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Profit Allocation within MNEs in Light of the Ongoing Digital Debate on Pillar I – A "2020 Compromise"?

From Using A Facts and Circumstances Analysis or Allocation Keys to Predetermined Allocation Approaches

Vikram Chand,
Alessandro Turina
and Louis Ballivet[*]

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The current profit allocation framework, i.e. the arm's length standard, is mainly based on a facts and circumstances analysis. In particular, depending on the situation, facts and circumstances-related allocation keys are used to allocate profits among various entities within a multinational enterprise (MNE). Nevertheless, there are situations wherein predetermined formulas and/or allocation keys are also used within the standard. The purpose of this article is to show that predetermined approaches will quickly infiltrate the profit allocation framework, although a facts and circumstances analysis and/or allocation keys will continue to be used. The authors support this proposition by analysing the current debate on profit allocation with respect to the digitalization of the economy. They conclude that the use of predetermined approaches is inevitable if the objective is to develop a simplified solution with respect to the profit allocation debate made in the context of Pillar 1 of the digital debate. A simplified solution would be to apply a formulary approach at the MNE group level and an arm's length principle (ALP) approach at a separate-entity level. More specifically, a predetermined formulary approach in the form of a simplified but modified residual profit split method could be applied at the MNE group level to reallocate residual profits (the so-called Amount A). Simultaneously, a predetermined formula based on the arm's length approach could be applied at a separate-entity level, that is, to routine distribution and/or marketing activities (the so-called Amount B). This latter approach will be complemented and backed up by a facts and circumstances arm's length analysis (the so-called Amount C, which, in some respects, would seem to be more of a process, rather than a separate amount). In this context, the authors address their view on a few key questions that arise in the "new" profit allocation context for Amounts A, B and C. For Amount A, the authors express their view on determination of the MNE tax base, determination of losses, revenue sourcing rules, information reporting, collection of taxes as well as stabilization of the MNE group approach. For Amount B, they provide their view on issues such as the determination of the scope of application, the determination of the fixed return, its legal qualification and its possible stabilization. The need to introduce a more robust dispute resolution institutional framework is also addressed with specific regard to Amount C. Finally, they analyse the impact of the new profit allocation mechanisms on selected business models used by MNEs. It should be noted that the present contribution does not address, as far as necessary to provide adequate context, the normative debate on a new scope, new nexus or new relief rules but rather focuses on the challenges arising from profit allocation.

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* **Vikram Chand is an Associate Professor, Tax Policy Center, University of Lausanne, Switzerland. Alessandro Turina is a Senior Research Associate in the Academic Department of the International Bureau of Fiscal Documentation, Amsterdam, the Netherlands. Louis Ballivet is a doctoral candidate at the University of Geneva, Switzerland. He has also finished the Executive Program in Transfer Pricing (EPTP) offered by the University of Lausanne.** **The first version of the article was submitted before the publication of the OECD's unified approach. The article was subsequently approved by the peer reviewers and has been updated to reflect recent literature on this matter.**

1. Introduction

There are two broad approaches that could be used to allocate profits to separate legal entities or separate establishments (such as permanent establishments, PEs) that exist within a multinational enterprise (MNE). At one end of the spectrum, countries can resort to using the ALP. This principle relies on the "separate-entity" approach, which implies that profit allocation to the separate legal entity or establishment depends on the value created or generated by such taxpayer. At the other end of the spectrum, countries can resort to the "enterprise doctrine", as opposed to the separate-entity approach, which considers an MNE as a single economic unit for tax purposes. The group's aggregated profit constitutes its tax base. This is then divided between various establishments by predetermined allocation keys that could be based on payroll, tangible assets or turnover or a combination of such factors. This approach is better known as MNE group-wide formulary apportionment.[1]

The current international corporate tax system uses the ALP to allocate profits in the vast majority of cases. The history of this framework can be traced back to the work done by Mitchell B. Caroll. In the 1933 Report, he took the position that the separate-entity approach should be the basis of profit (loss) allocation. This was mainly due to the fact that several countries already applied this principle with respect to transactions between related entities or head office and PEs.[2]Such a framework, developed in the 1930s, was built upon a more fundamental international consensus on the division of the international tax base between residence and source countries that in scholarship is frequently referred to as the "1920s compromise". As can be appreciated, profit allocation based on the separate-entity philosophy in the 1920s compromise was an offshoot (although not a necessary logical implication) of a fundamental agreement between source and residence countries. If it is to be speculated on whether a "2020 compromise" shall be reached, one of its main features will be that it will directly address the issue of profit allocation from which a new landscape in terms of a "balance" between source and residence will be established. To the authors, this circumstance appears as one of the key and unprecedented characteristics of the current debate, and it is for this reason that this contribution will primarily focus on the possible new mechanics of profit allocation rather than on a policy reconsideration of the existing and proposed nexus-related thresholds.

