# Challenges of the digital economy on international taxation rules from the perspective of global business society

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## Abstract

While the examination process on a new tax allocation rule has been developed in the OECD and its final discussion is still on-going, this paper explores what kind of efforts and contributions have been made by businesses who are important stakeholders on this issue and identifies whether those responses have been well addressed or not.

During the drafting stage managed by the Inclusive Framework (IF), supported by the OECD secretariat, the main issue has been to what extent any residual profits of digital transformation enterprises (digital MNEs) should be allocated between the home country of the digital MNEs and market countries. The features of the digital economy, especially "Scale without mass" have served as a mechanism to allocate their residual profits to their home countries. The private sector generally believes that such outcome seems reasonable, mainly because the digital economy heavily depends on intangibles developed by the headquarters company, that bears the huge R&D expenditures. The private sector claims that the traditional allocation methodology looks reasonable and legitimate and that the government should respect it to a great extent.

To support this discussion, the private sector has been referring to the 1998 Ottawa Principle endorsed by the OECD participants' ministers. The agreed document referred to several taxation principles, including neutrality, equity, etc, as a guidance on how to address taxation of e-commerce transactions.

During the discussion on the Action1 of the BEPS Project (taxation on the digital economy), businesses again have been sticking to the same Principle. It claims that any new allocation rule to address the challenge of digitalization should be proportionate to the value creation mechanism within any business model. The comments from businesses are summarized as following;.

To structure a new tax base and designate allocation keys to it, if necessary, the governments should respect business accounting practice as much as possible, and the additional allocation of profits to market countries should be minimized, because the private sector heavily depends on the intangibles that are developed by its parent company as well as on the global network that is managed by its parent company.

Thus, even if a new additional allocation rule would be agreed, the compliance cost for the new rule should be minimized. During the final stage of drafting the two pillar approaches, input from the private sector is important and indispensable, especially for the technical issues, such as the use of consolidated accounting reports, documentation requirements on taxpayers and dispute prevention and resolution program.

So far, it is observed that public consultations have been organized in a timely manner and working effectively, however, before final political negotiations among the IF countries, consultations with businesses could produce practical and administrable adjustments to the OECD frameworks.

Keyword: taxation of digital economy, allocation of tax revenues, business response to the new rule

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## I. Introduction

There are some options in drafting a new international taxation rule on the digital economy. It depends on which business model is focused on by that rule, digital native companies or digital transformed/transforming companies. While the former are modern highly digitalized business, such as new information technology (IT) companies like GAFA, which are sometimes referred to as digital native enterprises, the latter are ordinary businesses whose business value chain has been gradually transformed by using digital devices and networks. IT companies are defined as "highly digitalized business" in the BEPS project, so here I will temporarily say "digital native companies". They have enjoyed the favorable treatment provided by traditional taxation rules much more than the ordinary business.

In case of digital transformed business, global management activities are streamlined by using regional headquartered companies and information technologies. They also enjoyed tax favors, but its magnitude is different from the digital native businesses.

In drafting international taxation rule, the OECD usually focused on the ordinary business previously. A good example of such effort was Ottawa principles agreed by the OECD in 1998.

The communique at the Ottawa Electronic Commerce Meeting 1998 reconfirmed seven taxation principles for e-commerce transactions (neutrality, efficiency, certainty, simplicity, effectiveness, fairness, and flexibility).

Based on those principles, the OECD at Ottawa reached consensus to remain with the traditional international rules as much as possible. Thereafter, some small scale reforms have been agreed by the OECD even within the framework of traditional international tax rules.

During such reform processes controlled by the OECD, the private sector contributed greatly by presenting practical input on the OECD's drafting works, such as the new OECD guidelines on international VAT system.[1] After starting BEPS program, the private sector also contributed with input for any proposal on its action items. During public consultations, OECD Business Advisory Committee, namely BIAC, have contributed considerably to the consensus building.[2] The 2015 final report on Action 1 of the BEPS program was established as an extension of such process. However, as for the taxation on digital native compa-

nies' residual profits in the market countries, the report reserved its final conclusion. It said that the OECD should first examine whether the effect of the other BEPS recommendations, such as the transfer pricing taxation rule on hard-to-value intangibles or a new rule against the abuse of PE status, etc., before exploring reforms which allow the market jurisdictions to tax some portion of global residual profits of the digital economy. It was agreed that the OECD would spend some time to evaluate such effects, and, if necessary, it should propose the final recipe to allocate new taxing rights to the market jurisdictions by 2020. Thus, a grace period was granted.

But, the meantime, in the highly digitalized business the monopoly/oligopoly has been accelerated year by year such as market-coverage by GAFA companies. Thus, excess profits of those enterprises have been amplified steadily. In addition, digital transformation of businesses for general companies has also grown rapidly, especially by their use of AI or IoT technologies.

Due to such speeding up, the problem of tax leakage or vacancy in market countries is becoming one of the hottest issues for IF countries. The magnitude of this problem is also rising in the wake of the unilateral counter measures, planned and implemented by the UK, France, Italy, Spain, etc. They said that they could no longer wait for the 2020 global consensus. Those countries' new policy is digital service tax (DST) on the return of specific digitalized businesses, and when the EU failed to conclude its consolidated policy on the DST, the unilateral DST legislations have been materializing one after another not only in EU countries but also in some emerging economies.

Thus, considering increased tax burden and risk of new double taxation, global business requires the OECD to conclude the agreement on the new rule before the end of 2020. The private sector is ready to present their comments on the blueprint of the Two Pillar systems.

The Finance Committee of Business at OECD (BIAC) is the global representative on taxation.

The Committee is composed of tax professionals within MNEs, tax advisors of big firms, etc., and its opinions towards a new rule on digital taxation is well coordinated among its members, even though the opinions of government officials are diverging from each other. It is mainly because over many decades, global business as well as their client-consumers have been enjoying the fruits of economic modernization, which is supported by the stability of tax systems and so, both of them hope to maintain the sustainability of tax infrastructure systems as much as possible.

[1] As an example, regarding a permanent establishment (PE), 2010 edition of the OECD Model Convention Article 5 Commentary Paragraph 42.1 to-42.10 (Under the title of Electronic Commerce, approve server PE eligibility) and paragraphs 42.11 to 42.48 (Service PE is approved as an alternative). As a reference to this point, Tadao Okamura "Development of the Digital Economy and the Future of International Tax" (December 2019, Japan Tax Research Association 71st Tax Research Conference Record, p. 183)

[2] In addition to consultation, the OECD Tax Committee has set up five technical advisory groups (TAG), which was proposed by the Ottawa Conference, Its membership was composed of government, academics, and business representatives. Among them, the business income TAG discussed the interpretation of Article 7 (OECD Model) on income from electronic commerce. The discussion was centered on whether it belongs to business income (including service provision) or Article 12 (rental fee).

In this paper, from the drafting stage of the 2015 BEPS final report to the IF's Proposal Document for the 2020 final agreement, I will analyze the whole process and identify how and to what extent the global business' comments, which are important voices from big stakeholders, have contributed on such drafting work. Also I will focus on some corrections made during the drafting stage, because they are considered a kind of compromise between governments and businesses. Those research activities could help us to foresee what the decisive factors among many building blocks such as scope, tax base, threshold, dispute resolution mechanism, etc. are to structure widely acceptable framework, In this context, I am also interested in, for example, how the change of business concerns between 2015 report and 2019 secretariat's draft called "Two Pillar system" report affected the drafting works.

