness with an interim revenue-based tax which moves away from the existing tax framework of taxing profits and why they should be avoided. However, at a minimum we consider that where a transaction involves a UK and a non-UK user, the UK should only seek to tax a proportionate share of the revenue to DST (e.g. 50% where there are 2 users, one of whom is in the UK).

CBI Recommendation

We recommend that the DST is only levied on a proportionate share of revenues where users are located both in the UK and outside the UK.

Q11: Do you have any comments on this chapter, and are there any other issues the Government needs to consider in relation to the rate, thresholds or allowances?

As outlined above we envisage that business will encounter significant complexities and administrative burdens in determining whether they meet the thresholds. The CBI business survey indicated that 85% of businesses for which all (or part) of their business would (or may) fall within the definition of an in-scope activity[20] did not feel they would be able to accurately compute revenue subject to the DST or it would require substantial changes to current reporting systems.[21]

We also observe that the Government should not consider user participation as a proxy for value creation. This is an imprecise metric that is extremely difficult to value given the diverse spectrum of user relationship. We therefore consider that the 2% rate is arbitrary in nature and being a revenue-based tax, the effective tax rate as a result will varying significantly across businesses depending on their profit margins (as outlined in our comments in response to Chapter 6) being particularly burdensome for low margin businesses. However, rather than this being a function of the rate set we consider this is a fundamental flaw of a revenue-based tax and another reason why we would urge the Government to reconsider its implementation before the conclusion of the OECD work.

Chapter 6 – Safe harbour

Q12: Do you agree that the safe harbour should be based on a UK and business activity-specific profit margin?

Q13: What approach do you think the Government should take in relation to the issues identified in determining a UK and business activity specific profit margin?

Q14: Are there other elements of how the safe harbour would operate that need to be clarified?

The response below covers our comments in response to Questions 12, 13 and 14.

As set out in Chapter 7 of the consultation document, the Government acknowledges that DST should "remain proportionate for businesses with very low profit margins". Whilst the fact that the UK is proposing such a measure is welcomed, a number of members have concerns that the design of the safe harbour does not meet this objective, and it in fact produces highly distortive effects.

In particular, the fact that taxpayers are required to calculate a UK-only business activity-specific P&L solely for the purposes of the UK DST safe harbour, when this would not be required for any other purposes, is highly disproportionate for a tax that is only designed to be a short-term measure in anticipation of long-term tax reform. We believe that taxpayers should be allowed to use readily available and audited financial data to perform the safe harbour calculation as the closest available proxy in order to make the calculation more straightforward for taxpayers and HMRC.

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[20] 51% of respondents (being 107 out of 210 respondents in total) answered that all (or part) of their business would (or may) fall within the definition of an in-scope activity.

21 Respondents who thought their business (or part of their business) would be or maybe in-scope were asked whether they felt they will be able to accurately compute your revenues from in-scope business activities which would be subject to UK DST and given the following options;

Yes, based on current reporting systems we have this information readily available – 8.4% of respondents chose this option.

Yes, however this will require simple changes to current reporting systems – 6.9% of respondents chose this option

Yes, however this will require substantial changes to current reporting systems – 28.5% of respondents chose this option

No, we have answered based on an estimate and in practice it will be very difficult to accurately compute – 56.2% of respondents chose this option.

We address in more detail below the following factors of the safe harbour and provide suggestions of how the proposals can be improved to be simpler to apply and more proportionate: (1) calculation of the profit margin, (2) “X” (the multiplier), and (3) election and timing.

(1) Calculation of the profit margin

The design of any new tax should ensure that it is easy to comply with, in particular as it is only supposed to be a temporary tax. This is for the benefit of both taxpayers, who should not be required to incur significant spend and employee time in developing new technology, systems and processes, and also for tax authorities, who should be able to audit financials in a straightforward manner without incurring significant incremental time and cost. This means that the financial information used for DST should be financial data that is readily accessible for both taxpayer and tax authority, rather than taxpayers being required to produce a bespoke UK-only in-scope P&L specifically to implement these rules.

A reasonable proxy to calculate the profit margin would therefore involve using published and audited financial statements, either:

> (1) published and audited global consolidated financial statements (under U.S. GAAP/IFRS per the taxpayer’s parent company accounting standards), or
> (2) published and audited financial statements by segments (under U.S. GAAP/IFRS per the parent company’s accounting standards).