Besides being "rooted in history" and an expression of the fundamental compromise (or at least, as outlined above, an offshoot thereof), there are also normative reasons that would seem to corroborate the ALP's standing.[3]In this regard, the first chapter of the OECD Transfer Pricing Guidelines (TPG) states that the ALP should prevail for the following reasons: First, the ALP is widely considered to be a fair system. It is reputed to offer parity of tax treatment for members or establishments of MNE groups and independent enterprises. Second, the ALP works effectively in the majority of cases.[4]Third, the ALP is a functional profit allocation mechanism. It allocates appropriate levels of income between members of MNE groups and the countries in which they operate.[5]Lastly, as it takes into account the facts and circumstances of each case, it provides a good reflection of economic reality.[6]

Although the ALP allocates profits to separate legal entities or PEs within an MNE, several formulas are nonetheless used within the application of its framework. One type of formula or allocation key depends on the facts and circumstances of each case. However, using a fact and circumstances analysis (or facts and circumstances allocation keys) poses a problem of tax certainty as the analysis becomes subjective. This is evidenced by the OECD Mutual Agreement Procedure (MAP) statistics.[7]Thus, in order to achieve tax certainty, countries use predetermined formulas as well as safe harbours.[8]As will be seen later, predetermined

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1. For a detailed discussion on this matter, *see* R.S. Avi-Yonah, *Advanced Introduction to International Tax Law* p. 70 (Edward Elgar Publishing 2015); Y. Brauner, *Formula Based Transfer Pricing* , 42 Intertax 10, p. 615 (2014); R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle after BEPS* paras. 8.76-8.111 (OUP 2017); M.P. Devereux and J. Vella, *Implications of digitalization for international corporate tax reform* ,Oxford University, Center of Business Taxation, Working Paper 17/07, pp. 3-4 (2017); J. Monsenego, *Introduction to Transfer Pricing* p. 9 (Kluwer Law International 2015); A. Ting, *The Taxation of Corporate Groups under Consolidation: An International Comparison* p. 5 (CUP 2013); S. Picciotto, *Taxing Multinationals Enterprises as Unitary Firms* , ICTD Working Paper 53, p. 19 (2017); W. Schön, *International Tax Coordination for a Second-Best World (Part III)* , 2 World Tax J. 3, p. 233 (2009), Journal Articles & Papers IBFD.
2. M.B Carroll, *Methods of allocating taxable income* , in *Taxation of Foreign and National Enterprises* , vol. IV, (League of Nations 1993). *See also* Collier and Andrus, *supra* n. 1 , at paras. 1.73-1.77.
3. OECD, *Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administrations* para. 1.8. (OECD 2017) [hereinafter OECD, *Transfer Pricing Guidelines* (2017)]. On the "1920s compromise", *see* H. Ault, *Corporate Integration, Tax Treaties, and the Division of the International Tax Base: Principles and Practices* , 47 Tax L. Rev., p. 565 (1992), R. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification* , 74 Tex. L. Rev., p. 1301 (1995-1996), M. J. Graetz, M.J. O'Hear, *The "Original Intent" of U.S. International Taxation* , 46 Duke L. J., p. 1021 (1997).
4. OECD, *Transfer Pricing Guidelines* (2017), at para.1.9.
5. OECD, *Transfer Pricing Guidelines* (2017), at para.1.14.
6. Id.
7. The OECD MAP statistics illustrate this absence of certainty. Out of the 2076 MAP cases started in 2017, 779 were transfer pricing cases. The average case took 17 months to solve whereas an average transfer pricing case took 30 months to solve. Out of the 2385 MAP cases started in 2018, 930 were transfer pricing cases. The average case took 14 months to solve whereas an average transfer pricing case took 33 months to solve. *See* https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm (accessed 28 Sept. 2019). For a critical analysis of the ALP, *see* R.S. Avi Yonah, *Rise and Fall of the Arm's Length Standard* , Michigan Law Working Paper (Sept. 2007). For a reconstruction of the ALP in light of multinational firm theory (as well as of the modern theory of the firm in general), *see* R. Tavares, *Multinational Firm Theory and International Tax Law: Seeking Coherence* , 8 World Tax J. 2, p. 243 (2016), Journal Articles & Papers IBFD.
8. OECD, *Transfer Pricing Guidelines* (2017), at paras. 4.95-126.

formulas and safe harbours usually consist in assigning fixed predetermined profit margins to certain types of activities carried out by various establishments in an MNE.