For those works, I will refer to many OECD public documents, especially the BIAC published comment for the global perspective, but, for the Japanese reactions, I will refer to the Keidanren papers.[3] In the meanwhile, reactions on the VAT recommendations expressed in the 2015 reports are excluded from my research, since my interest is on income taxation.

## II. Response to the Final Report Draft on Action 1, 2015 ――Mainly based on the BIAC comments of 14th Apr. 2014

The BEPS final report draft was divided into 15 items, and those recommendations on each item are streamlined with the order of mandatory, common standard, and up-to the countries selection.

With those disparities in compliance obligations of participating countries, only Action 1 was free of any advisory opinion.

However, regarding the electronic economy, while an agreement was achieved as for a new VAT system, which was in accordance with the OECD WP9 drafts, it could not reach an agreement as for income tax system. On income taxation, it only supplied three options to be studied by 2020 at that moment. BIAC admitted that the BEPS risk of the digital economy on income taxation should be addressed, because such business conducts no physical activities in the jurisdictions of consumers. Then, BIAC suggested that we should not ring-fence the specific digital economies, and thus, it supported the opinions summarized in the draft report on Action 1, that so far we should oversee the effects of the other items' reforms on such challenges. It believed that the policy was rationalized by the facts and circumstances summarized in the following contexts.

### *II-1. BIAC comments,[4] which showed reluctance to "give new taxation rights to market jurisdictions"*

The characteristics of BIAC's assertion in that comment were as follows.

[3] In addition to BIAC, BEPS Action 1 was commented by a variety of business groups such as Business Europe and USCBI. OECD also received comments from tax experts and researchers as well, but they are not covered here.

## II-1-1. From the viewpoint consistent with the Ottawa Principles

First, the allocation of taxation rights to the digital economy should be consistent with the Ottawa framework, which was composed of seven principles and approved by 1998 Ottawa ministerial meeting. While BIAC admitted the necessity of some additional taxing rights for the market jurisdictions, it believed that the draft overly stressed the issue. Under the current situations, the major contributions of MNEs on the market jurisdictions are composed of physical resources, real assets and actual functions, Thus, it insisted that governments should stick to the Ottawa framework as much as possible that confirmed such contributions. They understood that the basic concept of the framework was to allocate taxing rights on income to the residence countries, whereas it allocated the taxing rights on consumption to the market jurisdictions. The framework clearly divided the taxing power between producers' residence (income taxation) and consumers' residence (VAT taxation)

It was considered that the new idea to allocate the taxing rights on income to the market jurisdictions might contradict that framework. The BIAC, then, did not want to support the new idea, because the new idea looks especially hybrid that long standing tax certainty might be damaged by its administration and could cause new double taxation risks, and finally might put severe pressure on the international investments.[5]

Furthermore, if some suggestions within the draft were realized, it would lead the global tax rule to a formulary apportionment system, which had been denied under the OECD transfer pricing guidelines for a long time. The private sector has always been complaining about arbitrary applications of profit split methods tried by tax examiners which are similar to that methodology. Unpredictability is always the enemy of taxation.

## II-1-2. Contrary points to the latest OECD rules was shown

The second focus of business comments was based on the recent developments of the arm's length standard (ALS) within OECD.

The OECD has achieved sophistication of the ALS in recent years through discussions with the government and business, especially on fixing the attribution principle to the PE (Authorized OECD Approach; AOA) and introducing some other sophisticated ALS methodologies on intangibles and service provision.

Under the OECD's AOA on the attribution rules, the emphasis has been on the location of business activities in conjunction with human functions and risk taking activities. They are accepted as the cornerstone on the roots of income distribution.[6] At that moment, the three options examined in the 2015 BEPS final draft (a new alternative of PE: significant economic presence, withholding tax, equitable levy) looked divergent from it. The idea of AOA was strictly referred in the other BEPS action items, such as Action 7 and 8-10, so, the

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[4] From the Business at OECD website (The following quotes from the BIAC website are unless otherwise noted. (As of 15th Jan. 2020)

[5] The comment of Action 1 did not discuss the distribution of taxation right in the framework of "source-based principle" vs. "residential principle."

[6] The process leading to this agreement is detailed in Article 7 Commentary Paragraphs 5-9 of the OECD Model Convention.

private sector thought that it should be equally applicable to the digital economy.

Such reactions from businesses were easily expected, so the draft on Action 1 concluded that three options were just for the future discussion purposes and in any way were not considered as an agreement draft. Furthermore, if any member country hoped to introduce one of those options, they were advised to respect treaty conditions on any of such domestic legislations.

#### II-1-3. Business need for effective dispute resolution

The third comment was on the need for the effective dispute resolution. Considering the new double taxation risk discussed above, the private sector believes that it is indispensable to improve dispute resolution in the future.

They have been concerned about some aggressive challenges from the tax authorities of emerging economies especially on transfer pricing. Therefore they suspected the new draft might encourage them to go forth with the new legislation to expand their taxing rights on the digital economy. As for effective resolution mechanism, those countries were considered to be still behind the OECD standard (Model Treaty Art. 25), such as on mandatory binding arbitration.

### *II-2. The BIAC comments on the three directions*

Of the electronic economy shown in the Action 1 report, the secretariat put forth the three possible directions to be examined, Those were ① PE example review for the exceptional cases (expanded PE concept); ② taxation on the value of data collected from consumers by companies; and ③ taxation on the return at electronic commerce settlement.

And direction No. 1 was explored in the other Action items, such as Action 7, 8-10. Thus, the draft focused on the latter two directions, and for that review, the above mentioned three options are introduced and preliminarily explored.

The BIAC conducted its screening test of the Seven Ottawa Principles on those three options. The BIAC's answer was "No," for the following reasons. By the way, since the third option, equalization levy, was only tested as a measure to reform the current VAT regime, the test as the income taxation was only conducted on "significant economic presence" and "withholding tax".

#### II-2-1. Significant economic presence as a new nexus

A new nexus called significant economic presence was introduced in the 2015 draft.

It was also interpreted as "virtual PE" in the draft, because it extended the definition of the PE beyond the physical existence.

At that moment, the BIAC was against the virtual PE. because it might ring-fence the digital economy to put unfavorable treatment, and thus contradict the basic principle of neutrality between the physical transaction and virtual transaction. Furthermore, its definition in the draft was full of subjective conditions, such as "substantial volume" or "widely used and

consumed” to prove the virtual PE. Those weak points were also clearly against certainty or the simplicity test of the Ottawa principles.

The BIAC concluded that the draft new nexus seemed an inappropriate proposal.

#### II-2-2. Withholding tax on digital transactions

This is a new withholding tax on the payment of digital transaction. The BIAC was also against this idea, because it put additional gross-base tax burden only on the digital businesses. The revenue source of digital businesses is composed of the huge and longstanding R&D activities financed by the headquartered company located outside the market jurisdictions. That’s why the withholding tax, which focuses only on the payment of final return, is evaluated as inappropriate measure compared with net taxation.

Furthermore, digital business usually targets the wide range of B2C customers. These special circumstances make it difficult for customers to comply with the withholding obligation. Perhaps, some additional support by the middle paying agent might be necessary, however, the BIAC was concerned about availability of those middleman, such as credit companies, merchant banks, etc. Those mechanisms were already implemented by the provider of consumed goods or services within the VAT system.

In short, the BIAC believed that taxation within the consumers’ jurisdiction should be monopolized by the VAT system, which is the taxation of consumption, not the taxation of income.

