



EUROPE'S
VIDEO GAMES
INDUSTRY

OECD
Tax Policy and Statistic Division,
Centre for Tax Policy and Administration
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OECD Secretariat Proposal for a “Unified Approach” under Pillar One
Comments of the Interactive Software Federation of Europe

ISFE – the Interactive Software Federation of Europe – represents the European video games industry. Our membership includes 16 major publishers of interactive software and national trade associations in most European countries, which in turn represent hundreds of game companies of all sizes.¹ The interactive software industry, representing publishers and developers of video games, is the fastest growing sector of the European content industry, with consumer spending estimated at more than €20 billion in 2018, out of a global market of approximately €120 billion in 2018. Our industry was “born digital” and is one of the greatest success stories of the digital sector, so we welcome the OECD’s initiative and would like to help it achieve practical and innovative solutions to recommend to the Member States. ISFE has a long record of engaging and cooperating with policymakers, both at a national, EU and global level, and is well respected in many related fora.

Summary of the Previous ISFE Submission

ISFE has submitted a set of comments on the *Public Consultation Document on Addressing the Tax Challenges of the Digitalisation of the Economy* in March 2019, wherein it contended that it is necessary to re-evaluate the current international tax framework to take into account of this evolution of the global economy, particularly the proliferation of highly digitised business models. ISFE’s membership also stated its wish to provide input in order to ensure that innovation and development in the video game sector are not hindered by unintended consequences and bureaucracy, in particular burdening businesses with heavy compliance or reporting requirements – see examples in the text below.

One of the overarching ideas put forth by ISFE is that, in order to have fair taxation in the digital economy it is paramount that double taxation is avoided. Furthermore operating losses must be properly taken into consideration, given that the creation of videogames generally entails heavy investment much of which is often unrecouped.

¹ ISFE’s membership includes Activision-Blizzard, AEPDV, AESVI, AEVI, ANGI, Bandai-Namco, BEA Interactive, Bungie, EA Games, Game, Microsoft, NIANTIC, Nintendo, NVPI OVUS, Roblox, SEGA, SELL, SIEA, Sony Interactive, SPIDOR, Square Enix, Supercell, Take 2 Interactive, Ubisoft, UKIE, Warner, Zenimax

It is also crucial that for smaller businesses (operating in a limited number of countries) tax collection mechanisms must not be a challenge. In absence of an EU MOSS type of tax collection process or collection by platforms, tax registrations and reporting in each country would in many cases create a higher cost than the actual revenue which would be secured by those countries.

Also it is essential that all key terms in the reform be fully defined, leaving as little room for inconsistent national interpretation as possible. Certainty is paramount, and therefore the use of ambiguous terms, such as “fair” or “reasonable,” must be avoided. In addition, clear dispute resolution procedures should also be put in place as many jurisdictions will not have arbitration clauses in treaties or elsewhere.

Privacy remains a concern for ISFE. The OECD should carefully follow the international principles of “privacy by design” and data minimization. The amount of data that companies should send to the tax authorities should, ideally, be limited to the number of consumers in each specific country. IP addresses should always remain private.

Additionally, the privacy laws of each country must be taken into account. Not all OECD members have established up-to-date data protection legislation, potentially creating situations where in some countries GDPR or equivalent legislation is in force prohibiting the transmission of data to countries where there is no equivalent protection.

Lastly, ISFE held that digital taxation should impact only business models which generate revenue predominantly from sales of advertisements, as this is where the tax failure was identified by the OECD, and not from the sale of copyright-based products. There should not be incremental taxation of businesses or transactions that are already effectively taxed.

We now move to reply to the queries posed by the OECD for public comment as follows:

1. Scope

a. Interaction With Consumers

Business models which rely heavily on user participation and input should be the primary target of the proposal. In these cases the value creation by a company is substantially reduced, as it tends to simply generate revenue through sales of advertising space on platforms where the activity, content and interaction is almost entirely user-generated, with the business in question being almost solely a ‘space’ for users to interact.

b. Defining the MNE Group

The threshold of being part of a MNE group should be limited to control of more than 50% of the voting rights in a company. The existence of reciprocal participation in companies within the industry should not lead to the classification of these situations as an MNE group. The “decisive influence” doctrine should therefore be followed by the OECD when creating a definition for an MNE group.

c. Covering Different Business Models (Including Multi-sided Business Models) and Sales to Intermediaries

Businesses whose model relies overwhelmingly on trade intangibles, rather than marketing intangibles, should be, if not excluded from the scope altogether, treated in a manner that is coherent with the investment and added value that they generate.

d. Size MNE Group, Taking Account of Fairness, Administration and Compliance Cost

A narrowing of the scope could be achieved under the provisions mentioned in point 1.6 of the OECD's "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy," according to which there might be "potential limitations on the scope of the new taxing right".