The purpose of this article is to show that predetermined formulas are quickly infiltrating or will infiltrate within the current profit allocation framework, even though facts and circumstances allocation keys will continue to be used. Accordingly, the article is laid out as follows. Section 2. maps the use of facts and circumstances allocation keys within the TPG. Section 3. discusses predetermined approaches within the ALP framework, either in the TPG or national tax practices. Section 4. links the previous findings to the profit allocation debate which is currently taking place in relation to the digitalization of the economy. Based on the analysis of the various approaches, the authors argue that the use of predetermined approaches (predetermined formulas), as opposed to a facts and circumstances analysis, is inevitable to implement a coordinated solution with respect to the profit allocation debate triggered in the context of "Pillar 1" of the digital debate. To be more specific, a predetermined formulary approach in the form of a simplified residual profit split method could be applied at the MNE group level to reallocate residual or excess profits. Simultaneously, a predetermined approach based on the ALP could be applied at a separate-entity level, that is, to distribution/ marketing-related transactions performed in a jurisdiction. This latter approach will be complemented and backed up by a facts and circumstances arm's length analysis. In this context, in section 5. , the authors provide a critical summary by addressing a few key questions linked to the " *new* " profit allocation approach that will be applied both at the MNE group level as well as at the separate-entity level. For the former, we will discuss our view on questions related to determination of the MNE group profits, selection of the appropriate profit level indicator, determination of losses, revenue sourcing rules, information reporting, collection of taxes as well as stabilization of the MNE group approach. For the latter, we will discuss our view on issues such as the determination of the scope of application, the determination of the fixed return, its legal qualification and its possible stabilisation. The need to introduce a more robust dispute resolution institutional framework is also addressed with specific regard to Amount C. Finally, we discuss the impact of Pillar 1 on centralized and decentralized MNE business models that deal with consumer goods as well as a selected digitalized business (online advertisers).

2. The use of facts and circumstances allocation keys

2.1. Preliminary remarks

According to the TPG, a transfer pricing analysis follows a two-step approach: the accurate delineation of the controlled transaction and the application of the relevant transfer pricing method.[9]A deep factual analysis is necessary to complete the first step. Once we have identified the precise intra-group transaction that we would like to compare to the free market, we must choose and apply one of the five transfer pricing methods (or other methods depending on the facts of the case).[10]Facts and circumstances allocation keys have been used within this approach. Thus, the objective of this section is to map the use of such keys within the TPG. In order to keep the contribution within manageable proportions, we will only make a reference to the approach adopted in applying the transactional profit split method as well as the approach adopted with respect to selected intra-group transactions such as intangible property (IP) transactions, intra-group services and intra-group financing.[11]

2.2. Transactional profit split method (TPSM)

In July 2018, the OECD updated its guidance on the TPSM. The guidance states that this method is applicable when: (i) each party to the controlled transaction makes unique or valuable contributions; (ii) the transactions are highly integrated; or (iii) both parties share key economic risks.[12]The method follows two steps. The first is to assess the combined profits and losses derived from a controlled transaction in which associated enterprises take part. The combined profit to share, depending on the facts of the case, is either the net operating profit or the gross profit.[13]These profits serve as a tax base.[14]The second step distributes this profit on a basis that reflects the manner in which independent enterprises would.[15]There are two possibilities within the TPSM: the contribution and the residual analysis.