### *II-3. My view on the above BIAC’s comments*

#### II-3-1. The features of Action 1 Report

As a result, the tone of the final Action 1 report was rather defensive, reflecting the concerns about the new tax system, which was presented by the BIAC. However, I think that it was not only because of the private sector response, but also because of the failure to reach agreement among member countries on the new idea like three options within tight time schedule. They needed more time in conducting intensive research on the ongoing digital economy to identify and address the issue. In addition, they also needed to identify the possible effects of the other BEPS proposal on the digital economy.

Finally, at that moment, the OECD/G20 set the extended time schedule on the tax policy for digital economy until 2020. It was considered as a sort of compromise, then.

#### II-3-2. The background of the BIAC comments

I think that the above mentioned business responses can be summarized in three policies, all of which followed its historical approach on international tax system.

First of all, the private sector seemed to be sticking to the traditional framework for corporate income taxation. It is so-called B2B framework. Since the mid 20 century, the MNEs were challenged by such innovative measures as transfer pricing, CFC rule, etc,, all of which targeted transactions between related parties. For example, if there was adoption of

the transfer pricing, in the US, we could identify the commensurate with income principle in the 1986 tax reform, followed by the comparative profit method within the best method rule, and then, in the OECD, the new transfer pricing guideline was approved in late 1990s.

Those developments have changed the allocation of income between related parties to some extent. In short, from residence country to source country allocable income has been shifted step by step through income-oriented methods rather than price-oriented methods.

Formerly, three basic methods were respected more than the other methods, and the hierarchy among methods was strictly observed by interested parties. At that moment, transfer pricing was considered mainly as dealings among the specialists, such as in-house economists and lawyers, who represent MNEs or tax administrations to find a fair market value (B2G dealings). However, in the 21st century, it was also re-characterized as G2G dealings to allocate income in accordance with equity principle among interested countries. Most countries have come to insist on reasonable allocation of MNEs' income under the BEPS concerns.

In addition, after 2000, the revised text on the OECD model conventions on the PE attribution rule was introduced, followed by the statement on anti-harmful tax regimes which was agreed by the OECD. All of them were about the adjustments of income allocation among the related parties. In the course of these developments, the headquarters companies played important roles in managing their global supply chain through a centralized accounting system.

Thus, it was observed that allocation of income among interested parties has been discussed within the framework of corporate income tax among countries where entities existed. In other words, income whose value was scaled by the B2B transactions were managed by corporate income tax, while consumption whose value was scaled by the B2C transactions were managed by the VAT.[7]

The second policy background was the magnitude of the new tax burden, when the private sector faced special taxation on the digital economy. As the Ottawa principle was just the re-confirmation of the assortment of widely accepted tax principles, so, it seems that they were not targeted exclusively at the digital economy. However, those widely accepted principles have been a cornerstone of the steady international tax coordination after World War 2, which has been managed by the OECD through the model convention. I think that even if those principles had experienced some reforms to be adapted to global economy, they have been well respected by both governments and business. And I believe that is the reason why international investments were secured and promoted to level up social welfare in the global market.

Especially, those principles have been articulated in the form of attribution to the PE and arm's length standard. In the BEPS 2015 final report, each advisory opinion in other action items never escaped from such respected legacies, instead, it stuck to both policies. For ex-

[7] It is generally said that while consumption tax covers value realized by B2C transactions, corporation tax covers value realized by B2B transactions. However, destination-based cash flow tax has been examined to break such a traditional theory.

ample, the DEMPE rule in the evaluation of "hard to value intangibles," defensive measures in treaty against abusive application of the PE exemption clauses, etc. After the active involvement in such discussions on the other Actions, I suppose that they were concerned about the new burden as the obstacle on innovation and reached the conclusion at that moment to be negative against any additional conditions that might be recommended for the digital economy in the Action 1 report.

The third policy concern was dispute resolution, as it was discussed frequently during the BEPS public consultation stage. It seems that the private sector has been skeptical about the efficiency of the current systems. Their opinion was clearly expressed during the discussion on the Action 14 draft. And so, two year time limit for MAP negotiations as well as introduction of mandatory binding arbitration was involved in the draft by the strong support from the private sector. Since the private sector has recently been damaged by the ineffective dispute resolution system (MAP) especially on the PE and transfer pricing issues, they seem to be concerned about new double taxation caused by new rules that might allocate a part of residual profits of MNEs to the market jurisdictions.

## *II-4. Reaction of Japanese business*

BIAC's comments are the summary of global business, which includes Japanese businesses (Keidanren is a consolidated business organization composed of listed corporations). So the specific comments from Japanese businesses were generally in line with the BIAC. However, in 2015, Keidanren was not so interested on the Action 1 draft, because it contained no concrete proposal like the Pillar 1 and Pillar 2 of the 2019 draft program of works.

In the following, I get through the Japanese reactions in 2015, by referring to the Keidanren's comments.[8]

### II-4-1. Keidanren's comment

First, like BIAC, Keidanren agreed with the summary of discussion on the Action 1 draft that respected the Ottawa principles insisting no ring-fencing. Then, it pointed out that significant economic presence or virtual PE concept seemed to be inconsistent with the Ottawa principles and added inappropriate double taxation risk, so, it recommended that careful examination before adopting such policy would be necessary.

Furthermore, as for the other option on withholding tax, Keidanren followed the BIAC comment that it is the job of VAT. It also concluded that the other BEPS actions (listing up No. 2, 3, 7, 8 and 12 respectively) could be effectively workable against the tax gap generated by the digital economy to great extent. So its position then looked rather defensive.

[8] Keidanren "Opinion on Draft Public Discussion on BEPS Action 1 (Addressing Taxation Issues of the Electronic Economy)" 2014.4.14 (From Keidanren website)

The points that could be identified from Keidanren's comments were as follows.

First, the 2015 draft seemed to focus on the digital native business rather than the general business that has entered in the process of digital transformation. As the majority of its membership was consisted of manufacturing and distributing entities, Keidanren then seemed to have judged that the draft was not so demanding on the Japanese business. Actually, grave concerns were expressed mainly by the European countries on the tax avoidance schemes conducted by US GAFA companies in Ireland (for example, double Irish Dutch sandwich type). Compared with them, Keidanren believed that Japanese big MNEs generally kept distance from such practices.[9]

Based on this recognition on Japanese business, when the OECD requested comments on any BEPS action item, Keidanren always responded as follows; "if necessary, any prescription on the digital economy should be structured within the framework reflected in the Ottawa principles."

### II-4-2. Other comments from Japanese businesses

At the OECD public consultation event held on April 23, 2014, besides Keidanren, two Japanese business associations, Japanese association of machinery exporters and Shinkeiren, presented their comments.[10] [11] Shinkeiren's membership is composed of digital native industries, so its comment was more specific than the others. It insisted that every option examined in the Action 1 draft might cause big concerns for the digital industries, for example, whether data value is appropriately scaled, or whether the monetization of data could be clearly identified. Shinkeiren was afraid of the draft options that might discourage their innovative investments.

### II-4-3. Environmental changes hereafter since the 2015 Japanese responses

The Japanese comments towards Action 1 in 2015 were not in-depth analyses, compared with comments on the other Action items. I think it is directly reflected the Japanese business environments at that moment. However, from then the environment surrounding the digital economy has turned around drastically.

