THE OECD'S WORK ON THE DIGITAL ECONOMY:

GAINS OR LOSSES OF TAX REVENUE FOR EUROPEAN STATES?

AFEP REQUESTS A QUANTIFICATION OF THE IMPLICATIONS FOR EUROPEAN COUNTRIES AND SAFEGUARDS FOR EUROPEAN COMPANIES

The OECD's work on the digitalisation of the economy is expected to remodel the ground principles governing international taxation, because the solution under discussion is expected to apply to all sectors of the economy. With the new system, large international companies would allocate part of their profits to market and to user jurisdictions (i.e. to consumption countries).

Afep is concerned about the outcome of this work for European States' tax revenue: It requests that the Commission and the Member States publish a detailed and documented report describing the position that will be defended by the EU during the negotiations.

Considering the inherent risks of legal uncertainty surrounding the future application of these new legal concepts, Afep requests that European companies be prevented from risks of double taxation: **a new multilateral convention implementing mandatory tax arbitration should be simultaneously negotiated by the states**. The combination of these new rules with existing custom duty rules should also be examined.

The present document describes the OECD's proposals, their implications for European companies and what Afep requests with regards to this public consultation.

CONTEXT:
A PROJECT THAT GOES BEYOND THE DIGITAL ECONOMY AND DEEPLY REMODELS THE ALLOCATION OF THE CORPORATION TAX BETWEEN STATES

Last January, the OECD announced that 129 countries - including 27 EU Member States[1] - reached an agreement to remodel - by 2020 - the principles of allocation of the corporation tax paid by large international companies.

The purpose of the OECD's work is to adapt the methods of allocation of the corporation tax between states to the era of digitalisation of the economy. **More generally, it goes beyond the taxation of highly digitalised businesses and aims to propose a supposedly fairer worldwide allocation of the corporation tax paid by companies operating in all sectors of the economy. In addition, the tax paid should not be inferior to a minimum amount**. This "fairer" allocation would consist in large international companies paying more taxes to market and to user jurisdictions, while current principles favor investing and risk-taking countries (i.e. Western countries).

In principle, the OECD's work is driven by the issues arising out of the digitalisation of the economy. In reality, the OECD proposes a deep renewal of the ground principles ruling international taxation. **With the new postulate, a group would have to pay more corporation tax in the countries where its customers/user base is located** (including the hypothesis where the group has no - or little - physical presence in the particular country).

This new allocation of the corporation tax does not take into account each group member's contribution to value-creation. Thus, it replaces the arm's length principle that governed intragroup flux over the last 50 years. For now, the principle is that, in order not to disrupt international competition and the allocation of the tax base between states, the existence of a group should not impact the pricing policy applied between related entities; i.e. entities that are part of the same group. Consequently, prices applied between related

[1] All but Cyprus

companies must correspond to prices that would have been negotiated between independent companies.

The OECD's proposals constitute a complete change of paradigm with significant potential implications for **Europe, in particular its larger Member States**: large and medium-sized companies are sensitive to international evolutions and pay an important amount of corporation tax overall.

CONTENT: THREE ALTERNATIVE PROPOSALS - TWO POTENTIALLY INVOLVING ALL SECTORS OF THE ECONOMY

The OECD proposes 3 new alternative methods of profit allocation on which the states part of the OECD's inclusive framework are expected to reach a consensus by 2020 (OECD countries, G20 countries and certain developing countries):

- The first proposal is entitled "user participation" and is based on the idea that soliciting the sustained engagement and active participation of users is a critical component of a company's value-creation.

The condition of active participation would limit the envisaged reform to highly digitalised businesses (more specifically, it targets social media platforms - e.g. Facebook - search engines - e.g. Google - and online marketplaces - e.g. Airbnb).

The new taxation method consists in determining the share of value-creation represented by user's intervention (for instance on the basis of a pre-agreed percentage - to be determined) and to allocate the corporation tax applicable to this share of value-creation between states with an allocation key based on revenue.