The contribution analysis apportions the combined profits in a way that independent parties would have distributed such profits if they had engaged into comparable transactions. The division relies on comparable data, if available.[16]On the other hand, the residual analysis allocates an arm's length remuneration for each party's non-routine contribution based on traditional methods

9. Id., at para. 1. 33.
10. Id., at para. 2.1.
11. In this regard, *see also* L. Ballivet, *Use of Non-Arm's Length Approaches within the Arm's Length Principle: Heading towards a New Standard?* , 27 Intl. Transfer Pricing J. 2, (2020), Journal Articles & Papers IBFD.
12. OECD/G20, *Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10* , p. 9 (OECD 2018) [hereinafter OECD, *Revised Guidance on the Application of the TPSM* (2018)].
13. V. Chand and S. Wagh, *The Profit Split Method: Status Quo and Outlook in Light of the BEPS Action Plan* , 21 Intl. Transfer Pricing J. 6, p. 403 (2014), Journal Articles & Papers IBFD.
14. OECD, *Revised Guidance on the Application of the TPSM* (2018), at para. 2.162.
15. Id., at para. 2.166.
16. Id., at para. 2.143

or on the transactional net margin method. Then, the parties share the residual profit. In order to split the residual profits, it is possible to use facts and circumstances allocation keys.[17]The crucial point is to translate the respective contributions of two parties to the transaction in a ratio that adequately allocates the profit. Essentially, the ratio will refer to either resorting to external or internal data.

Depending on the facts, it may be possible to use external sources of information available in the public domain.[18]However, obtaining information from external sources may be quite challenging.[19]Where sufficient comparable transactions are not available, taxpayers usually resort to the use of internal financial data.[20]Such data generally helps to determine the allocation keys to split the profits.[21]Essentially, depending on the situation, the allocation keys may rely on capital (capital employed), assets[22](fixed or intangible assets), costs[23](investment in research and development or payroll expenses or marketing expenses), turnover (sales) and so forth.[24]When external and internal data are lacking, an alternative is the survey approach. This approach uses surveys to obtain information and identify the contribution of each parties. It consists in performing personal interviews with either employees of the taxpayer or external experts. Subsequently, the opinions are turned into quantifiable outcomes. Furthermore, in some cases which concern intangibles, one may consider valuation techniques which could be based on the cost,[25]the market[26]or the income[27]approaches (which could utilize a discounted cash flow analysis).[28]It is important to mention that all these methods or approaches are subjective since they involve assumptions, approximations and hypotheses.

One may argue that the TPSM method is similar to formulary apportionment as it distributes income (losses) between group-related entities based on an allocation key. However, there are two fundamental differences.[29]First, the TPSM works on a transaction-by-transactions basis while group-wide formulary apportionment refers to the MNE group's overall profit. Second, the formulary apportionment system uses predetermined formulas whereas the TPSM relies on a case-by-case analysis in order to determine the appropriate allocation key.[30]

2.3. Intra-group IP transactions

Historically, most of a corporation's equity capital would finance labour resources and production facilities whereas very little of the equity capital would finance IP. Today, it is the opposite. In the current economy, intangible assets are the main value drivers.[31]Thus, commentators agree that they have an enormous impact on a MNE's income.[32]IP represents one of the biggest if not the biggest source of complexity within transfer pricing. The most challenging questions with regards to intangibles include the definition of intangible,[33]identification of intangibles,[34]the ownership of intangibles,[35]common IP transactions[36]and the

