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**Public Consultation Document – ADDRESSING THE TAX CHALLENGES OF THE  
DIGITALISATION OF THE ECONOMY**

Copenhagen Economics welcomes the opportunity to comment on the OECD's Public Consultation Document on Addressing the Tax Challenges of the Digitalisation of the Economy, issued on 13 February 2019.

Copenhagen Economics supports the OECD's efforts to develop rules to prevent base erosion and profit shifting by engaging in highly digitalised activities.

Copenhagen Economics believes that additional clarifications on the proposed guidance and examples will help both the taxpayer and the tax administration in addressing the tax challenges arising from the growing digitalisation of the economy.

It is our opinion that some of the proposals reported in the OECD's Public Consultation Document need to be critically reviewed in the scope and formulation to answer to the objective of addressing the tax challenges stemming from the digitalisation of the economy.

Eventually, it is our opinion that a clear and pragmatic guidance on how the proposals should be applied would represent a further step towards the proper allocation of profits based on economic substance.

We present our comments and feedback to the OECD's Public Consultation Document below.

## 1 BACKGROUND

The BEPS Action 1 Report on Addressing the Tax Challenges of the Digital Economy (hereinafter, “**Action 1 Report**”), released in 2015, identified the tax challenges arising from the digitalisation of the economy as one of the main focus areas of the Base Erosion and Profit Shifting (hereinafter, “**BEPS**”) Action Plan, leading to the 2015.

The Action 1 Report recognised that digitalisation of the economy brings key challenges for international taxation and that it would be difficult, if not impossible, to ‘ring-fence’ the digital economy from the rest of the economy for tax purposes because of the increasingly pervasive nature of digitalisation.

In March 2017, the G20 Finance Ministers mandated the Task Force on the Digital Economy (hereinafter, “**TFDE**”), through the Inclusive Framework on BEPS, to deliver an interim report on the implications of digitalisation for taxation by April 2018 and a final report in 2020.

The interim report, Tax Challenges Arising from Digitalisation (hereinafter “**Interim Report**”), released in 2018, highlighted the progress made in the implementation of the BEPS package - and its impact on the various challenges raised by digitalisation - and provided an in-depth analysis of new digitalised business models.

The Interim Report identified three characteristics frequently observed in certain highly digitalised business models (i.e. 1) scale without mass, 2) heavy reliance on intangible assets; and 3) data and user participation) and discussed the implication of such characteristics on the international tax framework, in terms of existing profit allocation and nexus rules.

The three characteristics above may indeed enable highly digitalised businesses to create value by activities closely related to a market/jurisdiction without the need to establish a physical presence (i.e. through a “remote participation”).

Moreover, the remote participation may enable a broader set of businesses to build their brands, develop engaged customer bases and create value in the absence of local activities or in the absence of local activities that attract a significant share of taxable profits, by benefitting of the digitalisation of the economy.

The Public Consultation Document - Addressing the Tax Challenges of the Digitalisation of the Economy (hereinafter, “**Public Consultation Document**”), released on February 13, 2019, presents three proposals that could form part of a long-term solution to the broader challenges arising from the digitalisation of the economy and the remaining BEPS issues.

The three proposal are:

- 1) the User Participation Proposal;
- 2) the Marketing Intangibles Proposal;
- 3) the Significant Economic Presence Proposal.

These proposals imply fundamental changes to the profit allocation and nexus rules and mandate an expansion of the taxing rights of user and market jurisdictions. Although each proposal presents specific peculiarities, all have the same over-arching objective, i.e. to recognise the value created by a business's activity or participation in user/market jurisdictions that is not recognised in the current international taxation framework.

In our comments below we focus on the Marketing Intangible Proposal, since in our view it represent the most impactful proposal and may create additional challenges to the international tax framework.

## 2 OUR COMMENTS TO THE MARKETING INTANGIBLE PROPOSAL

### 2.1 Overview

The objective of the Marketing Intangible Proposal (Public Consultation Document para. 30-39 of the Public Consultation Document) is to attribute the return related to the marketing intangibles to the markets where the customers are located, irrespective of the extent of the active involvement in digital activities.

The Marketing Intangible Proposal would not be applied only to highly digitalised businesses, but it would have a wider scope to respond to the broader impact of the digitalisation on the economy and to ensure the level playing field across businesses.