- The second proposal is entitled "marketing intangibles" and concerns all sectors of the economy. The underlying concept is that it would be illogical to create a specific tax regime for companies operating in the digital sector, especially because the actual main international tax principles no longer ensure a fair allocation of states' right to tax large international companies.

Under this second option, large international companies' "active approaches of attraction" with regards to consumers at a worldwide scale - trade name, brand image - constitute an intangible asset in each concerned country. This implies that the asset is remunerated and that the corporation tax is allocated between all states of "consumption"

- The third proposal, entitled "significant economic presence" consists in acknowledging a taxable economic presence in a given jurisdiction where the company has a purposeful and sustained interaction within the jurisdiction (i.e. on the sole fact that it exploits a market in the corresponding jurisdiction).

This economic presence - independent from any physical presence - would be characterised by certain criteria (existence of a user base and the associated data input, volume of digital content derived from the jurisdiction, amount of billing in the country…). The "source" country would be allocated a profit and a thus a share of corporation tax. This proposal concerns all sectors of the economy.

Apart from these three options, the OECD proposes in addition two mechanisms of minimum taxation aimed at ensuring a fair level of taxation between international companies:

- Profits made in a low-tax jurisdiction (taxation rate to be determined) would be taxed in the country of residence of the parent company's head office;
- Certain expenses borne by a group member would not be deductible anymore (from a tax perspective) if the corresponding income is not sufficiently taxed at the level of the beneficiary;
- Tax reliefs granted by double tax treaties (e.g. reduced withholding tax rate on dividends) would only be granted under the condition that the beneficiary is subject to a minimum tax rate in its state of residence.

CONSEQUENCES FOR EUROPEAN TAX REVENUES: A TRANSFER OF THE TAXABLE BASE TO THE UNITED STATES AND TO CHINA?

I) Afep is concerned about potential negative outcomes of the OECD's work for the EU Member States' public finances and, indirectly, for European corporations. Taking into account the main characteristics of large European companies and the reduced share in worldwide consumption of goods and services of Member States where they are headquartered, an evolution of international taxation based on an approach that favors the remuneration of value created by consumers over value created by group entities **could lead to a risk of erosion of Member States' tax revenues, in particular the larger ones'. Eventually, European corporations would be subject to a higher taxation to compensate this loss of revenue.**

- For instance, Germany is the world's 4th host country for corporations' headquarters but ranks 16th with regards to its population. France ranks 5th with regards to headquarters and 22nd with regards to its population. In contrast, the United States is the world's first host country for corporations' headquarters and is also the world's third most populated country (325 million people). China ranks second with regards to corporations' headquarters and ranks first with regard to its number of inhabitants (1.4 billion).

- Taking into account Afep's members, more than 75% of Afep companies' consolidated revenue is generated outside of France and approximately 40% of the consolidated revenue is generated outside Europe.

With regards to the industrial sector, most Afep members generate less than 10% of their revenue within the French territory. Thus, large French companies' revenue is mostly generated outside France and in particular outside Europe.

- In contrast, American corporations' main market, which was the purpose of the debates at the OECD level (including in particular the GAFA), mostly remains the United States. Even larger Member States, like France, represent a very small market for these companies:

- 68% of Amazon's worldwide revenue is generated in the US, while 32% of is generated in the rest of the world. Less than 4% of Amazon's worldwide revenue is generated in France;

- 47% of Google's revenue is generated in the US, while 53% is generated in the rest of the world. Approximately 2% of the company's revenue is generated in France. Google's worldwide allocation of users follows the same allocation: with 35 million of users out of 2.3 billion overall, France represents 1.4% of Google's worldwide users.

- 44% of Facebook's revenue is generated in the US and 56% is generated in the rest of the world. The company's consolidated accounts do not precise the worldwide revenue's geographical allocation but indicate that only the US represents more than 10% of the global revenue generated. Referring to the platform's number of users, 876 million are located in Asia, 241 million are located in the US and 377 million are located in Europe, including 28 million for France. Thus, France only represents 2% of Facebook's worldwide users.