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17. OECD, *Revised Guidance on the Application of the TPSM* (2018), at para. 2.168. As it has been observed, the prevalent underlying logic of profit attribution rules in the existing framework would seem to rely on a Knightian theory of the firm, according to which the ultimate risk-taking entrepreneur who delegates management authority to agents would be entitled to all residual income resulting from the business enterprise. *See* Tavares, *supra* n. 7 , at p. 253, and the business economics bibliography referred to therein.
18. OECD, *Revised Guidance on the Application of the TPSM* (2018), at para. 2.151.
19. Id., at para. 2.168.
20. Id., at para. 2.174.
21. Id., at para. 2.177.
22. Id., at para. 2.171.
23. Id.
24. Id., at para. 2.172.
25. J-F. Maraia, *Prix de transfert des biens incorporels* pp. 175-182 (Schultess 2008); M. Boos, *International Transfer Pricing – The Valuation of Intangible Assets* p. 75 (Kluwer Law International 2003).
26. Maraia, *supra* n. 25 , at p. 177; Boos, *supra* n. 25 , at p. 79.
27. Maraia, *supra* n. 25 , at p. 178; Boos, *supra* n. 25 , at p. 81.
28. OECD, *Revised Guidance on the Application of the TPSM* (2018), at para. 2.175; OECD, *Transfer Pricing Guidelines* (2017), at paras. 2.129 and 6.153. For issues with respect to this approach, *see* S-E. Bärsch and C. Erb, *Using Economic Valuation Techniques for Transfer Pricing Purposes: Recent Developments for the Valuation of Brands* , 25 Intl. Transfer Pricing J. 4, p. 289 (2018), Journal Articles & Papers IBFD; M. Milewska and M. Hurtado De Mendoza, *The Increasing Importance of Intangible Assets and the Rise of Profit Split Methods* , 17 Intl. Transfer Pricing J. 2, pp. 162 at 164 (2010), Journal Articles & Papers IBFD; M. Pankiv, *Post-Beps Application of the Arm's Length Principle to Intangibles Structures* , 23 Intl. Transfer Pricing J. 6, p. 469 (2016), Journal Articles & Papers IBFD; A. Oestreicher, *Transfer Pricing of Intangibles in Cases of Post-Merger Reorganization: Lessons from the Revised OECD Draft* , 42 Intertax 8/9, p. 515 (2014 **)** . For a reconstructive analysis of issues associated with intangible valuation primarily from a US perspective, *see* Y. Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes* , 28 Va. Tax Rev., p. 79 (2008).
29. Monsenego, *supra* n. 1 , at p. 59.
30. OECD, *Revised Guidance on the Application of the TPSM* (2018), at para. 2.166. A conventional dichotomy that is often invoked when it comes to the distinction between the ALP and formulary apportionment is that the former would rely on a separate-entity approach and the latter on a unitary approach. However, in the case of profit split, the line may be more blurred. As has been observed, "[t]he use of RPSM in APAs also serves to demonstrate that a general formulary method does not necessarily have to be developed in order to achieve fair and equitable results. It would be reasonable to expect that a firm-specific application of the ALP to a unitary business, through an in-depth value chain analysis developed multilaterally, would produce less distortionary results than any other alternative allocation of international taxing rights." *See* Tavares, *supra* n. 7 , at p. 275.
31. C. Elsten and N. Hill, *Intangible Asset Market Value Study* , 52 Les Nouvelles – Journal of the Licensing Executives Society 4, p. 245 (2017).
32. Monsenego, *supra* n. 1 , at p. 66; T. Miyatake, *General Report* , in *Transfer Pricing and Intangibles* (IFA Cahiers vol. 92A, 2007), Books IBFD; J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* p. 503 (Kluwer Law International 2010).
33. OECD, *Transfer Pricing Guidelines* (2017), at para. 6.5-31.
34. Id.
35. Id., at para. 6.32-86.

assessment of the arm's length price of IP transactions.[37] The authors will only focus on the determination of the arm's length price of IP transactions. Indeed, the objective of this section is to demonstrate the necessity to step away from the comparability analysis and use factual allocation keys.

One may categorize intangible assets in two broad categories, that is, intangibles for which comparables are available or not available.[38] For the first category, typically, the CUP method prevails as it should be possible to find comparables. However, it is noticeably difficult to find comparables for intangible transactions.[39] The second category is illustrated by the situation where two associated enterprises contribute equally to the controlled transaction. In this uncomparable situation, the only transfer pricing possibility is the application of the TPSM (or its variants). In fact, several examples mentioned in the updated report on the TPSM discuss the application of this method. For instance, Example 10 states that the TPSM applies to a situation wherein Company A develops and sells a product which incorporates highly innovative components (that uses unique intangibles) independently created by related Company B.[40] In several other examples, the guidance also discusses the application of facts and circumstances allocation keys to split residual profits. For instance, in Example 11[41] and Example 14,[42] the residual profits are split among the associated enterprises on the basis of R&D expenses (cost-based allocation key). On the other hand, Example 15,[43] in which two related members develop valuable intangibles and know-how and enter into a complex network of transactions, provides for the use of an asset-based allocation key for splitting residual profits.

2.4. Intra-group services

MNE group entities often provide services to each other. In this context, the transfer pricing analysis needs to answer two questions: has a service effectively been rendered? What is the arm's length intra-group charge for such a service?[44] With respect to the first issue, we need to determine if the service rendered, provided an economic advantage to its beneficiary. This is the well-known *benefits test* .[45] In addition, services considered as a shareholder service,[46] duplicated service[47] or an incidental benefit,[48] remain non-chargeable.