Japanese government started a new project called "Society 5.0," followed by the Keidanren Initiative to expand its membership to new industries, As a result, some foreign affiliated digital native enterprises such as yahoo Japan, Baidu Japan, Amazon Japan, etc. joined Keidanren. The government has streamlined many legal infrastructures speedy, including domestic taxation system.

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[9] According to the fact-finding survey by the Ministry of Economy, Trade and Industry, Japanese companies have a tax management system in which there are many cases in which they are entrusted to a subsidiary company.

In emerging markets, which have been expanding in recent years, local tax authorities are facing taxation offensives and some of local Japanese subsidiaries are under strong pressure by them.

[10] Comments from the Japan Machine Export Association (Comments Received on Public Discussion Draft (BEPS Action 1) OECD, 16April 2014) pp. 310

[11] Comments from the Shinkeiren (New Economic Federation) ditto. pp. 292

Volume of comments from the New Economic Federation was 18 pages, compared with the Keidanren (3 pages) and the Machine Exporters Union (7 pages)

On the other hand, in EU countries, a new unilateral "digital service tax (DST)" has been drafted and some countries have finished procedural steps already. The private sector concerns on double or excessive tax burden by such new taxes were about to be realized, especially after the US international tax law reforms in 2017, which included the global intangible low taxed income regime (GILTI). Those new unilateral taxations could have surely put additional tax burden on the digital economy, so, global business including Keidanren pushed the OECD to structure a widely acceptable new profit allocation rule between residence countries and market countries.

Thus, I conclude that the above-mentioned defensive comments from Japanese businesses in 2015 were reasonable, and they were harmonized with the global comments, however, they had to change their policy reflecting the global environments.

By the way, Keidanren and the 21st Century Public Policy Institute, a think tank organization of Keidanren, has organized annual conferences with the OECD and BIAC every year from 2015.[12] I think it has been a good opportunity for Japanese businesses to review the recent developments of the global digital economy and check the on-going discussions within the IF in order to contribute its revised comments on the OECD draft documents.

## III. Initiatives leading up to the 2018 interim report

After the 2015 report, the discussion on the digital economy has become the central theme of the post-BEPS era. Here I would like to summarize the important input from business up to the IF interim report in 2018.

### *III-1. Studies of the IF Steering Group on the digital economy*

Examination of digital economy taxation had been conducted by IF participating countries since 2015 and they presented the Interim Report to the G20 ministerial meeting in 2018. Task Force on the digital economy in IF, where Japan's Ministry of Finance joined as a core member, prepared the report, and during that process, many draft documents were examined by TF members in reference to the private sector's comments. Here, I have noted some interaction between business and government mainly based on the BIAC comments, and then summarized the environmental background of Japanese businesses under the changing tax rules.

[12] The first meeting was held in October 2015, and each year, with the support of the Tax Bureau of the Ministry of Finance, a panel discussion method was adopted.

At the 5th meeting in October 2019, main topic was the OECD work plan focused on the digitization of the economy. There was a concrete exchange of opinions regarding the Two Pillars of the plan (see the November 21, 2019. "Weekly Keidanren Times").

It is reported that the OECD/Tax department has limited annual business meetings with individual member countries which include the United States, Japan and Germany.

### III-1-1. Issues raised in the Interim report

The purpose of the Interim report[13] was to make total research on a variety of digital businesses and extract the essential building blocks to address the tax vacancy situation on the digital economy in market jurisdictions. Then, the OECD/IF received strong pressures from some unilateral tax measures drafted by a couple of European countries. The private sector, as usual, requested a coordinated multilateral solution on such issues. In order to start a substantive drafting work for that, IF completed in-depth analysis on the current and future digital business focusing on untaxed excess profits of that industry, and IF finally summarized a variety of government positions on this issue. Thus, the report did not articulate any concrete prescription on both short term and long term solutions.

The issues identified in the report were as follows.

Firstly, in order to recognize relevant issues correctly, IF realized that constant feedback from digital businesses was necessary. During the drafting work of this report, IF put many questions on business, namely, how digital transformation had been proceeded, and how the private sector had realized or monetized value by using consumers data or digital platform, etc. It means that IF would respect public consultation at any stage of discussion of solutions, fact-finding, framework-setting, drafting procedure, and finally political judgment.

Secondly, since IF also focused on the administration side, it requested analysis on information gathering policy with tax authorities. Among them, user information of online platforms, including sharing economy, block chain, and crypto currency transactions were highlighted by the report.

After the above research, IF summarized that any digital business concerned (highly digitalized business) was furnished with three common characteristics, such as ① scale without mass, ② heavy reliance on intangible assets, and ③ synergy of data, user participation and intangibles through the network effects. Based on this analysis, IF questioned participating countries on whether the three features are related with value creation in market jurisdictions, if so, to what extent, and finally how to address this issue.[14]

And finally, as its work towards 2020, IF have agreed its direction of this work program in Interim report, reflecting some business requests.

——New nexus and profit allocation rule be drafted, based upon the value creation analysis of digital businesses

——On drafting process, invite all interested parties, including the private sector, civil society, academics, and coordinate with regional administration in order to check the effect on developing countries

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[13] Brief on the Tax Challenges Arising from Digitalization Interim Report 2018 (OECD)

[14] The positions of BEPS project participating countries are classified into the following three types.

Group 1: to seek new advanced digital taxation rule on the HDB, considering that applying the existing tax rule on nexus and profit allocation might produce inconsistencies between place of taxation and place of value creation(focusing on users' participation on value creation)

Group 2: to seek new taxation rule on not only HDB but also on common international B2C business, insisting that coverage of new rule should be expanded on beyond HDB

Group 3: to wait and see(no additional measures are required, because the other responses to the 2015 BEPS final report would be sufficient to address tax issues on the digital economy)

——Present the update report on such long term solutions in 2019 in order to finalize this by 2020

In addition to the above long-term measures, for unilateral short term measures taken by some states, IF agreed on guidance that requires relevant countries to follow the obligations of bilateral treaties and international arrangements, such as WTO rule or EU directives. It was considered to be the response to the private sector's requests. Then, the private sector insisted on the critical effect on international business because short term unilateral solutions might be attached with excess burden caused by gross base taxation, possible double taxation with ordinary corporate tax, additional compliance costs, etc. Furthermore, the private sector was also concerned about its inflexibility once introduced in policy.[15]

The followings were some of the BIAC's main comments on the Interim report.

### III-1-2. BIAC's comments on the Interim Report

The basic BIAC stance (based on the Ottawa Declaration) was observed even on this stage.

In light of those Ottawa 7 principles, the BIAC presented negative reaction towards some options discussed in the Report.

As for the unanswered question on the 2015 draft, the BIAC responded to equalization levy option. BIAC indicated that the tax base of equalization levy is sales amount rather than net income so it is against neutrality and causes double taxation among relevant countries. In addition, it is also against flexibility, sustainability, the proportionate principle, effectiveness, and equity.

On the unilateral measures like UK diverted profit tax, a new withholding tax, a new sales tax, etc., BIAC showed numerous flaws, namely a risk of double taxation, incompatibility with current international laws, and damages on small companies. However, BIAC reserved its position, if it is equipped with global tax credit system. They could be acceptable, BIAC pointed out.

Besides such BIAC comments, Japanese businesses did not submit its own comment to the Interim report.

