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Confederation of Swedish Enterprise - Comments on the OECD Public Discussion Draft entitled: "Addressing the Tax Challenges of the Digitalisation of the Economy" 13 February - 1 March 2019

The Confederation of Swedish Enterprise is Sweden's largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

We are pleased to provide comments on the OECD Discussion Draft entitled "Addressing the Tax Challenges of the Digitalization of the Economy" 13 February - 1 March 2019 (hereinafter referred to as the Draft).

The Confederation of Swedish Enterprise finds it positive that the OECD is addressing this important topic and that a public consultation is being held. The challenges stemming from the digitalization of the economy is a global issue requiring a global solution. As the EU Commission Expert Group concluded in 2014, the ring-fencing of the digital sector or digital firms is not possible.[1] It has not become less true or relevant since then. All businesses are becoming digitalized. Consequently, in our view, a purely digital approach is therefore an inappropriate response.

[1] Commission Expert Group on Taxation of the Digital Economy, 28/05/2014. The group was chaired by Vítor Gaspar, a former finance minister of Portugal, and brought together six experts from across Europe with different backgrounds and expertise relevant to the subject. https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf

The last year has seen several initiatives, both unilateral and at EU level, to fundamentally change the corporate tax system by proposing to tax a company's revenue instead of its profits. Such a policy move would, in our view, be detrimental not only to cross-border investments but would also have a very negative revenue effect on countries with small domestic markets. The Confederation of Swedish Enterprise is of the firm opinion that corporate taxation should be based on profits and not revenue.

Considering the major policy changes that are being discussed in the Draft and the limited timeframe for providing comments, we will at this stage concentrate on preliminary comments on some of the major issues.

The Confederation of Swedish Enterprise considers it to be of utmost importance to find a global solution. The OECD, which has an instrumental role to play in this process, has made significant progress. The need to review how services are taxed when consumed is however strikingly absent in the Draft. The role of sales/VAT taxes is important and may very well alleviate direct tax concerns. The Draft has not embarked on such a path. This is regrettable. In the European Union, the VAT system is being revised into a destination-based system and to the extent consumers become producers of value, the issue of VAT liability should be addressed, even if the exchange is in the form of a barter trade.

It is obvious that the intent of pillar 1 in the Draft primarily is to reallocate taxation rights among countries and to increase profit distribution to market jurisdictions. This is addressed as part of the value creation concept, either under the user contribution approach or under the marketing intangibles approach. The significant economic presence concept can be part of the other two approaches or as a standalone measure.

It appears that the policy rational for the various proposals is based on the perception that the Digitalisation of businesses too often results in cases where the market jurisdiction does not receive a "fair share" of the taxable base under the current arm's length principle (ALP). The proposals attempt to resolve this by re-allocating residual profits to the market jurisdictions without any reference to how profits and losses are shared in an open market economy. This would essentially mean an arbitrary shift of taxable income from smaller net exporting countries with high levels of R&D-activities and associated entrepreneurial risk taking to larger net importing jurisdictions with large consumer bases.

Such a policy would in our view disincentivise countries from developing a good and competitive investment climate to support innovation and entrepreneurship. The rationale for a country to spend public funds on advanced educations, technological developments and entrepreneurship would arguably decrease if the taxable proceeds from these activities are redistributed to where the consumption takes place. Conversely, the incentive for markets with large customer bases to ensure efficient and competitive investment climates would arguably be reduced if the proceeds will be taxed there regardless. Such a policy would be bad for growth.

Needless to say, companies should be able to control in which jurisdiction they are active or deemed to be active. It is often a strategic business decision to enter a market or to be active in a jurisdiction. However, a new nexus concept based on user participation or significant economic presence could make some businesses taxable in jurisdictions in which they have not taken decisions to operate in. This may also occur with the marketing intangibles approach if taxable profit is allocated based on sales. As the proposals currently stands, businesses could lose control of which jurisdictions they are taxable in. We consider such a development problematic since it infringes on the right of the owners to exercise control.

The Draft mentions that the residual profits or even all profits could be allocated according to sales. This would harm countries which are net-exporters and would not recognize the legitimate taxation rights of countries where innovation, risks, HQ, strategic decisions or where production take place.[2] Consequently, there is a need to strike a balance between the revenue impact for net-importing countries and net-exporting countries.

Copenhagen Economics has, in a report presented at BusinessEurope on February 19, 2019, assessed the potential effects on corporate tax bases if residual profit is allocated to market countries.[3] They conclude that small, open economies with high R&D intensity in exporting services will lose significant net revenues. The Nordic countries clearly fall into this category with higher than average shares of life science and information and communications technology (ICT) industries but so does Germany. The USA is, according to the report, also likely to lose revenues. A high value of marketing intangibles is often the result of earlier strong investments in R&D which create market and brand names.

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[2] See e.g. Should We Use Value Creation or Destination as a Basis for Taxing Digital Businesses? – Krister Andersson's Comments on the 2018 Klaus Vogel Lecture Given by Professor Michael Devereux, Bulletin for International Taxation, 2018 (Volume 72), No. 12 Published online 14 November 2018.