If a bespoke UK-only business activity-specific P&L is required, the financial information would not be audited (unless a separate audit was undertaken solely for the purposes of DST, which would add unjustifiable incremental time and cost). HMRC would need to devote significant resource to review this unaudited financial information. Without a third-party auditor to express an opinion on the financials, there is a risk of disagreement between taxpayer and tax authority, as well as between different tax authorities in cross-border scenarios (i.e. with other countries who implement a DST). Given this increased risk of dispute, there would be an increase in controversy/litigation activity in order to reach a mutually agreed position.

A full value chain analysis would need to be performed in order to carve out a country-only or business-only P&L where this is not already in place, which would be a highly complex exercise that would not be justified for DST only.

Further, in an integrated business model, where there are many interconnected businesses, there are a number of highly challenging issues. Consideration would need to be given to how to allocate a relevant portion of central/shared costs to the in-scope P&L, which is complex, and unlikely to be something that businesses would do today. Significant additional work would be required to create bespoke financials solely for the purposes of DST.

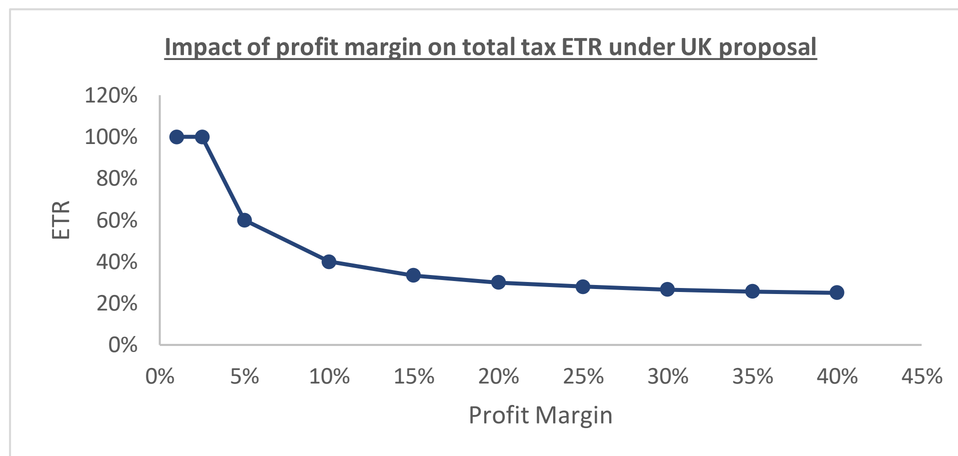
For the above reasons, we do not consider it practical that taxpayers would be required to produce a UK-only business activity-specific P&L. At a minimum, taxpayers should be able to choose to do this as a taxpayer option. However, we consider that financial statements should be the default basis for the calculation, but with the bespoke calculation to be performed only at the choice of the taxpayer.

(2) Safe harbour multiplier “X”

As drafted with X as 0.8, in order to fall within the safe harbour, a group must have a profit margin of below 2.5%. We consider this to be too low, and even groups within the safe harbour face hugely disproportionate impacts from DST. For example, a group with a profit margin of 2.5% or below can in very high revenue business end up with an effective tax rate of near 100% under the UK’s proposal

(taking both UK corporation tax at 17% and UK DST into account). This is clearly not proportionate and does not meet HMT's stated acknowledgement that DST should "remain proportionate for businesses with very low profit margins".

The graph below illustrates how high revenue, low profit margin groups bear a much higher tax burden than groups with higher profit margins[22].



For low margin businesses, the consequence of DST being a revenue based tax is that these businesses will have to choose whether to absorb the cost of the DST or to pass on the cost to the consumer or companies within the supply chain (many of whom will be SMEs who are not the target of the DST and who themselves are unlikely to be able to absorb the cost). Where X = 0.8, the DST will represent a significant portion of the profit margin when combined with CIT (as outlined in the graph above) and it may become unsustainable for low margin businesses to absorb this cost of the DST. We consider there is a reasonable risk these businesses will have no choice but to pass on the tax if their business model is to remain sustainable. Whilst the competitive nature of the market may drive down demand as a result, if the DST is applied and enforced effectively across the board, competitors are likely to take similar action seeing an overall rise in prices. This scenario is one of the distortive effects of revenue-based taxes however, reducing the value of X for the purposes of the safe harbour should reduce the impact of this flow through effect as the DST burden would be lower for these low margin activities.

