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Addressing the Tax Challenges of the Digitisation of the Economy – Public Consultation Submission

Dear Sir/Madam

We welcome the opportunity to provide input as part of the OECD's consultation set out in the public consultation document *"Addressing the Tax Challenges of the Digitalisation of The Economy – 13 February – 6 March 2019",* herein referred to as the "Consultation Document".

We refer to our paper dated 25 September 2018, which has been appended to this letter. That paper set out some of the concerns of the International Banking Federation (IBFed [1]) in relation to the taxation of global banks, and how banks differ from highly digitalised businesses which featured as the primary focus of the OECD's interim report in March 2018.

We also would like to make reference to a paper prepared by the European Banking Federation *"EBF comments on the proposal for a Digital Services Tax",* dated 15 November 2018, which reiterates the position as to why banks differ and also highlights specific issues with proposed legislation by the European Commission targeting digital services provided into the European Union.

We have set out our comments on the Consultation Document below. We have not sought to address each question in section 2.4 and 3.6 specifically and our comments are general in nature.

1. General observations

Global banks largely operate through branch structures in offshore jurisdictions for regulatory capital reasons. The OECD Report on the Attribution of Profits to Permanent Establishments (2010) is well accepted guidance for banks on the attribution of profit between their head office and offshore branch operations. Revenue authority guidance and industry practice is well understood and established on profit attribution principles as they apply to banks. Deviation from those principles would cause significant impact to banks and their operations.

Banks are already subject to extensive tax transparency and tax avoidance mitigation reporting rules, which seek to capture the diversion of profits to low tax jurisdictions by their customers. Banks are aware of the

[1] The International Banking Federation (IBFed) was formed in 2004 to represent the combined views of our national banking associations. The IBFed collectively represents more than 18,000 banks, including more than two thirds of the largest 1000 banks in the world. IBFed member banks play a crucial role in supporting and promoting economic growth by managing worldwide assets of over 75 trillion Euros, by extending consumer and business credit of over 40 trillion Euros across the globe, and by collectively employing over 6 million people. The IBFed represents every major financial centre and its members' activities take place globally. This worldwide reach enables the IBFed to function as a key international forum for considering regulatory and other issues of interest to the global banking industry. For more information visit: www.ibfed.org

heightened scrutiny globally in the post BEPS landscape and accordingly do not seek to subvert or facilitate that behaviour resulting in base-erosion.

Any reform should be based on international consensus and agreement. To the extent to which countries implement unilateral measures that impact financial services, there is the potential for unintended tax consequences for global banks. This can include the risk of double taxation if double taxation agreements are not amended or a global consensus is not agreed. Consideration should be made as to whether banks and financial services groups should be specifically excluded from these proposed measures.

2. Revised profit allocation and nexus rules

We make the following observation in relation to the first part of the Consultation Document:

User participation

The "user participation" proposal is set out in section 2.2.1.

We agree that this change to the nexus rules should be limited to those business models which benefit from the type of user base outlined, i.e. where value is derived from social media platforms, search engines and online marketplaces. We argue that banks should not be subject to this ruleset as they do not derive value from user participation in the same way that highly digitalised businesses do.

We argue that rules targeting user participation under this proposal should have a clear exclusion for banks.

The existing corporate tax framework adequately captures profits earned by banks, both traditional banking services and newer digitalised services. Banks utilise data that they obtain from their customers to provide services which in turn are subject to tax. Accordingly, to the extent that there is any monetisation of data by a Bank, this will be reflected in the profits already subject to taxation. Where data is mandated to be exchanged for no value between a bank and third party for no fee, for example under open banking laws , this transaction should not be subject to tax. Where a value added service in respect to customer data is provided to a third party, the profit should be subject to tax under ordinary principles.

Marketing intangibles

Section 2.2.2 sets out the "marketing intangibles" proposal. Banks do use intangible assets in their business, although the intangibles differ to those used by highly digitalised companies and consumer goods companies.

