Submitted by email to: TFDE@oecd.org
To the Tax Policy and Statistics Division,
Centre for Tax Policy and Administration

March 3, 2019

Dear Sirs:

We want to thank the OECD for the opportunity to provide our comments on the January 23 policy note, *Addressing the Tax Challenges of the Digitalisation of the Economy*, and the February 13 public consultation paper. We appreciate the work that has gone into these documents and hope that our comments are helpful in advancing some of the proposals that are discussed therein.

Our comments are limited to one aspect of the policy note, namely determining a practical, administrable, and just way of achieving the objective of enhancing taxing rights in market jurisdictions. This should not be read as necessarily endorsing that objective or some or all of the underlying premises or recommendations in the OECD document. For example, in focusing on practical implementation of enhancing market taxing rights, our comments below discuss some of the challenges in using transfer pricing *tools* to achieve an objective that, in our view, is not really related to transfer pricing. This should not be read as a criticism of the arm's length principle. We support the arm's length principle, and would strongly oppose measures that significantly undermined it. In fact, that is one of our primary motivations – allow transfer pricing to do what it does best.

Johnson & Johnson is the world's largest and most broadly based healthcare company and is headquartered in the United States. We fully support a taxation system that provides more certainty to both taxpayers and taxing authorities on a consistent, global basis. We also strongly recommend that we use this opportunity to deliver global simplicity as described as a goal under the Inclusive Framework. With sales in over 100 countries, we have varied and complex global supply chains. For example, our Consumer sector focuses on marketing to customers in a country that will consume our products, while much of our Medical Device sector sells products to hospitals for use in surgical and non-surgical procedures. Some of our businesses are highly regulated, limiting our sales and marketing activity on a country-by-country basis. We thought about these and other differences and have tried to suggest measures in this proposal to balance the complexities. Our focus is on the marketing intangibles approach discussed in the public consultation paper.

The methods described in the *Consultation on Addressing the Tax Challenges of the Digitalisation of the Economy* require a process whereby one must calculate the system profit, determine routine returns, and then allocate residual profits with a portion of the residual attributable to marketing intangibles that are then allocated to local markets. In our experience, these types of profit split methods lead to many disputes in the current environment when applied using the arm's length standard. Calculating the routine returns is one of the first uncertainties in this process, where companies and countries do not agree on what a "routine" profit is for the local sales and marketing company. This is soon followed by disagreements on residual profit drivers. The term "marketing intangible" also would lead to further uncertainties, as countries may significantly differ on how this term is defined and the importance of, for

example, customer lists versus trademarks. We propose the broader consideration of market value be used, taking into account that countries are likely to disagree even on the definition of marketing intangibles. We therefore do not recommend methods that lead to uncertainties in routine vs residual returns. Our proposal is to avoid subjectivity in differences of opinions between taxpayers and country tax authorities and propose an objective solution.

If we understand the key goals to be an increase in taxable profits to the local market sales and marketing companies (including markets with users but no physical presence in the case of highly digitalized companies in a local market), use of a formulaic method rather than a pure arm's length standard, and a solution that countries and companies will find easy to administer, then we recommend a solution that targets local market profitability in a simple manner. We view this as an extension of the simplification efforts proposed by the OECD in Section E of Chapter IV to expand the guidance for safe harbors. These efforts included recommendations of Memorandums of Understanding (MOUs) related specifically to activities such as sales and distribution in local markets. The safe harbor discussion in Chapter IV acknowledges that the trade-off between the arm's length standard may be balanced by simplicity and elimination of disputes.

This extension entails that all countries agree that if the taxpayer pays tax in accordance with the results determined by the method, then disputes are limited to confirming the calculation of the method. We support a solution that provides more certainty and are willing to pay higher taxes to achieve this. We also believe that many countries would rather use their limited tax resources on more productive matters than highly complex disputes on the profitability of de-risked sales and marketing companies.

This extension could be viewed as providing a minimum level of profitability for taxation, with taxpayers using arm's length pricing showing returns above the OECD method results being exempt from future tax disputes on local country profitability.