In a second step, we need to apportion the service fees to the beneficiary group members. The *direct charge method* [49] applies if the service and the associated fees directly relates to a particular group entity. This method usually prevails, if applicable. However, highly integrated organizations require the application of another method. For example, if a group has centralized its marketing activities in one entity, many group members may indirectly benefit from the services provided by the marketing entity. Here, the transfer pricing methodology demands the application of the *indirect charge method.* [50] Accordingly, the service costs are apportioned among the beneficiaries following a facts and circumstances allocation key. For instance, in this example, the total service cost could be divided in proportion to the sales generated by the affiliates.[51] Nevertheless, depending on the service rendered, other allocation keys may emerge such as time spent by employees, units produced or sold, number of employees, total expenses, space used, capital invested, quantum of assets, and so on.[52] Essentially, the utilization of one or another of the aforementioned allocation keys depends on the facts and circumstances. More precisely, they must offer a plausible estimation of the amount of service received by a given MNE entity.

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36. Id., at para. 6.86-106.
37. Id., at para. 6.107-212.
38. Id., at para. 6.203.
39. Maraia, *supra* n. 25 , at p. 1; Boos, *supra* n. 25 , at p. 168.
40. OECD, *Revised Guidance on the Application of the TPSM* (2018), at Annex II, paras. 46-50.
41. Id., at Annex II, paras. 51-53.
42. Id., at Annex II, paras. 74-79.
43. Id., at Annex II, paras. 80-84; this example also figures in OECD, *Transfer Pricing Guidelines* (2017), at Annex II to Ch. II, paras. 431-35.
44. OECD, *Transfer Pricing Guidelines* (2017), at para. 7.5.
45. Id., at para. 7.6. In May 2018, the OECD invited public comments on the scope of the future revision concerning intra-group services. The resulting comments were published in June 2018: OECD, *Comments Received on the Request for Input Scoping of the future revisions of Chapter VII (intra-group services) of the Transfer Pricing Guidelines* (OECD 2017); Collier and Andrus, *supra* n. 1 , at para. 3.50; S. Biswas, *Intra-Group Services: Issues, Solutions and Issues in Solutions* , 23 Intl. Transfer Pricing J. 5, pp. 393, 395 (2016).
46. OECD, *Transfer Pricing Guidelines* (2017), at para. 7.9.
47. Id., at para. 7.12-13.
48. Id., at para. 7.12.
49. Biswas, *supra* n. 45 , at p. 400.
50. Monsenego, *supra* n. 1 , at pp. 66, 83.
51. Biswas, *supra* n. 45 , at p. 400; OECD, *Transfer Pricing Guidelines* (2017), at, para. 7.19-26.
52. Biswas, *supra* n. 45 , at p. 402.

2.5. Intra-group financing

Facts and circumstances allocation keys also exist in intra-group financing transactions. For instance, an MNE may direct its various entities to enter into cash pooling arrangements.[53]Such arrangements could lead to cash pool benefits either in the form of netting benefits or volume discounts. If the cash pool leader merely acts as a service entity, depending on the precise facts, the netting benefit or the volume discount is allocated to the cash pool depositors on the basis of an allocation key. If a thorough functional analysis shows that the consolidated cash volume is the main driver of these benefits, the amount of cash deposits serves as the basis for deriving a reasonable allocation key.[54]In fact, in the *ConocoPhillips* case,[55]the Bogarting Court of Appeal arrived at a similar conclusion.

There could also be situations where a captive insurance entity within a MNE does not carry out core underwriting activities but rather serves as a negotiation tool vis-à-vis independent reinsurers for obtaining favourable pricing conditions.[56]For example, consider the situation of a cooling equipment manufacturing group that consists of multiple manufacturers. Each manufacturer, located in a different country, insures its natural disaster risk with the group captive insurance company. The captive then reinsurers all its risk with an independent reinsurer by paying premiums that are lower than the premiums it receives. Essentially, the captive obtains a favourable price with the reinsurer due to its collective negotiating power over the risks that have to be reinsured. If the functional analysis indicates that the captive acts as a mere service provider, i.e. it insures the risks of the members of the group and then reinsures all the risks without performing the key insurance activities such as the underwriting function, then the captive should only receive a compensation for the routine service it provides on an arm's length basis. In other words, the synergistic benefit (the difference between the premiums received and paid to the extent it is higher than the costs of compensating the captive) should be allocated to the insured parties (members of the group) as opposed to the captive itself.[57]A potential allocation key may follow the initial premiums paid by the insured parties.

2.6. A conceptual issue

The ALP relies heavily on the separate-entity principle and a comparability analysis. However, at the conceptual level, the question arises as to whether the use of the profit split method represents a non-arm's length approach?