In relation to marketing intangibles, retail or consumer banking services are more likely to benefit from their brand than wholesale banking services.[2] Through their interactions with customers, history, reputation and goodwill, a bank can develop its marketing intangibles, primarily in the form of brand and customer data and insights. However, it would be unusual for a bank to develop marketing intangibles (e.g. by having strong brand recognition) in a jurisdiction where they are not also licensed to operate (and where they do not already have a taxable presence). The location of intangible assets related to brand for a bank would typically align with the location of the head company, and not artificially in another jurisdiction.

Banks also generate trade intangibles that do not possess "an intrinsic functional link with market jurisdictions".[3] These may include IT product systems, software and apps for internal and external customers, trading, data security, automation, and credit approvals etc. Typically these assets would be

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[2] Wholesale banking activities and business-to-business interactions, for example in relation to financial markets and trading activities are typically considered less sensitive to brand and marketing intangible variations than services provided to individual customers.

[3] Para 34 of the Consultation Document

located in the jurisdiction where they are developed, which is where a bank would already have a substantive economic and taxable presence. The current profit allocation and nexus rules operate to determine the taxation treatment related to such intangibles, and should continue to do so.

Banks traditionally do not fall within the three key fact patterns outlined in para 40 to para 42 of the Consultation Document. This means that banks generally do not directly or indirectly generate revenue from the types of sales or marketing activities specified in para 40 (e.g. the operation of a free search service, free email, free digital storage) in jurisdictions where they do not have a taxable presence. The same applies to para 41 and 42 because banks generally do not operate in countries using a limited risk distribution model and are dissimilar to consumer product businesses (e.g. luxury goods) in the manner they use intangible assets.

We would therefore argue that banks do not derive non-routine income from marketing intangibles, and that banking business largely comprises routine activities whereby related party transactions are adequately covered under the existing transfer pricing framework including the arm's length principle. This is due to the nature of the intangible assets that banks develop as part of their business and the fact that these are located in jurisdictions where they generally have a substantive (economic and taxable) presence. Accordingly banks should be specifically excluded from proposed new rules in relation to marketing intangibles. We would be pleased to have further consultation with the OECD on this issue.

Significant economic presence

Section 2.2.3 sets out the "significant economic presence" proposal. Banks are generally not active in jurisdictions unless they are regulated and licensed to operate in those jurisdictions. Accordingly, ordinary banking services would be subject to taxation through the branch or subsidiary company established in the jurisdiction that the bank is operating.

As noted elsewhere, to the extent that a bank provides services via a digital platform in another jurisdiction, a bank will generally have a traditional economic presence for business and regulatory reasons. In the unlikely event the bank has no other taxable presence, the attribution of profits for taxation to that other jurisdiction due to a significant economic presence test should not result in double taxation where the bank is already subject to tax on its profits. Any significant economic presence nexus factor based on a digital presence should be focused on actual user interaction and input in a sustained capacity, rather than, for example a mere matching of trades or derivative positions under a clearing house or digital trade execution service.

Consideration should be made as to whether banks and financial services groups should be specifically excluded from proposed new rules. We would recommend that the OECD consult with the financial services industry to ensure that no unintended adverse outcomes arise to financial markets business and wholesale debt/equity markets.

Administration and withholding taxes

Paragraphs 57 and 86 of the Consultation Document note that withholding tax could be a collection mechanism used for administration or enforcement of new rules. Whilst banks have systems and processes to deal with withholding tax, in particular interest withholding tax, we argue that banks should not be used as the collectors and administrators, or to police any new withholding taxes. If they were, this would add financial and administrative burden on banks. We also note that there is a broader trend away from withholding tax on customer payments and towards information reporting to tax authorities as automatic exchange of information regimes have been introduced.

To the extent banks are able to provide a service to assist with such additional taxes that do not form a bank's BAU, we expect those services to be subject to fees. Withholding taxes on payments made to offshore parties under a new tax rule should be built into the legal agreements between the parties.

3. Global anti-abuse proposal

As an initial comment, this proposition sets rules designed to remedy where a jurisdiction has no or very low taxation, whereas the application of BEPS is still not completed. We think that it is too early to propose an additional layer of rules relating to the corporate tax bases. The impacts of this new proposition are not known and should be carefully examined. A consensus between states should also be a precondition to this new proposition.