## *III-2. Changes on BEPS environment of Japanese business*

Comments from Japanese businesses have been modified after the 2018 Interim Report, from conceptual in character to practical in character. It was mainly because the program of work at IF entered into the practical drafting process in 2019 (the Two Pillar approach), but, partly because surrounding conditions around Japanese businesses have changed year by year. Thus, firstly, I will examine such environmental changes in Japanese businesses in accordance with some published information.

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[15] Oct. 13, 2017 Letter and comment from BIAC to Digital Taxation Task Force. This comment is explained in detail by Hiroki Yamakawa, "Electronic Economy;-A Study on the Taxation Issues of Corporate Source Country," 21st Century Policy Research Institute Report (2018.6,) p. 33

### III-2-1. Fact-finding survey held by the Ministry of Economy, Trade and Industry[16]

Analysis conducted by the METI showed specific features of Japanese businesses. It was conducted by a private research agency from the request of METI in 2018. The agency collected intensive questionnaires on big Japanese MNEs based on the past six years for Japanese business offshore performance. The report indicated that for majority of responder companies the biggest concerns on offshore taxation issues were transfer pricing with Asian countries. They pointed out that especially with China, Indonesia, and India, they sometimes face deemed profit ratio taxation without using concrete comparables, which seems to them to be deviation from the ALP principle. In addition, for consumption tax, it was reported that they were comfortable with the new nexus rule based on the location of consumers, which was introduced in Japan, before the 2015 BEPS report. They welcomed a level playing field policy on the digital inbound business on VAT matters. However, the concerns on the unilateral digital service tax had not yet materialized to any substantial amount at that time.

Based upon those fact findings, the report recommended several initiatives for Japanese businesses.

——A more effective dispute resolution mechanism should be made

——Fix the international rules and share practical guidance on the PE attribution rule, and royalty taxation

——Fix bilateral treaties not to allow abusive taxation[17]

Among them, the royalty taxation issue seems to me that it reflected the frustration of the market jurisdictions. For examples, Chinese authorities sometimes denied royalty payment based on the related party's contract, because they are likely to judge gradual depreciation of intangibles. India also sometimes evaluate local-origin marketing intangibles in order to deny payment. Emerging economies have already insisted on such discussions in the UN Expert Committee.[18] I think those discussions could be characterized as a sort of fore-runner of the new taxation draft (Pillar 1, Amount A).[19]

In this report, it was reaffirmed that Japanese business are likely to keep distance from such aggressive tax planning as Double-Irish & Dutch sandwich scheme. And so it seems to consider that a new tax rule on the digital economy might only affect Japanese digital native MNEs in EU markets,[20] so the new rule might be unnecessary if other Action Items of 2015

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[16] Research Paper on "Cross Border Outbound and Inbound Investments and Japanese International Tax Regime," presented to METI by PWC Japan (Feb. 2019) (METI website)

[17] A similar statement was made by Aoyama, "Global movements related to international taxation and transfer prices" (21st Century Policy Research Institute Report "International Trends in the tax system and international taxation issues of Japanese companies in Asia," 2011.6), page 1

[18] Under the UN Model Convention, although the provisions of the transfer pricing clause (Article 9) are the same as those of the OECD, the implementation guidance is modified to some extent. "UN transfer pricing manual" describes the realities of emerging countries that allocate taxation rights by equating market characteristics with intangible assets.

Practices are introduced as reference cases. Aoyama "For the 2012 Transfer Pricing Manual based on the UN Model Convention," (Japan Tax Research Association "Tax Research Magazine" 2013.7) page 275.

[19] Prior to the idea of Pillar 1, the OECD Transfer Pricing Guideline was adopted as pursuing a similar income distribution effect. It is thought that the location saving and location specific advantage that have been raised can be positioned.
Aoyama "Tax Information under the New International Tax Environment" ("Tax Research 2019. 11" Japan Tax Research Association) page 98

BEPS recommendations were implemented.

In addition, another METI survey[21] indicated that Japanese headquartered companies are likely to entrust local tax management jobs to regional holding companies, so, the size of tax departments is usually small compared with foreign based MNEs.

Through the implementation of the country by country reporting system recommended by action13 of 2015 BEPS report, it said that Japanese business are expanding the capacity of headquarters function on global tax management. But, so far there still recognized some distance with other MNEs, exists, I think those conditions were surely one reason for the special features on Japanese comments.

### III-2-2. Verification by National Tax Agency report

We can identify taxpayers' reaction towards BEPS initiatives through administration data. I made reference to the National Tax Agency Report for that purpose.

It substantially shows the relation between the recent years' tax law reform and the taxpayers' reaction.

Firstly, let's follow the recent tax law reform on the offshore transactions. To address international tax avoidance regarding the BEPS type scheme, Ministry of Finance was so energetic that they drafted many important new rules recently, namely introduction of an earnings stripping rule (2012), streamlining of the PE attribution rule in line with the OECD standard (2014), new documentation rule for transfer pricing (2016), fundamental reform on the CFC rule (2017), redefined the PE concept (2018), introduction of commensurate with income principle (2019), etc. All of those were in line with the recommendations of 2015 BEPS report, therefore all of which are directed towards the tightening tax regulations.

During this decade, the NTA's data showed no specific change in the number of examined cases and the amount of adjusted income.[22] In short, those data can be interpreted that current frequent domestic tax law reforms were mainly to coordinate with the OECD standard, not to prevent large scale and aggressive tax avoidances in the past. For the Japanese businesses, they welcomed the recent developments in international tax regime. I think It was another reason why comments from Japanese businesses up to 2018 focused on a principled basis of opinion rather than on practical issues.

### III-2-3. Environmental changes which are going on

However, OECD/IF efforts on drafting new rules on the digital economy under BEPS environment would definitely mobilize the current conditions for the Japanese businesses. I believe that Japanese businesses will not be able to enjoy such a stable conditions as in past

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[20] The New Economic Federation, which is mainly composed of the technology industry whose current leader is Rakuten, Rakuten operates digital business beyond border in foreign countries including the EU. From the time of proposing DST, they have shown great interest because of its big impact.

[21] Mar. 2017, EY Japan tax unit, "Survey of Japanese multinational companies related to international taxation system"(METI web-site)

[22] "National Tax Agency Report" (2019, 6), page 73. Looking at the data for each year, the number of examinations and additional tax charges peaked at H.21.and then they appear to be stable at low levels (NTA web site)

decades. They have experienced the strong impact from the Trump tax law reform in 2017. If the essence of the US reform are realized in the draft of the pillar 2, that is dealt by the next chapter and is agreed by IF, I think they will be forced to strengthen tax management system more effectively and face tax risk in complying with both domestic and international rules.

## IV. Business Initiatives for the 2020 Final Report

### *IV-1. Approve of Program of works*

Tentative taxation measures on the digital economy were widespread especially in European countries, after the EU Commission gave up on reaching an agreement on the draft directive on digital service tax in 2018. Both business and governments expect the OECD/IF to draft and conclude agreements on the long term solutions for digital economy taxation. Under such circumstances, IF agreed on the policy note consisting of Two Pillar approach in January 2019, followed by the consultation documents to organize public consultation. In May, IF successfully agreed on the Program of work (PoW),[23] which was later endorsed by the G20 ministers meeting in Fukuoka and G20 summit in Osaka. Japan was the Chair country for G20 at that moment. I will summarize the PoW itself and some major comments from the private sector mainly through BIAC.