The rationale of the Marketing Intangible Proposal implies that an intrinsic functional relationship between marketing intangibles and the market jurisdiction exists (given the possibility for an MNE group to enter a jurisdiction, either remotely or through a limited local presence, to develop a user/customer base and other marketing intangibles).

According to the policy rationale, this intrinsic link would manifest in two different ways:

- 1) some marketing intangibles, e.g. brands and trade names, are reflected in the favourable attitudes in the minds of customers and therefore are seen to have been created in the market jurisdiction;
- 2) other marketing intangibles, e.g. customer data, customer relationships and customer lists, are derived from activities targeted at customers and users in the market jurisdiction, supporting the treatment of such intangibles as being created in the market jurisdiction.

As such, the non-routine return attributable to the marketing intangibles are to be attributed to the market jurisdictions where the customers are located.

### 2.2 Impact on traditional businesses

It is our opinion that the Marketing Intangible Proposal may lead to situations where, especially in the case of traditional businesses, certain market jurisdictions may benefit from attributed returns without any specific contribution to the intangible value creation.

In our view, the proposed marketing intangible approach, where extended to all the business sector, may exacerbate the challenges of base erosion and profit shifting and contradict the result of the BEPS Actions 8-10, since it could create a division between the economic substance and attribution of the related profits.

Below we provide an example of the effects of the Marketing Intangible Proposal with reference to a non-EU group operating in a traditional business sector, i.e. retail distribution of tea products (hereinafter, “Tea Group”).

**In our view, the application of the Marketing Intangible Proposal in a traditional business such as this, and in the absence of relevant contributions stemming from digital activities, may lead to an arbitrary shifting of profits within the Tea Group without any economic link to the value creation process.**

The Tea Group operates a centralised organisation, where the central departments – including branding and marketing (hereinafter, “**B&M**”) - are located at the headquarter outside the EU, with limited support functions located in the countries of operation, including the EU. All the Group’s valuable intangible assets, including brands and patents, and the related economic risks are centrally managed. The Tea Group is not actively involved in relevant digitalised activities towards the consumers (e.g. collection of data, online advertising, etc.).

In our example, the Tea Group adopts a selective direct distribution only in certain European countries, through controlled limited-risk distributors. All strategic decisions concerning B&M campaigns in the EU markets of operation are taken by the central B&M department outside the EU.

No B&M campaign is deployed in the neighbouring EU countries without operations.

The Tea Group started the first EU retail location in 1995. Other Tea Group retail locations have been opened in the following years in various EU countries.

In 2017, the Tea Group decided to enter a new target EU market (hereinafter, “**Target Market**”), where no physical or remote operation has been put in place before. Like in all other EU markets, the Target Market is served through a fully owned limited-risk distributor responsible for the routine marketing and sales activities in the country.

The Tea Group brand (hereinafter, “**TG Brand**”) has been known in the Target Market since the early 1980’s, since more and more customers have had direct experiences in one of the Tea Group locations in other EU countries of operation.

Due to these unmanaged circumstances, mainly driven by both customers’ direct experiences in international travels and word-of-mouth, the TG Brand’s knowledge has spread in the Target Market 1) before the incorporation of the controlled distributor; and 2) in the absence of any deliberate B&M action in the Target Market neither physically nor remotely managed by the central B&M department via digital means.

In the current international tax framework, with the current nexus and profit allocation rules, the controlled limited-risk distributor operating in the Target Market would be attributed a routine return on sales (hereinafter, “**ROS**”) commensurate with the value generated in the country in terms of 1) routine marketing and sales functions performed; 2) limited risks assumed; and 3) limited intangible assets owned.

The extra-profit (loss) generated in the Target Market would be attributed to the Tea Group entities responsible for the high value-adding functions, control and management of economically relevant risks, and ownership and economic management of the unique and valuable intangibles (including the TG Brand).

In case that the Marketing Intangible approach was in place, a portion of the non-routine return linked to the marketing intangible of the Tea Group would be attributed to the jurisdiction of the Target Market and taxed accordingly.

Assuming that in the Tea Group business, the marketing intangible assets, including the TG Brand, play a key role in the value creation process, a significant portion of the Tea Group profits would then be shifted to the jurisdiction of the Target Market, even in the absence of any contribution to

the development, enhancement, maintenance, protection and exploitation (hereinafter, “DEMPE”) of such marketing intangible assets.

