March 5, 2019

Submitted via email to TFDE@oecd.org

Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Tax Policy and Statistics Division
2, Rue André Pascal
75775 Paris, France

Re: Comment Letter on the Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy

**Submission by the Securities Industry and Financial Markets Association (SIFMA)**
**In Response to the 13 February 2019**
**Consultation Document on the Digitalisation of the Economy**

## I. Introduction and summary of recommendations

These comments are being submitted to the OECD by the **Securities Industry and Financial Markets Association** (SIFMA)[1] in response to the public draft released on 13 February 2019 by the OECD entitled "Addressing the Tax Challenges of the Digitalisation of the Economy" (Consultation Document). In this submission, we address the two areas discussed in the Consultation Document. The first area relates to proposals for revised profit allocation and nexus rules aimed at expanding taxing rights by the user or market jurisdiction based on the existence of certain intangible assets, including so-called marketing intangibles. The second area relates to the global anti-base erosion proposal that includes the income inclusion rule (a minimum tax on foreign source earnings) and the tax on base eroding payments (a tax through the denial of tax deductions for so-called undertaxed payments and the denial of treaty benefits under the subject to tax rule).

As the OECD continues to develop approaches aimed at preventing base erosion and profit shifting, and as it endeavors to establish new taxing principles relating to the digitalization of the

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

economy, it is critically important that the OECD develop a practical and realistic "best practices" approach that takes into consideration the distinctive business models and practices and pervasive non-tax regulation of regulated financial services businesses.

At the outset, we share the following general observations:

- The nature of our business and regulatory requirements mandate that, for the most part, we locate in the jurisdictions in which our customers are located. As a result, it is uncommon for us to have a significant digital footprint in a jurisdiction without a corresponding physical presence; thus, we generally already have taxable nexus to customer jurisdictions.

- To the extent that our industry has valuable marketing/customer-related intangibles, the common practice in our industry is for the customer jurisdictions to pay for the cost of developing those intangibles in their country and correspondingly retain the profits associated with those intangibles.

- Due to the way we operate and oftentimes in accord with local regulations, regulated financial services companies have no equivalent to the "limited risk distributor" referenced in the Consultation Document. This means that we already allocate appropriate value to these jurisdictions, raising fundamental questions as to how a further identification of profit relating to certain intangibles and apportionment of taxing rights to those profits should or could be workable.

- We believe, at a minimum, application of new standards relating to nexus and profit allocation should be segmented by industry and line of business. As noted below, we do not believe these standards should have application to our so-called institutional business.

- The development of a minimum tax on foreign source earnings and a related tax on base eroding payments should focus on simple models that impose a minimum tax only when earnings are subject to tax below an agreed upon minimum rate, and that any tax on base eroding payments be coordinated in such a manner as to prevent double taxation. We note the proposals seem conceptually similar to the global intangible low-taxed income (GILTI) provisions and the base erosion anti-abuse tax (BEAT) enacted in 2017 by the United States as part of the Tax Cuts and Jobs Act (TCJA), but the OECD should be mindful that these rules create double taxation and unnecessary complexities.

## II. Revised profit allocation and nexus rules

The first area of the Consultation Document focuses on a re-examination of so-called "nexus" and profit allocation rules, and the Consultation Document addresses several different concepts to determine taxing authority in a given user jurisdiction. These concepts focus on allocating more taxing rights to user jurisdictions in situations where value is created by a business activity through participation in the user or market jurisdiction that is not currently recognized by the arm's length principle. The Consultation Document considers proposals for revising the allocation of taxing rights based on user participation, marketing intangibles and significant economic presence. These proposals must consider the nature of the financial services industry, including regulated portions thereof, and keep in mind the OECD's 13 February Policy Note's requirement that any solution must find the "right balance between accuracy and simplicity."

The scope of a solution should be consistent with the policy rationale that it is designed to support. The Consultation Document outlines policy rationales for each of three proposals for revising nexus and profit allocation rules. The rationales provided don't seem to support revising those rules for regulated financial services businesses:

- The "user participation" proposal "is premised on the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalized businesses."[2] This premise does not hold for regulated financial services, even in the retail context. Data analytics, for example, do have some relevance for our retail businesses, but the provision and consumption of funding do not require or benefit from "sustained engagement" or "active participation" by lenders and borrowers in any meaningful sense. The OECD notes this proposal would target highly digitalized businesses and potentially be limited to social media businesses, search engines and online marketplaces.[3] If this approach is adopted, it should expressly exempt electronic securities exchanges, as several European proposals have done.