Considering the objective of the measure, i.e. to reflect the value of user participation in certain business models, "X" should be representative and a proxy for user value contribution and the UK corporate tax rate of 17%.

There is no explanation as to how 0.8 has been derived as a value for "X", or why 2.5% is considered as the level of profit that is sufficiently low to be within the safe harbour.

In order to reduce the distortions, members would propose setting the multiplier at a much lower level that reflects a more realistic value of user participation. If a generous rate of user value contribution of 10% is considered, at a corporation tax rate of 17%, would suggest a multiplier of 0.017. A multiplier at in this region would have a significantly more proportionate effect.

Alternatively, the safe harbour could be adapted to be a gateway test to fully scope out loss making <u>and</u> low margin businesses from DST. This could be, for example, for all groups with a profit margin

[22] Please note for simplicity this graph is based on a 20% CIT rate and assumes that the first £25m of revenues (which are not subject to DST) is insignificant in the context of total revenues. It is recognised that the distortions between profit margins will be less pronounced for those businesses where £25m is a significant portion of total revenues, given that the first £25m of revenues will not be subject to the DST.

below a set percentage, say 10% (based on audited financial statement data), and including loss-makers. The rationale for this would be that these businesses do not benefit from any material user value because they are loss-making or making small margins, and the impact of DST is particularly disproportionate below this profit margin as can be seen in the graph above.

(3) Election and timing

Consideration should be given to the timing and duration of a taxpayer's election to use the safe harbour. We believe that the election should be made on an annual basis, given that a taxpayer's profit margin could vary significantly between years. In order to prevent taxpayers paying a rate of DST above 2%, HMT should clarify that the level of DST should be capped at 2% of revenues, regardless of which method is used to calculate the DST.

In terms of payment, we understand that HMT intend for a quarterly payment regime to apply for DST, and as such taxpayers will need to calculate the estimated DST liability for a given year based on forecasted data. Consideration needs to be given to at which point in any given year an election is required for the safe harbour. Flexibility needs to be introduced into the election and payment mechanisms in order to provide flexibility for taxpayers whose profitability may change above and below 2.5%.

CBI Recommendation

We recommend the following is applied in the design of the safe harbour;

- Financial statements should be the default basis for the calculation, but with the bespoke calculation to be performed only at the choice of the taxpayer.

- X should be reduced to 0.02 or alternatively the safe harbour could be adapted to be a gateway test to fully scope out loss making and low margin businesses from DST.

- The safe harbour election should be made on an annual basis and flexibility should be provided on the timing of this election annually.

Chapter 8 – Deductibility and crediting

Q.15: Do you agree with the Government's characterisation on the circumstance of when the DST will be a deductible expense for UK corporate tax purposes? Are there other issues that require further clarification?

We observe that the DST will result in double taxation as it is not covered by the existing tax treaty framework which provides a means to eliminate double taxation in cross-border scenarios.

Double (or multiple layer) taxation is highly likely to arise for foreign-parented multinationals, given that the residual profits are likely to be earned outside the UK. As a result, there would be limited, if any, expense relief available for the UK DST suffered, even if the UK entity earns an arm's length return on which it pays UK corporation tax. In contrast, a UK-based group that earns residual profit in the UK and which is able to benefit from full expense relief from UK DST will be paying a lower effective tax

rate globally and will suffer less from double taxation. This may be considered discriminatory in comparison.

Double taxation will be particularly apparent for those businesses with low profit margins, higher margin businesses will have the ability to absorb more of the tax. We refer to our comments made in response to chapter 6 regarding the implications of the DST being passed on through the supply chain and the distortive impacts this would have. Conversely, if other countries follow the UK's proposal, UK multinationals making sales overseas and paying foreign DST and foreign corporate income tax would find themselves of incurring double taxation, where they are not able to benefit from relief – this will make UK groups less competitive and may mean they incur higher effective tax rates.