- 42% of Apple's worldwide revenue is generated in the US. 34% is generated in the rest of the world. Only 24% of Apple's revenue is generated in Europe. The allocation of this revenue between European states is unknown.

Afep considers that any solution favoring the remuneration of the value created by consumption markets - potentially affecting all the sectors of the economy - presents serious risks of transfer of the taxable base to foreign countries. If Member States' tax authorities do not accept these new allocation rules, it may result in a double taxation for all European companies.

II) With regards to minimum taxation, which aims to enable the residence state of the parent entity to tax subsidiaries' foreign income - provided that subsidiaries have not been subject to a sufficient level of taxation in their country of residence - it is reminded that the French Constitutional Council already rejected a similar proposal in the Amending Finance Law for 2014, notably due to its difficult application for international groups with several chains of companies.

Besides, this proposal appears contradictory to the objective of a fairer allocation of international corporations' taxable base between states. Indeed, many developing countries try to attract investors by creating "free zones" with low - or nil - levels of taxation. In the long term, this mechanism could be disadvantageous for these countries.

The measure could particularly harm Member States above the EU average corporation tax rate.

REQUESTS OF AFEP MEMBER COMPANIES:
LEGAL CERTAINTY AND GUARANTEES AS TO THE ABSENCE OF DOUBLE TAXATION

Afep member companies request:

- **A detailed evaluation of the effects of each of the OECD's proposals on the EU jointly conducted by the European Commission and by the Member States. This evaluation should be made public and focus in particular on the net impact of a tax system based on consumers' value-creation**. Companies also wish to be consulted prior to the adoption of EU and national official positions to be defended at an international level;

- **That the OECD's work is followed in detail at the highest levels of the EU and its Member States**: The Commission and the Member States must dedicate sufficient means to analyse the OECD's proposals and negotiate at the OECD level. A multi-experts unit regrouping experts in the field of taxation, economics and trade must be created within the Commission for this purpose;
- The EU and its Member States must refuse any compromise based on insufficiently defined concepts, which are source of legal uncertainty and of double taxation for companies. Should an international consensus be reached, it must in priority define precisely the new allocation methods of international companies' taxable base between states.

Notwithstanding the allocation method chosen, it is necessary to define the modalities of valuation of the consumer's intervention, the methods of valuation of this intervention and the keys of allocation of the value between states.

The apportionment of the value between consumers' intervention and the tasks assigned to the different group members (including mainly research and development) must be clearly defined in order to avoid discussions either between taxpayers and tax administrations, or between tax administrations.

It is besides essential that the system chosen at the OECD level does not lead to the creation of new property rights on intangible assets, which could lead to multiple taxations of capital gains in different countries in the hypothesis of groups' reorganisation;

- **That any double taxation arising out of the application of these new "legal" concepts is eliminated in an efficient and in a timely manner:**
    - a new multilateral convention implementing mandatory tax arbitration should be simultaneously negotiated by the states;
    - a compensation mechanism with import duties should also be considered: third countries receiving the most important "share" of corporation tax should compensate this tax by a decrease of the declared customs value.

- **If the OECD's work should lead to a shift of allocation of Member States' corporations' taxable base from Europe to "Market" countries, the Member States must bear the consequences** of this reallocation of taxing rights. In particular if, by application of the new rules, European companies' margin is taxed in foreign countries, EU national tax authorities must not engage in aggressive tax audits, especially because the new rules of allocation were backed up by themselves.
- **With regards to the minimum taxation, the proposition aiming at taxing automatically profits in the "headquarters" country in the hypothesis of a foreign low-taxation for the subsidiaries must be rejected**, or applied in such a manner that countries with a high level of corporation tax are not disadvantaged.

About Afep:

Afep brings together the 115 largest companies operating in France. Afep aims to foster a business-friendly environment and to present the companies' vision to French and European authorities and international organisations. Restoring business competitiveness to achieve growth and sustainable employment in Europe and tackle the challenges of globalisation is Afep's core priority.

In France, Afep members represent 13% of the GDP, 2 million of direct employees and 19 % of the overall compulsory levies paid by companies.