The PoW was refined after the consultations, and was agreed as legitimate framework for the unified approach in January 2020.[24]

#### IV-1-1. Contents on initial Program of work

The PoW structured the following Two Pillars for the long-term solutions. They were agreed as the framework for the future drafting works. And further, it was also designated as the platform for assessment of the potential revenue impact. The initial proposal draft of the 2 pillars as of 2019 spring Public consultation was as follows:

The 1st Pillar

This is to allocate new taxing right to market jurisdictions on the digital economy. Thus, IF agreed that Pillar1 can be deviated from the current nexus rules and profit allocation rules. As for the new nexus rule, it is to follow either of three options (single or combined).

——User participation (UK proposal)

——Marketing intangibles (US proposal)

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[23] Program of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy, (Inclusive Framework 31st May 2019)

[24] “Statement by the OECD/G20 Inclusive Framework on BEPS on the two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy” In addition, OECD, “Tax Talks, 31st January 2020” (both posted on the OECD website) explains it

——Significant economic presence (India and developing countries)

As for the new profit allocation rule to market jurisdictions, the following three measures are to be examined

——Simplified residual profit split method (residual profit: total global profit minus routine profit attributable to each entity, allocation: depending on certain formula)

——Allocation of group-wide total profit by way of certain formula

——Deemed local profit (calculated by way of local sales amount multiplied by certain %)

The 2nd Pillar

The Pillar 2 is to address the tax avoidance arrangements which used low taxed jurisdictions, and successfully escaped from the coverage of the other anti-BEPS prescriptions.

For that purpose, the target countries should be non taxed tax havens and low-taxed (below X%)countries. The methodology are composed of an income inclusion rule of local entities and a non-deduction rule on certain payments to local entities.

### IV-1-2. Initial Business Comments on the PoW

(BIAC comments on its basic policy)

BIAC presented its eleven fundamental principles to be applied to any draft solution on international tax issues, when IF publicized the Policy Note along with PoW in January 2019.[25]

It indicated that the purpose of those principles were assurance of any tax reforms to be consistent each other overtime, and to be pro-growth, not to hinder digital innovation and transformation. Each principle was explained as follows.

——To follow widely accepted and long lasting principles, such as net taxation, nexus, PE principle, transfer pricing reflecting ALP,

——To avoid ring-fencing of the digital economy (which is clearly against neutrality principle)

——To follow the Ottawa principles

——To focus on the value-creation theory

——To reduce risk of double taxation

——Solutions should be combined package of nexus and profit allocation rules. In addition, those are to be implemented simultaneously

——Solutions should be reflected in OECD model conventions

——To provide effective dispute resolution mechanism in order to assure tax certainty, BIAC especially expect mandatory binding arbitration including ICAP initiative

——To arrive at global consensus

——To minimize compliance cost both for taxpayers and administrations

——To organize public consultation not only with businesses but with any other interested parties

[25] Business Principles for Addressing the Tax Challenges of the Digital Economy, January 2019 (BIAC website)

I accepted that each of above 11 principles seemed reasonable in any context, however, I noticed at that time that compared with the first 5 items, which was repeatedly stressed by BIAC in the former comments, the BIAC seemed to focus on the latter 6 items resolution, all of which are to assure simple and non burdensome implementation with effective dispute resolution system. I suppose it reflected the big concerns of BIAC on the unilateral measures going on in European countries and skepticism on the future political negotiation between developed and developing countries on the final solutions until 2020.

(BIAC comments on the specific issues)

The BIAC applied the above 11 principles to make specific comments on each pillar draft. On the March 2019 public consultation,[26] BIAC focused on the first two options of Pillar 1 resolutions, and gave more favorable comment on the second marketing intangible option.

(Keidanren comments)

On the other hand, Keidanren's presented the coordinated comment with BIAC's on the basic structure of the PoW, however, it stressed the strong concerns about new marketing intangible option to put excessive burden on the Japanese consumer-facing business.[27]

It requested proportionality in drafting the scope of Pillar 1 under such options. Thus it seemed to me that Keidanren agreed the framework of Pillar 1's approach, but for the specs of Pillar 1 they were likely to be against the draft. To be more specific, I would like to focus on the discussion on some essential issues.

For example, Keidanren claimed that the current APAs based on the TNMM should be respected because they reflected correctly the Japanese business model in foreign market jurisdictions. They believed that generally speaking, Japanese manufacturing companies concentrate their marketing efforts in the headquarters, so, TNMM is considered as best method in deciding ALP for the local entities.

This argument looked a little bit divergent from the marketing intangible option. In my opinion, Keidanren's comment might be more in line with the user participation option, which limits the coverage of Pillar 1. By the way, the Keidanren's domestic proposal of tax law reforms contains arguments on digital taxation, where Keidanren warned of the risk of over evaluation of marketing intangibles, and it expected a future new rule to be proportionate in its context of covered business. I suppose that at the background of this argument, there is undeniable Japanese situation that many Japanese MNEs are categorized as consumer facing business that might be damaged by the second option.

As for the third option, Keidanren looked to be against it, because it is far away from current practice and discussion within IF had not been materialized.

Finally, in addition, Keidanren requested arbitration to address the future double taxation

[26] Over 200 groups in total submitted comments to the Public Consultation Meeting on March 13-14, 2019, with over 2000 pages of written comments.
It is said that there were 400 participants from the public and private sectors.

[27] Keidanren, "Keidanren's Opinion on the Tax Issues Related to the Digitization of the Economy in Response to the OECD Draft Documents for the Public Consultation" 6th, Mar. 2019 (Keidanren website)

problems.

## *IV-2. Business comments on the second PoW draft (Unified Approach)*

After collecting fruitful contributions from business at the spring consultation, OECD/IF secretariat redrafted the unified approach for the Pillar 1. Together with the revised draft on Pillar 2, the second public consultations were organized in autumn 2019.

It was stressed that the new draft extracted the commonality of three options and prepared the consensus-based draft for the coming G20 meeting in early 2020. Here, I would like to summarize those drafts proposal and introduce business comments on it. On this stage, the argument has been concentrated on the practical issues, so, the private sector has become more active.

### IV-2-1. Summary of consultation documents

(Pillar 1)

In the consultation document on Pillar 1, the secretariat presented so-called unified approach as follows;

——Recognize nexus in market jurisdictions on the condition of certain local sales amount, no matter whether there is PE or not,

——Covered business are both automated digital service (ADS) and consumer facing businesses (CFB). And the safe harbor rule which set threshold on global sales amount is attatched to it

——As for allocation of residual profit (named “Profit A”) to market jurisdictions, X% of excess profit if any, which are calculated after deducting routing global profit, To the market jurisdictions, amount B and C would also be allocated, based on the conditions of having local PE there. Amount B is a sort of simplification of ALP calculation using some formula, when local entities perform only basic marketing and distribution functions. And amount C would be allocable to local entities out of excess profit, if they perform excess functions beyond above-mentioned basic functions, Thus, amount A represents a new taxing idea, while B and C represent reforms under the traditional ALP principle.

Thus, comments from business have been concentrated into amount A. Furthermore, in structuring A,B and C, businesses required an effective dispute resolution mechanism, In order to reach final answers on how much residual income is to be allocated to one of the marketing countries, we have to get through three stages, namely, first, to extract excess global profit, and second, to divide it into two, one for market jurisdictions, the other for headquarters, and finally, to allocate total market jurisdictions share to each jurisdiction. We need the agreeable portion in each stage, however, such indicators has not been drafted yet. The draft left that procedure for the last stage on the final political negotiation.

(Pillar 2)

In the draft, components of Pillar 2 have increased from two options to four options.