Consideration also needs to be given to how the DST interact with other taxes (such as the Diverted Profits Tax) and the anticipated tax on offshore receipts in respect of intangible property. We consider that there could be potential overlaps, for example revenues facilitated by UK users could include payments for the use of IP rights, particularly in the case of subscription fees for the use of online marketplaces.

Whilst on a separate point, we would urge the Government to consider where other countries follow the UK's proposals, would HMRC treat the equivalent DST (arising in the foreign jurisdiction) as deductible. If DST becomes widespread around the world, which appears to be a possible outcome as many countries are considering copying the UK and implementing their own DST, and some at rates much higher than 2%, there may be a significant impact on UK corporation tax take if UK companies are incurring significant foreign DST cost which is treated as a deductible expense. As noted previously, the UK must seriously consider the possible knock on consequences and retaliatory measures from other countries.

Link with 'just and reasonable' revenue apportionment

Where businesses do not solely carry out in-scope activities, there will need to be a just and reasonable allocation of revenues attributed to in-scope activities. These in-scope activities may not represent a separate and distinct trade. Therefore, consideration should be given to whether the 'wholly and exclusively' terminology needs to be broadened in this instance to ensure that DST continues to be deductible.

Deductibility for recharges

Where a UK company incurs and pays DST on behalf of its worldwide group this DST may need to be re-charged under transfer pricing principles. It is assumed that any revenue generated would be taxable but correspondingly the full expense deductible however, this point should be clarified in HMRC Guidance to provide certainty on the matter.

Q16: Do you have any observations on the proposed review clause?

We welcome the intention for the DST to be dis-applied on reaching an appropriate global agreement to this policy challenge.

In the absence of such certainty, there is a risk that the distortive impacts of the DST will be amplified, with more businesses taking measures to re-arrange their operations and the markets they operate in response. For example, serving the UK market will ultimately come with additional costs, where businesses are unable to pass on the cost of the DST it will impact their return on capital in the UK market which feeds into businesses investment decisions. Certainty that the tax is temporary in

nature will not eliminate the impact of the DST in such appraisals, but it may dampen the impact on long-term investment decisions.

In order to provide business with this certainty, we would strongly recommend that at the 2025 date, the default position is that the DST is to be dis-applied. If it was still deemed to be required then an active decision by Parliament would be required to continue it, rather than a passive decision as currently intended. However, at this point we would recommend a more sustainable long-term solution is sought.

We believe this clear commitment from Government is needed to signal to business the DST will be a temporary measure. There is currently a concern that an interim DST could easily become long-term due to political inertia and the fact that the question over whether an international solution has been reached will be subjective. There are a variety of fundamentally different proposals being put forwards at the OECD level, each would result in a differing allocation of taxing rights between jurisdictions. To reach a consensus-based solution at this multi-lateral level will inevitably require compromise between countries and we welcome the Government's active engagement in this arena.

Alongside this, there is a concern that future Governments will wish to retain the revenues generated from the DST and therefore this may be a difficult revenue stream to justify losing. This policy objective of the DST is clearly not to raise revenue but to address the balance of how differing businesses pay taxes. It is essential that sight of this policy objective is not lost over time and this is reflected in the design of the tax upfront.

There is also a wider concern that interim solutions act to delay and discourage debate of a long-term solution rather than expediate it. Having a fixed date for its end will ensure that momentum is maintained in finding a solution.

CBI Recommendation

We recommend that the DST should incorporate a 'sunset clause', to provide a clear signal to business that the DST will remain a temporary measure.

Chapter 11 – Reporting

Q17: Do you foresee any difficulties for individual entities to calculate whether the worldwide group is in scope, and if so, how could they be overcome?

As outlined in this consultation response, we observe that there are practical difficulties for multinational enterprises in assessing i) whether they have in-scope activities and ii) the allocation of revenues to these in-scope activities. We have proposed safeguards (including an additional revenue stream test) which we consider would simplify this process for a number of businesses.

In addition to this we would recommend that the following routes could be provided to give business certainty over whether they have a liability to DST.

- ***HMRC Guidance –*** as outlined in response to questions 3 and 5 it will be critical to provide extensive and comprehensive guidance on both those businesses that are expected to be in-scope (and those that are exempt) alongside guidance on how business should attribute revenue to in-scope activities.

- ***Customer Compliance Managers*** – CCMs should be empowered to be able to provide decisions to business on a real-time basis regarding whether they have in-scope activities and the method by which they attribute revenue to this activity on a 'just and reasonable' basis.