The most basic version of a simplified method would be to take a fixed amount of global operating profits and allocate it to the local market companies. If this is fixed at say 20 percent return on sales (ROS), the resulting amount of profit could be allocated to the local markets on the basis of local revenues, number of employees, or a combination of measures. While this is simple, we thought there should be some measures around the differences in local country markets and types of businesses, and we were uncertain if all countries would accept a splitting of losses when a company generates an overall loss that could be related to product development or manufacturing problems unrelated to the local market distributor. Therefore, we offer a revised methodology for consideration.

Our proposal uses a formulaic solution to calculate local market profits, beginning with a base rate and using three levers to adjust the profit target for a particular country. We eliminate the distinction between routine and residual returns as well as any specific efforts to define particular marketing intangibles and focus instead on calculating a local country profit level.

In our example, we suggest a base return of three [3] percent ROS for the local market distributor (LMD). For highly digitalized companies with no reported revenues in countries with "users," an allocation of total revenues may be required to calculate the base return. Note that all the numbers in this example are for illustrative purposes only, and it may be prudent to consider ranges rather than fixed points that we use here to reduce the potential for future disputes.

Lever 1 is the group profitability. This lever attempts to bridge the differences in industry profitability, providing the LMD with higher profit targets when the group as a whole is more profitable and lower returns when the group is less profitable. Companies with high operating margins would add to the 3 percent base rate using a formula. In companies where overall enterprise operating margins exceeds a fixed amount, twelve [12] percent ROS in our example, the LMD target profit would increase from the base amount by twenty [20] percent of the increase. Thus, a group with overall profitability of 17 percent ROS would see the LMD target ROS rise from 3% to 4% (group ROS is 5% higher than 12% base, LMD receives 20 percent of the difference, or 1%). One could see this as the sharing in residual profits that was discussed in the OECD proposals.

Conversely, in cases of lower group profitability, the base return would decrease accordingly. Take a company with an overall 7% operating margin, where the 3% ROS base target provides the LMD a share of the group profitability. Here, the 7% actual ROS result is 5% below the 12% ROS comparison rate established, and we propose the impact again be 20% of the difference resulting in a 1% impact to the base target and a reduction of the target to 2% ROS.

While the first calculation provides an overall allocation of group profits to the LMDs, Lever 2 would involve an analysis of the level of marketing spend on a country-by-country basis to take into account differences between countries with regards to local markets. Like the Lever 1 mechanics, we propose a basic calculation of LMD marketing spend as a percentage of LMD sales be compared to a target, with the LMD ROS target being increased where heavy marketing expenses are incurred and reduced where marketing expenses are lower. This would account for differences in margins required for brand-focused B2C markets versus less marketing-intensive B2B markets.

An important part of implementing Lever 2 is a definition of marketing expenses. For example, does it include coupons, free samples, registration costs of trade marks, etc. or is it limited to purely advertising activities? For Johnson & Johnson, marketing costs may be accounted for in different line items on the P&L. There is also the role of the sales force, particularly as related to developing customer lists and loyalty. We would recommend more discussion around whether this category should be expanded to include both sales and marketing costs. This might be a very practical consideration for companies and tax authorities in terms of evidencing the spend in any future review; otherwise, disputes on calculating marketing spend would likely increase.

As an example of Lever 2, we might increase or decrease the ROS determined in Lever 1 depending on country marketing spend being higher or lower than a 10% of sales target. For example, if marketing spend is 20% of local revenues in Country A, but only 5% of revenues in Country B, then the formula should reduce the ROS margin developed after applying Lever 1 for Country B and increase the ROS margin for Country A. This impact could be measured as the local country receiving a proportion of the difference, as in Lever 1. For example, if we use twenty [20] percent of the difference as the lever, country A would need to increase the Lever 1 ROS by a further two [2] percent (20% actual marketing spend is 10% higher than 10% target, and 2% is 20 percent of the difference. Conversely, Country B, which has a lower marketing spend per dollar of sales would adjust the Lever 1 ROS by one percent (20 percent of the 5% difference between the 10% target and 5% actual.)