In the example, it is undeniable that the marketing intangibles represent key assets for the success of the operations in the Target Market, due to the *favourable attitudes* in the consumers’ minds. At the same time, the lack of any economic link between the value of the marketing intangibles and the contributions (in terms of functions, risks and assets) made in the Target Market is apparent.

In the example, in fact, the *favourable attitudes* towards the Tea Group marketing intangibles in the consumers’ minds in the Target Market have been created by a series of factors, none of which is linked to the contributions made in the Target Market jurisdiction, e.g. 1) B&M campaigns designed, tested and expensed at the central B&M department (eventually executed in the neighbouring EU markets under the guidance and control of the central B&M department); 2) international travels of Tea Group customers; 3) spontaneous occurrence of the word-of-mouth phenomenon.

In a context such as the one described above, any attribution of non-routine intangible return to the Target Market jurisdiction may represent a profit shifting without any link to the value creation process in the Tea Group, to the detriment of the other jurisdiction actively involved in the DEMPE of such intangible assets.

### **2.3 Impact on businesses with digitalised processes**

Following the arguments under the scenario presented in section 2.2, it is our opinion that the Marketing Intangible Proposal may also create distortions in the allocation of profits in businesses involved in digitalised processes throughout the supply chain.

In our opinion, digitalisation in traditional businesses (in contrast to businesses that are purely based on a digital platforms) simply transforms business processes already in place through traditional means (e.g. market researches on consumer habits, consumer advertising, etc.) into digitalised processes or adds digital components to the supply chain of an MNE Group.

However, even in digitalised businesses, the Marketing Intangible Proposal may overestimate the value stemming from the digitalisation of business processes by simply stipulating that (only) the market jurisdiction contributes to the development of marketing intangibles.

In our view, even in digitalised businesses, 1) the value created by MNE groups should be linked to the performance of DEMPE functions and 2) the attribution of profits should mirror the effective contributions to the development of said marketing intangibles throughout the organisation, taking into account the role digitalisation plays and the related generated value.

### **2.4 Remuneration of DEMPE functions**

It is our opinion that additional clarifications would be needed regarding the role played by DEMPE in the value creation process of MNE Groups and the related attribution of any non-routine profit.

As indicated in the mechanics of the Marketing Intangible Proposal (Public Consultation Document para. 44), “The special allocation of some or all non-routine returns from marketing intangibles [...] would apply regardless of which entity in the MNE group owns legal title to the marketing intangibles, regardless of which entities in the group factually perform or control DEMPE functions related

to those intangibles (though as noted above, routine marketing functions would receive a routine return in the location where carried out) [...]”.

It is our opinion that the current description of the mechanics in the Marketing Intangible Proposal may create confusion by associating the DEMPE related to the marketing intangibles to routine marketing functions. It seems indeed that contributions to marketing intangibles concerning the performance of DEMPE are to be remunerated through a “routine return in the location where carried out” (Public Consultation Document para 44) without any consideration of the related value generated to the marketing intangibles.

## **2.5 Attribution of risks to the market jurisdiction and loss-making businesses**

It is our opinion that further guidance ought to be delivered on the link between the attribution of risks related to the marketing intangibles to the market jurisdiction and the subsequent attribution of non-routine profits.

As indicated in the Public Consultation Document (para. 32), “[...] the proposal would modify current transfer pricing and treaty rules to require marketing intangibles and risks associated with such intangibles to be allocated to the market jurisdiction”.

In the light of the described mechanics (Public Consultation Document para. 43-49), it seems that only a positive association between the economically significant risks and the related profits has been considered in the Marketing Intangible Proposal (i.e. attributed risks to a market jurisdiction deserve a non-routine remuneration). However, the possibility that the attribution of risks may drive to business losses, in case the risks are negatively manifested, is not mentioned.

It is our opinion, indeed, that once attributed relevant marketing intangibles and the related economic risks, the market jurisdictions may also incur in business losses.

On the same argument, it is our opinion that further guidance would be needed regarding the attribution of non-routine profits to the market jurisdictions in case of loss-making businesses.

In the case of loss-making businesses, both the rationale and the mechanics of the Marketing Intangible Proposal do not clarify whether the market jurisdiction is liable for a proportionate part of the loss or no profit/loss is attributed to it.

For clarification of any aspect of our responses presented above please contact:

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