- ***Clearance mechanism*** – Given that business models in the technology sector are often characterised by being novel and constantly evolving it will be difficult to provide guidance that will be applicable to all organisations. We therefore believe, there should be a clearance mechanism available for business to provide certainty on whether they have an in-scope business activity and if so, the basis under which they attribute revenue to that activity. We would expect in return that as part of any clearance there could be critical assumptions that put the onus on taxpayers to contact HMRC in the event that their business model changes (similar to conditions typically found in advance pricing agreements regarding appropriate transfer pricing methodology).

As outlined in this document, there is a significant burden for businesses to implement additional systems to capture the necessary information to comply with the DST. If and when legislation and HMRC guidance is issued, there should be sufficient lead time for businesses to design and implement the necessary systems. We would anticipate that at a minimum 6 months would be required, although 12-18 months would be more reasonable.

Q18: Do you agree that the DST should be reported annually?

We are in agreement with the proposed approach that DST should be reported annually. In order to ensure that the administrative burden is not increased further, it is important that this reporting period is aligned with company financial accounts as proposed.

Q19: Do you see any difficulties applying the CT rules for accounting periods for DST, and if so, how could they be overcome?

We have no additional comments.

Q20: Are there any other issues relating to reporting the Government should consider?

Reporting requirements

It is not appropriate to follow the corporation tax notification requirements for the purposes of the DST. Whether a business will be within the scope of the DST will be a detailed assessment, first on whether there is an in-scope activity and secondly whether revenues exceed the relevant thresholds. The latter will not be possible to determine until after the end of the accounting period, having to notify prior to this could only be done on an estimated basis.

It’s important that business feel able to comply with the requirements of DST and as such require more time to assess their activities and attribute revenue. We would therefore recommend on this basis that notification should be done at the same time as filling the DST return.

Furthermore, paragraph 11.24 of the consultation document talks about consideration being given to requiring businesses to provide aggregate global revenue from in-scope business activities which would then need to be broken down per in-scope business activity. Such an exercise creates a heavy administrative burden/cost on business which seems unnecessary where a business’ revenue is below the £25m threshold of UK taxable revenues. Similarly, for businesses that are clearly within the scope of UK DST, a simpler approach could be to have a tick box for companies to indicate whether they are in-scope for DST, without the need to analyse global revenue from in-scope business activities.

Penalties

As outlined, there are several areas where members are concerned regarding the ambiguity and complexity of the DST. We would, therefore, urge HMRC to consider taking a light touch for penalties, especially in early years.

Chapter 12 – Payment and Compliance

Q21: Do you agree that mirroring the CT framework is the correct approach to minimise the compliance burden? If not do you have a preference for an alternative framework and can you give details of why this is preferred.

We disagree that the DST compliance should be administered through the corporation tax framework, given the DST is a revenue-based tax.

In particular, the new quarterly instalment payment (QIP) deadlines, which accelerate the deadline for payment of corporation tax, are very tight. Given the compliance issues outlined in this response for businesses to calculate the DST, the requirement to calculate the DST on forecasted data will amplify these issues. In addition, being a revenue-based tax (which could represent a significant proportion of a businesses’ profit as outlined in the diagram included in response to Chapter 6) would present substantial cashflow businesses where the DST is required to be paid on a real-time basis in line with the QIP deadlines.

Q22: Do you agree that allowing a Nominated Company to act on behalf of the group will reduce the compliance burden?

Yes, we agree with this.

Q23: Do you foresee any difficulties with the Nominated Company calculating DST liability on behalf of the whole group?

We have no additional comments.

Q24: Are there any practical issues around the Nominated Company accessing information from the rest of the group?

We have no additional comments.

Q25: Would specific rules be needed from companies whose AP does not coincide with the Nominated Company's AP?

We have no additional comments.

Q26: Do you have any observations on either of the proposed anti-avoidance provisions, or other avoidance risks?

We have no additional comments.

Q27: Do you think it will be necessary to introduce additional rules to ensure compliance with the tax?