Two treaty-related supporting rules are attached to the basic minimum tax schemes, so the whole structure is as follows;

——Minimum tax rules (income inclusion rule (IIR) and under taxed payment rule (UTPR))
——Supporting treaty rule (switch-over rule and subject-to-tax rule)

The two basic rules resemble the US GILTI system and BEAT tax as minimum taxes, so I assume that introduction of the pillar 2 could be an incentives for the US that has kept negative reactions on digital economy taxation.

## IV-2-2. Comment from Business: from BIAC[28]

BIAC's comment reflected again the above mentioned 11 principles. Based on that theory, BIAC highlighted some important issues, which may cause disputes.

The first issue is the unpredictability of the covered business, especially on the definition of CFB, and on difficulty to identify the effectiveness of marketing intangibles in the context of value creation, Then, BIAC asked IF of some homework to complete, before the final consultation in the future. They are:

(For Pillar 1)

——As for the definitions of CFB, precise definition is necessary. For example, how to treat loyalty programs, web-sites targeted to consumers to collect their feedback, targeted advertisements, etc.
——As for the safe harbor of minimum volume of global sales amount, proportional limit of the foreign sales amount should be applied,
——As for its administration, one-stop shopping is required,
——As for a new nexus rule, it should be applied only to amount A. In such cases, it should be noted of the difficulty to identify the location of consumers when final sales are conducted through third party traders,
——As for calculation of group-wide excess profit, any consolidated accounting system should be respected in order to minimize administration costs,
——As for the mechanism of double taxation relief, corresponding adjustment system should be respected rather than tax credit system,
——As for amount B and C, it is necessary to clarify its relevant tax principle and provide a mechanism to avoid double counting with amount A, and in case of a dispute, a mandatory arbitration should be applied

(For Pillar 2)

——As for the Pillar 2 proposal, further clarification on reasons for additional measures would be necessary, while any concrete comment is retained until further developments on two policies, income inclusion rule and under taxed payment restricting rule.

[28] Letter from BIAC Tax Chair, Mr. W. Morris, to OECD Secretariat, dated 12th Nov.2019 and 2nd Dec. 2019.

### IV-2-3. Comments from Business : from Japan[29]

This time, Japanese business presented in-depth comments on consultation drafts for Two Pillars, based on the analysis of recent developments in Japanese economy.

(Pillar 1)

Keidanren was basically concerned about excess allocation of residual profits to market jurisdictions. It believed that if a new system is designed according to the proportional principle, then the percentage of allocable profit could be rather small. It's because Japanese business in foreign countries is conducted through active local PE, so, any allocable amounts has been already reported to the local authorities.

Keidanren also insisted that any new system should be provided with an effective dispute resolution mechanism.

Hereafter are some major responses from Keidanren on the questionnaires listed in the drafts.

Scope

In order to minimize compliance costs, the threshold on sales amount should be increased, and exemption should extend to sales of intermediary products, machines (only for manufacturing entities), prescribed medicine, transportation services and telecommunication services, some of which are regulated by domestic regulations.

Nexus

Simplification on the rule to calculate sales amount in consumer jurisdictions and for the consumer-located small countries, a threshold using GDP ratio should be adjusted.

Tax base

Tax base for amount A should be calculated by Japanese GAAP, and the deemed normal profit ratio should be well beyond 10% and deemed residual profit ratio to be allocable to market jurisdictions should be less than 10%, a loss as a group could be extended to cover future profit.

Double taxation relief

As BIAC, Keidanren also requested one stop shopping with a corresponding adjustment rather than tax credit system and sought mandatory binding arbitration.

Amount B & C

Keidanren appreciates the TNMM method which has been frequently utilized in Japan, and so, did not agree with usefulness of amount B.

I think that the reason why Keidanren were strongly against the new taxing mechanism is from its historical background, where Japanese businesses have been struggling with disputes with some Asian local tax authorities, and thus they tried to conclude APAs on their transfer pricing by way of TNMM.[30] That's why at the November 2019 public hearing, a representative of Keidanren insisted their opinion on Pillar 1 in the following three ways;

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[29] Keidanren's letters to the OECD secretariat dated 12th Nov.2019 and 2nd Dec. 2019 Both are disclosed at Keidanren website.

——One stop shopping of filing and payment be recommended
——Double taxation relief be implemented through a corresponding adjustment style
——To be net taxation rather than any withholding tax measure

On the other hand, the comments from Shinkeiren, whose membership are composed mainly of digital native enterprises, reflected strong concerns about unilateral DSTs planned in the EU countries. Shinkeiren eagerly requested the long term solution by IF to be completed as soon as possible. Thus, they supported the extended scope up to CFB with exception only for highly restricted business sectors, and, as for nexus and profit allocation mechanism, they preferred neutral single policy on both ADS and CFB, while their support on one-stop shopping and allowance of loss were same as Keidanren's opinion.

(Pillar 2)

Keidanren had a basic position against Pillar 2 that it could overlap the effect of the recommendations on other BEPS action items, such as CFC legislation, in order to challenge low taxed jurisdictions. Especially because Japanese CFC rules has recently been modified frequently to adapt current situations, Keidanren was likely to think the Pillar 2 is not necessary. Majority by Keidanren's comment seemed to be similar to the BIAC's, however I would like to draw attention to some Japanese additions as follows;

——If consensus attained for the minimum tax system under Pillar 2, a global blending of the group profit should be allowed under the consolidated accounting used by its parent company (Shinkeiren's comment was the same). In addition, small affiliates that are excluded from consolidation by reason of principle of importance should be exempt under Pillar 2.

——If entity-based blending is accepted, then the mechanism to measure effective tax rate should be common to the local CFC rule in order to minimize compliance costs. In addition, the de minimis rule is necessary.

In Japan, the CFC rule has long history in harmonizing two objectives under the proportionality principle, namely between anti-tax avoidance and pro foreign direct investment promotion. Under the CFC rule, which exempts substantial business activities, are so well respected that an unconditioned top-up taxation rule with a threshold local tax rate seems to be excessively burdensome and duplicated. Keidanren also then insisted that received foreign dividends should be excluded from the permanent difference to be adjusted in calculating the effective local tax rate.

Shinkeiren also put the same comment as Keidanren on global blending issue, while it insisted that exemption under Pillar 2 should be allowed for all the highly restricted business including digital native industries.

[30] In the comments, Keidanren also expressed caution about the market premium sometimes claimed by the Chinese authorities regarding profit C.

# V. Confirmed two documents as of January 2020 and later consultation stage with business

## *V-1. Approval of two documents*

IF member countries under OECD/G20 (total number is around 140) on January 31, 2020 unanimously agreed and published two documents on the revised PoW on two pillar system.

The first was the concrete draft proposal by secretariat on the Pillar 1 based upon the last autumn business consultation, and the second was a progress report on the Pillar 2 drafting work which was also reflected in the last consultation.

The first document confirmed the above mentioned unified approach as a framework of Pillar 1 (scope is ADS+CFB) and provided the building blocks in structuring a new rule, with some important issues such as the threshold of scope, percentage of allocable residual profit to market jurisdictions, or how to allocate to each jurisdiction, etc., still undecided and left to later political negotiation. The second document introduced the on-going discussion on the IIR and UTPR.

And, the future schedule to reach agreement within 2020 was disclosed at the same time.

After those disclosures, the G20 ministers meeting in February endorsed IF initiatives on those documents and supported its future program.