- The "marketing intangibles" proposal relies on "an intrinsic functional link between marketing intangibles and the market jurisdiction," positing that brand and trade name, for example, "are reflected in" the minds of customers and so can be seen as creating marketing intangibles, and that other marketing intangibles, such as customer relationships, are derived from activities targeting the market jurisdiction.[4] As further explained below, brands and trade names do not play a meaningful role in our institutional businesses, and the sales/marketing function is typically a routine one; marketing intangibles (if any) do not create non-routine value in our institutional business. On the retail side, although brands and trade names are markedly less important than for consumer products, we do engage in targeted marketing activities and collect user data. In retail activity, the relevant regulatory framework requires that continuous and regular customer-facing activity be conducted in regulated entities that are present in the location where the customers are located.[5] Similarly, in the institutional space, the nature of our business and the needs and preferences of our institutional clients dictate a similar end result in most cases. As a result, regulated financial services businesses do not have the equivalent of the "limited risk distributor" framework that the Consultation Document describes in paragraphs 3, 13 and 39. Non-tax regulation

---

[2] Consultation Document at paragraph 18.

[3] Consultation Document at paragraph 28.

[4] Consultation Document at paragraphs 30-31.

[5] Noting that EU passporting, where one local company in an EU country can conduct business throughout Europe, would be an exception.

generally requires that we have significant people functions in our market jurisdictions, so the return, if any, to marketing activities is already booked (and taxed) there.

- The "significant economic presence" proposal is motivated by the heavy involvement of businesses with no significant physical presence in the economic life of a jurisdiction. To reiterate, we must generally have taxable presences in our market jurisdictions to comply with non-tax regulation and/or meet the needs of our customers.

### a. Institutional financial services

The market for institutional financial services products is limited to a relatively small number of firms, and competition is based primarily on pricing, quality of service and availability of product offerings. The ability of firms to compete in this market is driven by access to capital and funding and corresponding ability to assume risks, and by the activities of highly-skilled employees (e.g. front office, portfolio managers or sales/traders) that decide which risks to assume and at what price. As a result, valuable intangibles of any sort are atypical. Similarly, in the OECD's prior examination of the banking industry, the OECD concluded that sales/marketing activity is generally not a KERT function.[6] Furthermore, by definition, institutional finance clients are businesses, not consumers, and thus no "user participation" is involved in the production of income. For these reasons, we do not think that revisions to the profit allocation rules should apply to typical regulated institutional financial services businesses. We are primarily concerned that the proposal, through a formulaic rule that ascribes all business models (including institutional banking) a deemed return on marketing intangibles, will allocate income disproportionate to the actual value of any marketing intangibles in our business.

We hope the OECD's proposal will provide clarity on this topic and eschew broadly applicable, formulaic rules inconsistent with business realities. Specifically, we urge the OECD to exclude lines of business that interact with other businesses rather than with consumers, including in particular institutional financial services, as Paragraph 71 of the Consultation Document contemplates. Moreover, as written, the description of the profit allocation proposal contemplates businesses with "process" intangibles and businesses with "market" intangibles, but does not describe businesses that are not driven by intangibles. It would be helpful to clarify that such businesses do exist, and also helpful to note that typical institutional financial services is an example of such a business. Therefore, even if this business is not explicitly exempt, it should be clear that the value of the marketing intangibles in this case would be zero.

### b. Retail financial services

In contrast to institutional financial services businesses, retail by definition involves consumers and economically significant marketing activity, including digital marketing and use of consumer data. However, the common practice in our industry (and generally the preference of our regulators) is for

---

[6] *See*, *e.g.*, paragraphs 6 and 9 of Part II of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments (noting the distinction between sales/marketing, sales/support, and sales/trading).

the customer jurisdictions to pay for the cost of developing those intangibles in their country and correspondingly retain the profits associated with those intangibles.

Retail financial services company operations are largely domestic in nature because regulators generally limit such cross-border retail financial services and few consumers have or desire such cross-border relationships. Although highly digitalized, the vast majority of a retail financial services business is carried out through a subsidiary or branch in the country of the consumer. The local branch or subsidiary generally performs valuable functions, employs valuable assets (primarily capital, but also including local marketing and customer-based intangibles), and bears economically significant risks; as noted above, the financial services sector does not have the equivalent of the "limited-risk distributor" contemplated in the Consultation Document. Therefore, we believe that the retail financial services sector does not represent a significant BEPS risk that is not already addressed by the existing sector specific transfer pricing guidelines.

For these reasons, the profit allocation proposal should exclude regulated financial services firms including retail lines of business. Indeed, there is an argument for excluding all businesses having similarly robust taxable presence in their market jurisdictions. However, if such an exception is not provided, we urge the OECD to include the following:

- None of the examples mentioned in the Consultation Document bear much similarity to the operation of a retail financial services company. We would request that the OECD specifically consider the retail financial services sector when drafting the proposal, and consider how the proposal would apply to a business such as retail financial services entities that is highly digital but also generally already takes place in the jurisdiction of the consumer.