We make the following observations in relation to the second part of the Consultation Document:

Income inclusion rule

An income inclusion rule "would tax the income of a foreign branch or a controlled entity if that income was subject to a low effective tax rate in the jurisdiction of establishment or residence."[4]

Banks make decisions on where they operate based on a number of different commercial considerations to align with their overall strategy and risk appetite. These are not decisions that are typically related to tax considerations, rather they relate to revenue opportunities, customer base, regulatory regimes, operating costs and risks (market, operating, funding etc). Accordingly, the structure of a global bank's operations can be differentiated from a multinational that is accumulating profits in low tax jurisdictions to avoid returning profits to a parent. Banks must hold (often costly) regulatory capital to support their offshore operations (either in the country of operation or by way of an allocation from within the same legal parent entity). Banks do not therefore establish an offshore regulated presence to obtain the benefit of low taxation as profits are generally returned and subjected to tax in the head company jurisdiction.

An income inclusion (minimum tax) rule has the potential to impact all multinationals (not only banks) which have operations in low tax jurisdictions. It would be important to identify the appropriate base and rate for a global minimum tax. We appreciate that significant technical aspects need to be considered as part of the design of this rule. We would argue that such a rule should operate based on included income being subject to a minimum rate of tax rather than the full domestic rate.

Currently there is significant divergence between the corporate tax rates of many OECD member countries. For example, Australia has a corporate tax rate of 30% and the UK has a main corporate tax rate of 19%.[5] A global bank will have differing rates of tax based on their footprint, including potential exemptions (or credits) for foreign branch profits in comparably taxed jurisdictions, and may be subject to controlled foreign company rules. A country with a relatively high rate of tax in the home jurisdiction should not be unfairly taxed where the high domestic rate is imported to the income derived offshore. This needs to be factored in for implementation of minimum tax measures and should be based on global consensus.

In relation to the generation of intangible property, as noted above, banks would typically locate assets in the jurisdiction where they are developed and not artificially move these assets offshore to low tax jurisdictions. We would also argue that the impact of a minimum tax on financial payments and funding costs should be considered and discussed with the banking industry. We note that some controlled foreign company rules have specific rules which address financial institution subsidiaries to recognise the function of such companies. Should the minimum tax be implemented to supplement controlled foreign company rules, the interaction with domestic rules would need to considered.

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[4] Para 92 of the Consultation Document

[5] Banks are subject to additional levies in both Australian and the UK

Tax on base eroding payments

A tax on base eroding payments "would deny a deduction or treaty relief for certain payments unless that payment was subject to an effective tax rate at or above a minimum rate."[6] In terms of the operation of any such measure, we would expect that netting would be available i.e., payments would be netted against any income and that the broader transaction is considered.

As a more general comment, the funding structure of banks needs to be taken into account when considering any new framework. As banks are largely debt funded, they are required to hold sufficient regulatory capital and buffers to cope with instability and liquidity shortages. This differs from other multinationals and any new ruleset should be sensitive to the requirements imposed on banks.

In relation to the "undertaxed payment rule", it is frequently the case that banks have difficulty claiming deductions for recharges into certain jurisdictions due to tax or regulatory payment restrictions. This is the case even when any mark-up on those charges would be subject to tax in the jurisdiction from which the recharge originated and comply with existing global transfer pricing methodologies. Any rules that permit the denial of a deduction would need to be carefully considered in the context of such transfer pricing allocations and not exacerbate existing problems with obtaining deductions.

We would welcome a consensus based approach whereby a multilateral framework is established. We would stress the need for any changes to be comprehensively included in domestic law of jurisdictions as well and double taxation agreements.

Administration

As noted above, banks should not be given a burdensome guardianship over administering any new rule changes whether via withholding tax or otherwise.

We thank you for taking our comments into consideration, and we look forward to the planned discussions with you in the coming weeks.

Yours sincerely,

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Appendix: ***IBFed Paper dated 25 September 2018***

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[6] Para 92 of the Consultation Document