[3] Future Taxation of Company profits – What to do with Intangibles? by Sigurd Næss-Schmidt, Palle Sørensen, Benjamin Barner Christiansen, Vincenzo Zurzolo, Charlotta Zienau, Jonas Juul Henriksen and Joshua Brown, Copenhagen Economics, 19 February 2019.

According to Copenhagen Economics, a conservative estimation suggests that 18-21 per cent of the current corporate tax base in the Nordics came from foreign residual profits in 2017. For Germany, the share is estimated to be 17 per cent. If the marketing intangible approach is introduced, the bulk of this corporate tax revenue would be allocated to other countries. The effective corporate tax rate for these businesses would furthermore increase since large countries typically have a higher corporate tax rate than smaller countries. This will reduce investments and jobs in these businesses. Sectors with high marketing intangibles as share of total enterprise value include internet & software, pharmaceuticals; telecom; biotechnology, media, services and retail. These sectors would be more affected than other sectors, but all sectors have marketing intangibles.

Furthermore, the report from Copenhagen Economics shows that most venture capital investments never generate any corporate tax revenue and that very few become global players. With a residual profit split approach, the costs for innovation and development for all the failed venture capital investments would likely remain in the exporting country, while future profits for the few successes would, at least partly, be taxed in other countries, without proper recognition of the costs or previous losses. It seems a fair question to ask why the country funding the R&D should not be allowed to symmetrically tax profits if and when they materialize.

For the Confederation of Swedish Enterprise, it is arguable that value is to a large extent created in the country where innovation, production, strategic decisions and financing are made, and that taxation therefore should remain in that jurisdiction. The Draft does not sufficiently address the need for, and the methods of, how to allocate costs and losses among countries, so that the net profit of the Group is taxed over time. The unwillingness of countries to accept losses from other jurisdictions constitute a significant challenge. Rules need to address this issue and in general provide clarity of how profits and losses should be attributed among countries.

A political allocation of profits must be avoided, and allocation must be rule based. Companies with their HQ in a small country are likely to have less support and weaker negotiating power than a company with its HQ in a large country, like the US. This distorts the market outcome if the allocation is not rule-based.

The effect of allocating residual profits to Market countries could possibly be reduced if the allocation key for distributing profits from intangibles is also

based on other factors besides sales. Irrespective of formula used, allocating residual profits is an extremely complicated exercise which would substantially increase tax uncertainty.

When designing new methods, the objective must be to come up with a system that strikes a balance between complexity and compliance issues versus the policy objective to change taxation allocation rights among countries. It is also crucial to only use methods that are in line with the agreed counter-BEPS measures, assuring taxation in line with value creation. With a residual profit split, the arm's length principle would apply to normal profits while part of residual profits (or all) would be allocated to market countries. The need for simple and stable rules is a challenge, not only for developing countries but for every country and company, in particular for SMEs engaging in cross-border sales. The combined system of the arm's length principle for normal profits and some kind of formulary apportionment for the residual profits due to marketing intangibles would be extremely complicated and it would be virtually impossible for businesses to get clarity at an early stage, i.e. at the time of the investment decision and/or transaction.

An alternative to such a complicated system could perhaps be to increase the remuneration to limited risk distributors (LRDs) within the current framework of benchmarks and profit level indicators. As we understand it, such an increase would not necessarily deviate from the ALP. The Confederation of Swedish Enterprise is of the opinion that, before any dramatic changes are made to the international tax system, a thorough analysis should be conducted as to why the ALP, through modifications of the current Transfer Pricing Guidelines, cannot be adapted to achieve the desired outcome of redistribution of profit throughout the value chain.

The risk of international double taxation due to different assessments of the portions of profits and its allocation, is obvious. The OECD has stated that the corporate income tax is the most harmful tax to growth and jobs. Since that is the case, it is important to limit the administrative costs associated with the corporate income tax.

The Draft mentions the need for dispute resolution mechanisms. The Confederation of Swedish Enterprise fully endorses the need for such mechanisms. Any agreement on revised rules for allocating taxation rights among countries should therefore include binding mandatory arbitration. However, there is also a need to prevent disputes from arising. Disputes are

mainly between governments/revenue authorities and must be addressed from the outset in any agreement.

On the second pillar regarding a global anti-base erosion proposal, it may be noted that potentially there can also be a base erosion profit shifting (BEPS) situation in relation to the new business models in the digitalized world. However, such rules would apply to all companies and should be seen as a general BEPS-measure, not necessarily related to digital business models.

Any BEPS measure must also provide clarity and not lead to international double taxation or undue administrative costs. The risk of increased complexity if single payments must be traced to an ultimate beneficiary is substantial and should be avoided in any endeavor to introduce minimum taxes.

It is also important to respect the views by parliaments. In almost all countries parliaments ask for the preservation of the right to structure their tax system without undue interference from other governments. Provided such assurances can be given and extra-territorial taxation can be avoided, it may be worth exploring how a minimum tax rule could be formulated and implemented. Perhaps, measures within the first pillar then can be avoided, in particular if the use of consumption tax rules are reviewed at the same time.

On behalf of the Confederation of Swedish Enterprise

5 March, 2019

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