- We note that the Consultation Document contemplates a "formulaic" rule for allocating residual profit. We urge the OECD to ensure that the formulas are clear, sensible and produce reasonable results for a retail financial services operation, such as by creating a separate formulaic approach for the financial services industry.

- The Consultation Document addresses concerns about increased controversy and double taxation. The new rules should be accompanied by strong double tax relief and dispute resolution mechanisms.

### c. Interactions between retail and institutional financial services and business-line segmentation

As described above, retail and institutional businesses have very different characteristics. Many financial services firms have both an institutional business and a retail business; in practice, these businesses primarily interact through transfer of funding, e.g., retail customer deposits may provide part of the funding for a corporate loan. We believe that (provided the funding is transferred at arm's length) no further reallocation of profit is appropriate, and that the proposal should not create any new interaction (e.g. there should be no reallocation of residual profit from the corporate loan book to the jurisdiction of the retail deposit customers).

## III. The global anti-base erosion proposal

The second area of the Consultation Document focuses on remaining issues from the Inclusive Framework's BEPS work. The global anti-base erosion proposal would impose a minimum tax on income that is subject to no or low taxation, with a tax on base eroding payments as a backstop to the minimum tax rule that would impose additional tax through denied deductions and lost treaty benefits. The United States sought similar solutions by enacting anti-base erosion measures under the TCJA: the GILTI provisions, putatively intended as a minimum tax, and the BEAT, a tax imposed on certain deductible gross payments. The Consultation Document would coordinate the operation of the minimum tax with denied deductions for income that is not subject to a minimum rate of tax. This is an important distinction from and improvement to the manner in which the United States implemented its anti-base erosion provisions as the GILTI provisions and the BEAT can tax the same income twice.

### a. Implementing the minimum tax

Several principles should be followed in the OECD's design of a minimum tax on foreign source earnings:

- The tax model should be as simple as possible and result in a mechanism that actually taxes only low-taxed income. The OECD should therefore recommend that the minimum tax only apply (i.e., result in an income inclusion at the shareholder level) if the offshore income is taxed below a specified rate. If offshore income is taxed at or above the specified rate, the minimum tax rules should not apply.[7]

- The tax should be calculated and applied on a global basis, rather than on a jurisdiction-by-jurisdiction basis.

- The minimum tax should avoid taxation of the same income twice, and should be integrated and coordinated with existing country specific anti-base erosion rules.

An initial implementation question under the anti-base erosion proposal is how to calculate income subject to the minimum tax and whether that income has been taxed in accordance with a minimum rate. The Consultation Document proposes making these determinations on a per jurisdiction basis.[8] This proposal should be reconsidered. Variations in how and when jurisdictions measure gross income and allow deductions, both of which impact taxable income, can create mismatches in determining whether the income has been subject to a minimum rate of tax. For example, in jurisdiction 1, the taxable income of Corp is calculated as $100 and a 20% corporate income tax rate applies. Corp pays $20 of tax to jurisdiction 1. However, under jurisdiction 2's tax rules, Corp is not

---

[7] This is in contrast with the US GILTI rules, which require an income inclusion at the shareholder level regardless of the tax rate of the offshore earnings, resulting in significant mechanical and operational issues (discussed below) that give rise to double taxation of offshore earnings, even if those earnings are subject to sufficient offshore tax.

[8] Consultation Document at paragraph 96.

able to use as many deductions in the current year, and taxable income of Corp is calculated as $175. Under jurisdiction 2's tax rules, Corp has paid $20 of taxes on $175 taxable income, which results in a lower effective tax rate on that income than in jurisdiction 1. On a per-jurisdiction basis, Corp could be subject to a minimum tax based on the rate of tax in jurisdiction 2, even though the income was not low-taxed income in jurisdiction 1. The potential for these mismatches are most relevant in industries like ours, where we operate in high tax jurisdictions. Other complications will arise under a jurisdiction-by-jurisdiction method, such as where a hybrid entity's income is taxed, but a global regime can target low-taxed income without these complications.[9]

The Consultation Document also suggests that the income targeted by the minimum tax will be any income subject to a low rate of tax.[10] Applying the minimum tax across industries, as opposed to isolating certain types of income to be subject to a minimum tax, is a simpler and fairer application of the rule. The GILTI provisions attempted to target only specific types of income –income that is not related to tangible assets is deemed to be related to intangibles. For financial services companies with few tangible assets, most income becomes subject to tax as GILTI despite the fact the industry generally has relatively little income relating to intangible assets.

Another implementation question is how credits for taxes paid on the targeted income will operate in order to prevent double taxation.[11] Foreign taxes paid on earnings is direct evidence of whether foreign earnings are subject to low or no tax. The GILTI provisions placed existing and new limitations on the credit allowed for taxes paid on the targeted income. These limitations have the effect of adversely impacting high-taxed foreign earnings more than low-taxed foreign earnings and should be avoided in the implementation of the OECD's minimum tax proposal.