The last lever is to place limits around the profitability targets for the LMD activity, taking into account that the activities of the LMD are not typically high-risk activities. We recognize that in many companies, Johnson & Johnson included, the LMD is part of an extensive supply chain, where significant risks are taken in countries other than LMD locations (perhaps around product development, complex

manufacturing, etc.) Given that we do not think it is appropriate to begin allocating these risks to the LMD entities, we propose a floor and a ceiling in Lever 3 to avoid the LMD being impacted by other areas of the supply chain. Our straw-man proposal would be to limit the LMD to break even on distribution, even if the application of the other two levers would result in the LMD targeting a negative ROS. Additionally, we think a ceiling is necessary to allow other entities in the supply chain to earn returns for risks and intangibles developed. Our proposal is to cap LMD returns at no more than 40% of group operating profits (this could be calculated on an aggregate basis.)

Implementation is an important question in this formulaic solution. We propose that companies have the option to achieve the new margins through changes to transfer pricing, i.e., lower the price of goods coming into the local market. As mentioned previously, while we are proposing a formulaic method for the LMD, we believe that the arm's length standard is the only viable solution to deal with the complexities ranging from high-risk product development to multi-location high-value manufacturing. If we adopt this type of approach, our data will be easier to use in the more complex calculations once we can carve out the returns for the LMDs. It may also be appropriate to consider using a three-year average calculation and/or ranges to provide better implementation.

There are a number of other areas that should be further discussed and analyzed. First is a scoping question: do you apply the method to a company as a whole or apply it separately to different lines of the business. For J&J, we have separate management and financial statement reporting on three sectors: Consumer; Pharmaceutical; and Medical Devices. In any local market, we may have separate legal entities with LMD activities for each sector or perhaps a combination of two sectors in one legal entity and two legal entities performing LMD activities for the other sector. For example, our Medical Device sector contains businesses like Vision Care, which has a high degree of customer focus in marketing, and our Biosense Webster business, which sells products used in medical procedures on patients that sells to hospitals, for example, and, therefore, does not market to the patient population. In any country, these businesses could reside in separate legal entities. This may lead to a decision on scoping that is separate by legal entity in a country. If one sector generates a global loss large enough to move the whole enterprise into a loss position, then would it not be more accurate to evaluate on a sector-by-sector basis? This will be of particular importance with multinationals operating diverse businesses with little in common related to marketing and sales types of activities.

A second point for further discussion and analysis is the definition of LMD activities. For Johnson & Johnson, our LMDs operating in the Pharmaceutical sector typically provide contract R&D services when needed (e.g., if a clinical trial is being conducted). In our Consumer sector, some LMDs may provide back-office services to a cluster of nearby countries. For these types of examples, activities that do not relate to the sales, marketing, and/or distribution in country, we would expect that the cost-plus returns for these services would remain outside of the LMD calculation and would continue to be remunerated according to the arm's length standard.

One other consideration is the bridging of returns covered in existing Advance Pricing Agreements (APAs). Given the high costs to negotiate an APA and the extensive level of negotiations between the taxpayer and the local country government, we recommend that these arrangements be respected for the duration of the APA term. If the APA method provides a lower level of profitability than that of a formulary method, then the local government should not pursue additional profitability during the term of the APA. This should equally apply in the case of bi-lateral or multi-lateral APAs.

Thank you again for the opportunity to present our thoughts on this important area. We remain strong advocates for taxation where value is being created and believe the arm's length standard provides the best solution to take into account the intricacies of each fact pattern. That being said, we encourage the OECD and member countries to develop a solution to local market taxation that brings simplicity and reduces the number of disputes so that the limited resources of both companies and governments can be focused on the larger questions of value creation around product/service development, manufacturing, and other more focused high-value activities. We would be happy to discuss our thoughts with you. We are planning to attend the March consultation in Paris, along with our colleagues Kris Bodson and David Kavanaugh.

Best regards,

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