This work would include the development of rules to limit the scope of the new taxing right based on the size of a MNE group or business line. It would also include an evaluation of rules that could focus the scope of the rules on businesses that are of a type to which the rules should apply.

ISFE believes that any compliance costs that may emerge from the final proposal by the OECD in this procedure should be minimized to the greatest possible extent, potentially mimicking or working in parallel with the system applied in each country for the reporting and collection of VAT, which represents the largest share of tax paid by the video games sector. In fact, VAT collected by the imposing country accounts for approximately 60% of all tax levied on industry and its value chain.

In addition, companies face a number of challenges with VAT regimes, such as a lack of appropriate thresholds or a failure to identify the appropriate market for sales in our sector. These and other related issues should, we feel, be thought through, and improved, under this new approach to Pillar One.

Ideally, the OECD should make use of the best practices from the OECD International VAT/GST Guidelines, for example, using a simplified registration and compliance regime for non-resident suppliers. In the long term, this could potentially evolve into a system where there would only be a need for registration in a single country, where all the tax would be paid, and that same country would distribute the revenue to the other countries, based on the company's tax filings.

e. Carve-outs That Might be Formulated

Any form of digital taxation cannot and should not be fully levied on sales/distribution of copyrighted content, as these are not the business models that created the existing taxation gap and exploited the shortcomings of the current international tax framework. No tax authority has yet identified video games publishers and distributors as systematically resorting to such tax avoidance mechanisms.

VAT/GST is currently the heaviest fiscal burden on the acquisition of a videogame by a consumer, reaching up to 27% in some Member States of the EU.

It must be kept in mind that the entire logic behind marketing and advertising is to generate sales to consumers, and where there are B2C sales there is generally a VAT/GST system in place. In the value chain associated with the video games industry - the country that collects the VAT from sales receives by far the biggest share of the total tax revenue generated by a consumer's expenditure.

For these reasons, ISFE considers the revised Profit Allocation and Nexus rules as problematic and encourages the OECD to devote their efforts to further develop the Global Anti-Base Erosion and Profit Shifting proposals (BEPS), possibly by adopting a digital version of VAT in keeping with the OECD International VAT/GST Guidelines.

2. New Nexus Rules

a. Defining and Applying Country Specific Sales Thresholds

Thresholds here should be considered as flexible, given the wide breadth of countries and of business models that will be covered under the final proposal. Specifically, there should be thresholds on both sales and local taxable profits. This is because with lower margin businesses, the total amount of non-routine profit allocated to markets under Amount A (below) could be relatively small. If this amount is then spread out across lots of market jurisdictions (point 60) because the company exceeds sales thresholds in many countries, it may mean that companies having to register for tax all in many jurisdictions despite actually having a very small tax base in each individual jurisdiction.

Should the final scope also cover profits generated by trade intangibles, such as the sale of copyrighted content and associated services, there should be a higher threshold for these types of revenues, given the heavy investment required to develop them.

b. Calibration to Ensure that Jurisdictions with Smaller Economies can also Benefit?

Any digital taxation proposal must take into account **the entire value chain**. It is clear that any rule which allocates profits on a geographical basis alone will significantly advantage those countries with a higher number of consumers, and may significantly disadvantage those countries which have fostered investment in high-tech businesses and encouraged employment.

Our goal is simple and workable - to ensure that an easy solution is found for reporting taxable profits in each country.

Many smaller population countries are host to commercially successful video game producers and distributors which could face a substantial tax revenue loss should the final OECD proposal not contain mitigating provisions to ensure that any such asymmetry does not occur.

3. Calculation of Group Profits for Amount A

a. What Would be an Appropriate Metric for Group Profit?

b. What, if any, Standardised Adjustments Would Need to be Made to Adjust for Different Accounting Standards?

c. How can an approach to calculating group profits on the basis of operating segments based on business line best be designed? Should regional profitability also be considered?

We feel that there should be a differentiated treatment for taxation of profits depending on their origin; products that have had substantial capital investment, and whose operability/functionality is not heavily predicated on user input, should be subject to a more favorable treatment. This more favorable treatment could consist, for example, of higher thresholds, or allowing longer loss deduction periods.

Regional profitability should also be considered, as in our sector video games are often launched on a region-by-region basis. Consumers often also have, at times, local preferences that can substantially impact the regional success/failure of a title. Regional profitability should therefore be considered as an element for calculating taxable profits.

4. Determination of “Amount A”

The concept of ‘**non-routine**’ profits is obviously essential to the section of the Work Programme dealing with the Nexus Rules as it is present in all of the three aforementioned proposals.² Any ambiguous wording will most likely lead to different interpretations in different jurisdictions, and could therefore be very difficult to deal with. It therefore requires solid clarification and definition in the text to ensure maximum legal and practical certainty. As it is not wholly clear based on the existing work published by the OECD, what would constitute ‘non-routine’ profits for the video games sector, ISFE and its members cannot provide input in a meaningful level without more clarity in this regard.