We do have concerns relating to the ability of the UK to implement and enforce the DST against non-UK/non-EU taxpayers. In particular, given that many of the in-scope business models are able to be carried out remotely to some extent, members are concerned that there may not be a level playing field if foreign taxpayers are not subject to the same compliance obligations. In particular, this is a larger concern in business models where there is high substitutability, e.g. physical goods, where foreign imports not subject to DST would be cheaper. This cannot be in line with policy intent and it would be UK SMEs who would suffer further due to cheaper imports being available. The UK should give further thought to how DST can be robustly enforced against foreign taxpayers, and measures such as published lists of offenders should be considered.

Chapter 13 – Assessment of impacts

Q28: Do you have any comments on the summary of impacts?

It is clear that the introduction of the DST will impact those businesses that fall within the scope of the tax. However, it could also indirectly impact those businesses that interact with or rely on in-scope business activities for their own business activity. For instance, a business might advertise via a search engine, buy data from a social media platform or sell its products via an online marketplace. The extent to which these businesses are impacted will depend on the pass-through rate i.e. how much of the tax is passed onto its customers in the form of higher prices.

The CBI business survey examined this in more detail. It found that over 80% of respondents that do not fall within the scope of the DST interact in some form with those that do. Of the SMEs[23] surveyed, 75% stated interaction with in-scope business activities. This is a fairly large proportion, suggesting the DST could have wider economic impacts.

The nature of this interaction appears to vary by sector and the tax could therefore create distortionary impacts across the economy. For example, the survey finds that businesses in sectors such as accommodation and food, agriculture, arts and entertainment, other services, and transport, all stated they interact with in-scope business activities in some form, while sectors such as human health and social work interact very little with the in-scope business activities. In addition, the survey indicates that a business in the accommodation and food sector is more likely to advertise and buy

[23] This survey defines an SME, as a business with less than 250 employees and turnover below or equal to EUR 50 million.

data from all in-scope business activities whereas a business in the agriculture sector is more likely to advertise via search engines and social media platforms.

While some businesses may interact with in-scope business activities, they may not necessarily be reliant on them to perform their own business activity. The level of reliance should therefore be considered when understanding the magnitude of the wider economic impact. The survey finds that the extent to which businesses rely[24] on in-scope activities is the highest for social media platforms. Of those businesses that interact with in-scope business activities, over 40% are reliant[25] on social media platforms, falling to just under 40% for search engines and almost 20% for online marketplaces.

As is the case for interaction, reliance appears to be more pronounced in certain sectors. The survey indicates that a business in the accommodation and food services sector is more reliant than the average business across all in-scope business activities, placing significant reliance on search engines and social media platforms in particular. On the other hand, while a business in the arts and entertainment sector is more likely to interact with in-scope business models, these businesses are unlikely to be reliant on such activities. Furthermore, for both search engines and social media platforms, the level of reliance is higher when looking at SMEs in isolation, with almost 70% of SMEs surveyed reliant on social media platforms in particular.

While there is evidence to suggest businesses do rely on in-scope business activities and could therefore be indirectly affected by the DST, the extent to which these businesses are affected will ultimately depend on how much of the tax is passed on through the supply chain in the form of higher prices. Of those businesses that fall within the scope of the DST, 30% of businesses surveyed stated they would pass on 50% or more of the tax to business customers, with 15% claiming the pass on rate would be 100%.[26]

Where there is pass-through, this will ultimately hit the end customer through the supply chain i.e. the consumer. Those in-scope businesses who sell either wholly or partly to consumers were mostly not sure how much of the tax would be passed on to consumers (94%), with 1% stating they would pass on at least 50% to consumers.

While there is not enough evidence from the survey to understand exactly what the pass on rate will be to consumers, there is evidence to suggest that in some cases there will be pass-through. In conjunction with evidence suggesting a large number of businesses, including SMEs, rely on in-scope business activities, this indicates that the indirect impacts on both businesses and on consumers could be fairly significant, and there could be distortions created across sectors where reliance is higher. In light of this, it is recommended that a full impact assessment is carried out by Government to understand the significance of these impacts as well as other impacts that have not been considered as part of this analysis.

[24] Respondents were asked whether they were very reliant, moderately reliant, reliant, not that reliant or not at all reliant on each of the in-scope business activities.

[25] The definition of reliance here is based on those that responded very reliant, moderately reliant or reliant.

[26] It should be noted that 67% of respondents did not know how much would be passed on in B2B transactions.