However, the unstable conditions on this future work have been created by the US reactions.

First, in late 2019, US Treasury Secretary Mr. Mnuchin sent a letter to the OECD secretary General Mr. Gurria on the US position on the two pillar system. It suggested that Pillar 1 should be used as a safe harbor for taxpayers. It meant that tax payers have option to select a new rule or the traditional tax rule to address the Pillar 1 situation. The majority of IF members expressed concerns on the US proposal, because they thought it might put substantial damages on the expected objective to allocate additional taxing rights to market countries.

## *V-2. Business involvement in approved documents*

Since the approved documents were examined by business during the 2019 autumn consultation and already reflected some business comments, it was expected that the next stage would be clarification of each building block and completion of so-called blueprint draft for the final consultation with business. In 2020, businesses are still cautious about the expansion of unilateral DST measures around the world. They are increasingly skeptical about the negative effect of the US safe-harbor proposal, because it might cause dispute on this issue, resulting in the failure to reach agreement , that could promote many countries to start unilateral DST.

In addition, IF later published the impact assessment report on the proposed two pillar system draft in order to stimulate political discussion on the blue prints, especially regarding for the decision on normal profit percentage, allocable portion of the residual profit, index used for allocation to each market jurisdiction, and minimum effective tax rate for the Pillar 2 measures. As already indicated in the public hearing, businesses as well as IF membership countries, especially most developing countries, would expect a more simple system to be administered. From the business perspective, they want to be assured of predictability of tax burden, which among others is the focal point for the private sector who are struggling with solution of transfer pricing and PE taxation. However, if some decisive indexes are fixed at a single figure, then its effect on the tax burden of a variety of business models might be different from each other, which causes the neutrality issue. Considering such problems, when IF structures and discusses draft blueprint of the Two Pillar system, input from business sectors would be still important from now on,

Up to now, BIAC summarized the comments of global business as a whole, that was very useful in exchanging fundamental policy issues with tax authorities, however, in the coming consultation, comments reflecting each industry model or business-line model might be expected. I think that BIAC and Keidanren should collect specific industry by industry demands to represent all business. And then, at the final stage, political negotiations should be conducted under the strong leadership of G20.

### *V-3. Future issues*

#### V-3-1. Issues raised by the package documents of January 2020

For the time being, the US proposal on safe harbor rule is one of the critical issues to draft blueprints. During the negotiation of the unified approach, US has not presented safe harbor approach so clearly,

I think it might be caused by US frustration on the increasing number of unilateral measures spreading from EU countries to some emerging economies, or by their reflection on impact assessment on not only GAFA style digital native companies but also big CFB business like pharmaceutical business.

Thus, as mentioned above, input from the private sector on the blue print is likely to be more requested, here I would like to summarize the favorable business stance on some important building blocks.

#### V-3-2. Issues related with Pillar 1

Regarding Pillar 1, many important decisive indexes to calculate tax base still remain open.

The first issue to focus on is the consolidated accounting system used to assess global group excess profit. As the international accounting system has been converged to great extent, the private sector wants to follow their own system, no matter how it deviates from, for example, IFRS style methodology. In order to minimize compliance cost, permanent differ-

ences between tax account and financial account to be adjusted should be limited. Contrary to the ordinary domestic corporate taxation, consolidated financial data would be used to assess its tax base, so, multilateral evaluation on accounting system should be flexible enough not to place excessive administrative burdens. Even under the new tax rule, traditional entity by entity accounting still remain as important infrastructure, because transfer pricing or the PE attribution rule continue to depend on the traditional accounting. Following such a hybrid system, businesses and administrations should get advantage of digital transformation in each sector.

The second issue is about index or parameters to structure its tax base. According to the OECD impact assessment, it temporarily assumed deemed normal profit ratio (10%), estimated allocation ratio to market jurisdictions (20%), minimum tax rate for Pillar 2 (12.5%), etc., its simulation pointed out that indirect effect (voluntary reallocation of income between related entities, or on-shore shifting of profit within the group) could be expected other than direct effect of the new rule. It said that in total tax revenue effect was favorably estimated for the low income group rather than mid income group, that is surely good information to organize consensus among IF memberships.

The third issue for business is how to react against the proposed spec of a new rule depending on each business model. Because of a diversity of business structure and profitableness of business model, the new rule would have to reflect such difference in order to be neutral and keep equity. Providing information on the business practice for that purpose would be expected of the industry-wide or business-wide representatives during the consultation.

The last issue, the US option proposal on safe harbor will be exclusively handled by the G2G negotiations.

### V-3-3. Issues related with Pillar 2

Pillar 2 was positioned by IF as the counter measure to the residual risk of BEPS, where low taxed jurisdictions has been utilized to minimize tax burden for the MNEs, resulting in further promotion of so-called “race to the bottom” situation in spite of the other BEPS measure such as CFC rules. The main framework, IIR supported by UTPR, was proposed in the consulting draft in reference to the minimum tax rate (X %) that is agreed among IF members. The applied top up system is different from the current CFC rules (usually subject to the domestic tax rate).

As explained above, blending stage could be the most critical issue for the private sector, and businesses definitely supported the global blending, however, during the consultation, draft papers insisted on the country base blending in order to challenge the race-to-the bottom situations.[31]

In addition, if Pillar 2 is introduced, some adjustment with the current similar system should be conducted, for example IIR with reference to CFC rules and UTPR with reference

[31] GILTI and BEAT in the United States seem to be an example of a comprehensive study.

to the interest deduction limitation rule, etc.

In those examination procedures, businesses would be also expected to present practical input.

### V-3-4. Challenges for Japanese Business

Once Two Pillar reforms are materialized, global allocation of group profit would be definitely affected in accordance with the future hybrid mechanism, such as amount A combined with traditional transfer pricing, etc,, for Pillar1 and IIR combined with CFC rules. Such change might affect Japanese MNEs on the decision where to put their new direct foreign investment, or whether the current value chain could be modified or not, depending on the evaluation of in house impact assessment of the new rules. In the impact assessment, not only does Japanese tax law change matter but also foreign jurisdictions tax law change matters.

Furthermore, any new rule about the Two Pillars seems to request taxpayers of new documentations on tax base. Considering that those new rules focus on consolidated accounting, headquarters should play a central role in any compliance procedure. This environmental change on business management could encourage Japanese MNEs to centralize their tax management further. As we found such changes during the introduction of CbCR system recently, I think the knowhow of the US or EU MNEs with big in-house global tax teams might be imported.[32]

## VI. Final remarks

From now on, not only in the business industry but on a national government basis, many negotiations based on the estimation of tax revenue effect will be materialized.

In the process of this negotiation, I hope IF members as well as any business group get advantage from the traditional cooperation mechanism that has long been promoted through the discussion on OECD model conventions or its commentary, while trade disputes have recently faced difficulties in reaching friendly agreement. Sticking to political wins and losses is not likely to be a good policy.

I agree that “Stop the race to the bottom” could be a legitimate reason for Pillar 2, because the impact assessment conducted by OECD received many supports from market countries. which will get more portion of the expected global corporation tax of 100 billion US dollars in size. However, if the system could not be structured in accordance with proportionality principle, the private sector would be severely damaged by such new rules to discourage innovation.

[32] The discussion above was made with large companies in mind, but SMEs in Japan are also affected as part of the supply chain.

It seems that at the same time, the advisory service provider (tax accountant, lawyer, accountant) should expand the collaborative system with other providers located in foreign countries.

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