In point 57 of the Public Consultation, it is stated that: *“Once profits in excess of the stipulated level of profitability are deemed to be the group’s non-routine profits, it is then necessary to determine the split of those deemed non-routine profits between the portion that is attributable to the market jurisdiction and the portion that is attributable to other factors such as trade intangibles, capital and risk, etc.*

This is important as non-routine profit generated by MNE groups is attributable to many activities including those not targeted by the new taxing right.”

The concept of ‘**trade intangibles**’, is also not clearly defined by the OECD, but rather defined by exclusion,³ and offers little in the way of legal certainty.

² Pages 12-16 of the Work Programme

³ The 2017 OECD Guidelines defines a ‘trade intangible’ as “an intangible other than a marketing intangible, which the developer generally tries to recover and obtain a return thereon through product sales, service contracts, or licence agreements”. Chapter VI of the 2017 OECD Guidelines goes on to provide specific examples of ‘trade intangibles’ which include:

- Patents, which involves a legal right provided to its owner;
- Know-how and trade secrets, which includes undisclosed information of an industrial, commercial or scientific nature, often related to manufacturing and R&D.

Again, as with 'non-routine' profits, this concept should be strengthened in order to provide a predictable framework. A clear definition is essential for our sector.

As previously noted, the video games industry is characterised by high levels of investment further up the supply chain including in research and development and brand/IP development. Any non-routine profit allocated to market jurisdictions under Amount A should then reflect the industry value chain and should be restricted to a range of 0 to 5%.

5. Elimination of Double Taxation In Relation to Amount A

a. Identifying relevant taxpayer(s) entitled to relief

b. building on existing mechanisms of double tax relief, such as tax base corrections, tax exemptions or tax credits

c. ensuring that existing mechanisms for eliminating double taxation continue to operate effectively and as intended

ISFE contends that the current mechanisms can, in theory, be adapted to the new proposal. However a standardized mechanism should be adopted across member country jurisdictions; otherwise, double taxation could apply in jurisdictions using different approaches. We look forward to having the opportunity to make more detailed comments at a more finalized and concrete stage of the OECD proposals.

6. Amount B

a. The need for a clear definition of the activities that qualify for the fixed return

As with Amount A above, this is unclear, as the descriptions are far too abstract for us to identify, with a satisfactory degree of confidence, which types of revenues for our sector would fall under which category.

b. a determination of the quantum of the return (e.g., single fixed percentage; a fixed percentage that varied by industry and/or region; or some other agreed method)

More details would be required for ISFE to voice an informed opinion on the fixed percentage concept and so we cannot at this stage provide meaningful input without the clarification of requests on point 6.a.

However, and in keeping with the argument sustained throughout this submission, ISFE contends that, should the profits emerging from trade intangibles and their sales/associated services not be excluded from scope, then these forms of revenues should be eligible for higher thresholds when determining the amount of non-routine profits, in order to allow for recoupment of losses and/or investment.

7. Amount C/Dispute Prevention and Resolution

a. (unilateral or multilateral) APAs

ISFE membership is of the opinion that unilateral APAs may not always be effective. While multilateral APA's are a potential solution to this problem, if a sectoral approach is adopted, the fluid and multi-sectoral nature of many businesses would mean doubts would emerge as to which APA would apply in borderline cases. Some of our members have also had difficulties with current APA processes around non-routine profits for digital businesses as Pillar One does not address the attribution of non-routine profits to jurisdictions (e.g., in line with BEPS Actions 8-10).

b. ICAP

The spirit behind the ICAP initiative is commendable, as eliminating double taxation is, and should remain, the main goal behind the international tax law system. However, ISFE at this stage has no defined position regarding this initiative.

c. Mandatory Binding MAP Arbitration?

Any new rules should be supported with effective MAP for all countries signing up, otherwise the risk of double taxation is significantly enhanced.

6. ISFE Conclusions and Recommendations

ISFE restates its commitment to provide input to ensure a fair taxation environment and one that is adapted to the realities of the digital economy and the prospective changes it will experience in the coming years.

As we have also stated in multiple instances throughout our submission, any measures recommended by the OECD should safeguard business models that rely primarily on Trade Intangibles such as are utilized in our industry.

Additionally, the features of the OECD's final recommendations to the Member States must ensure that the risk of Double Taxation is limited to the maximum possible extent, as the risk of double taxation in these matters is heightened by the nature of the digital economy itself.

ISFE welcomes the progress being made by the OECD at this stage, and looks forward to contributing with meaningful input throughout this process. However, as was reiterated through this submission, the lack of clear definitions remains a critical issues that requires further development in order to bring about a workable solution.

We remain available for further inquiries and consultations, and look forward to assisting the OECD reaching a balanced final proposal that serves the interests of taxpayers, consumers and industry.

ISFE Secretariat, 11 November 2019