Finally, in considering the design of a minimum tax, the OECD should clearly articulate its objective and ensure that the tax's design matches that intent.  We urge the OECD to be mindful of the rules in the US GILTI tax model and all its features that, as noted above, undermine it as a minimum tax.

### b. Implementing the tax on base eroding payments

The second element of the global anti-base erosion proposal would apply when payments are not subject to the minimum tax. This element would impose a tax on such payments through denied deductions (the undertaxed payments rule) and lost treaty benefits (the subject to tax rule).

---

[9] Grubert and Altshuler. *Fixing the System: An Analysis of Alternative Proposals for the Reform of the International Tax* National Tax Journal, September 2013, 66 (3), 671-712. ("For example, it would not be necessary to allocate the assets in a foreign acquisition to particular locations under the overall minimum tax. It might be successful in targeting the companies that can best exploit a low foreign tax rate. The incentives that a company faces may be usefully summed up by its overall foreign tax rate without having to look at individual country.").

[10] Consultation Document at paragraph 92.

[11] Consultation Document at paragraph 96 (proposing credits will be allowed for underlying tax paid on targeted income).

The Consultation Document identifies, as a key implementation issue, how to determine whether a payment has been subjected to a minimum rate of tax and therefore is not subject to the undertaxed payments rule.[12] This determination will be critical to ensuring the tax on base eroding payments acts as a backstop to the minimum tax rule and does not create an additional tax on the same income. Payments may be subject to an effective tax rate at or above a minimum rate due to a variety of reasons that need to be taken into account in determining whether this provision is triggered. For example, payments could be subject to a minimum rate of tax because the source country adopts the minimum tax regime. However, payments also could be subject to a minimum rate of tax because other unrelated anti-base erosion regimes, such as the US subpart F rules or GILTI provisions, or the UK diverted profits tax regime, may apply to those payments. A payment by a foreign affiliate of a US company to another affiliate of the US company that resides in a low-tax country could be subject to full US tax because that income is taxed in the United States as either subpart F income or GILTI. In this case, the payment is subject to a minimum rate of tax, though not by the country from which the payment was made. The undertaxed payments rule must be implemented in a manner that coordinates with other domestic tax rules, so that payments that are subject to tax are not taxed again under this rule.

Another implementation issue is the minimum level of ownership that should be met before the undertaxed payments rule apply. The Consultation Document proposes to apply the rule where there is 25% common ownership.[13] This percentage is far too low in the case of many related party payments. A minimum ownership level should be set no lower than 50% by vote or value. At a 25% ownership level, taxpayers will not have enough control over the entity in question to drive base erosion activities. The threshold is also too low for the owner to obtain the detailed, by company, information needed to comply with the proposal.

The Consultation Document proposes to limit the scope of these rules to related-party payments.[14] We agree that this is a necessary constraint and that the proposal should not apply more broadly to, for example, payments related to third-party debt. As long as other anti-abuse provisions are in place, including anti-conduit rules and overall debt caps as prescribed by the OECD, there is no need to place any restrictions on payments to third parties.

Finally, we note that the US BEAT is not an appropriate model to achieve the results that are being targeted in the Consultation Document. The US BEAT effectively imposes a minimum tax on companies that make payments from the United States to a foreign affiliate that are deductible in the United States and thus reduce the US tax base beyond a specified threshold.[15] Unlike the OECD's

---

[12] Consultation Document at paragraph 103 (explaining the denied deductions would apply, unless the payments were subject to a minimum tax) and paragraph 105 (identifying the issue as a key area to be considered).

[13] Consultation Documents at paragraph 103.

[14] Consultation Document at paragraph 103 (regarding the undertaxed payments rule) and paragraph 107 (regarding the subject to tax rule).

[15] The rules are tightened for banks and broker dealers because the BEAT applies when the amount of deductible payments made to foreign affiliates equals 2% of all their US deductible payments (instead of the 3% threshold for other

proposal that would apply the tax only as a backstop to the minimum tax proposal, the BEAT captures income already taxed by the United States, allows few and narrow exceptions, and does not mitigate double taxation because foreign tax credits are not permitted. The BEAT's application to our industry is particularly harsh and it is critical, therefore, that the OECD's tax on base eroding payments (the undertaxed payments rule) be developed keeping in mind issues unique to our industry, such as the volume of transactions financial services companies enter into every day to provide funding or advice to clients/customers around the world.

* * * * *

SIFMA thanks you for your consideration of these comments. Please contact Jeff Levey (jeff.levey@ey.com) and Payson Peabody (ppeabody@sifma.org) if you have any questions regarding this submission.

---

taxpayers), and subject to an 11% add-on tax (instead of a 10% add-on tax), and includes all members of an affiliated group (regardless of the type of business conducted) where there is a bank or a registered securities dealer.