On one hand, it can be argued that the facts and circumstances allocation keys used for the TPSM fit within the arm's length approach. This is because such keys seek to determine the value created or contributed by each party to the transaction. In other words, their ultimate goal is to simulate what independent parties would have done in a similar situation. In fact, two authors to this contribution support this position. On the other hand, it can be argued that the TPSM, particularly with regard to its application for intangible transactions, departs from the traditional understanding of the arm's length approach. The necessity to aggregate profits to apply the TPSM contradicts with the separate-entity principle since it is no longer possible to separately observe the profit and loss statements of the tested parties. It can also be argued that the residual TPSM departs from the comparable analysis approach as it was precisely designed for situations where comparables are lacking. The increasing resort to the residual TPSM to apportion the returns of highly integrated controlled transactions is an important departure from the traditional ALP logic. Additionally, intangible assets have become the main value creator. This is increased by the digital economy, which is becoming the economy itself.[58]The vast majority of the international commerce is generated by integrated MNEs who have acquired most of the intangible assets and the inherent rights.[59]The enhanced guidance on the TPSM, especially, with respect to intangibles, reflects a departure from the separate-entity principle and comparability analysis.[60]Some argue that this trend represents hidden convergence towards formulary apportionment.[61]

In the next section we will discuss the situations wherein predetermined allocation keys or safe harbours are implemented within the transfer pricing framework, even though these are clearly non-arm's length approaches.

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53. OECD, *Public Discussion Draft, BEPS Action 8-10: Financial transactions* , paras. 94-130 (OECD 2018). The report was recently finalized. *See* OECD, *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10* , paras. 10.109-10.148 (OECD 2020) [hereinafter OECD, *Financial Transactions* (2020)].
54. A. Haller and V. Chand, *Application of the Arm's Length Principle to Physical Cash Pooling Arrangements in Light of the OECD Discussion Draft on Financial Transactions* , 47 Intertax 4, pp. 361-363 (2019).
55. H.M. Andresen, N. Pearson-Woodd and H-M. Jørgensen, *ConocoPhillips Case: Implications in Norway and Beyond* , 17 Intl. Transfer Pricing J. 6, pp. 461-462 (2010), Journal Articles & Papers IBFD.
56. OECD, *Financial Transactions* (2020), at paras. 10.222-10.223.
57. V. Chand, *Transfer pricing aspects of captive insurance arrangements: recommendations to the OECD* , IFF Forum fur Steuerrecht 2, p. 175 (2017).
58. OECD/G20, *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report* , p. 11 (OECD 2015), Primary Sources IBFD [hereinafter *Action 1 Final Report* (2015)].
59. For example, *see* The Economist, *The retreat of the global company* (28 Jan. 2017), available at https://www.economist.com/briefing/2017/01/28/the-retreat-of-the-global-company (accessed 24 June 2020).
60. Collier and Andrus, *supra* n. 1 , at para. 6.68.
61. R. Tavares and J. Owens, *Human Capital in Value Creation and Post-BEPS Tax Policy: An Outlook* , 69 Bull. Intl. Taxn. 10, p. 590 (2015), Journal Articles & Papers IBFD (2015).

3. The Use of Predetermined Approaches or Allocation Keys

3.1. Introductory remarks

Over time, both the OECD and some national systems have adopted a pragmatic remedy to the uncertainty that characterizes the application of the ALP, envisioning an approach based on predetermined formulas or *safe harbours* , that is, an approach based on "a simple set of rules under which transfer prices would be automatically accepted by the national tax administration".[62]

Safe harbours may take different forms, but generally feature two main categories: (i) safe harbours implying the exclusion of certain transactions (e.g. those whose value is below a certain threshold) from the scope of application of transfer pricing legislation; and (ii) safe harbours implying the application of simplified transfer pricing rules (e.g. the determination of ranges within which prices or profits shall fall in order to be compliant with the ALP). In this regard, the position of the OECD vis-à-vis safe harbour approaches has significantly evolved over time: from the generally negative appraisal to be found in the 1995 edition of the TPG to a qualified acceptance of safe harbour-based approaches introduced in 2013.[63]The outcome of a survey conducted by the OECD in 2011 drove this reconsideration.[64]The survey, in which 41 OECD and non-OECD countries participated, indicated that several countries adopted simplified approaches, in most cases, to smaller taxpayers or less complex transactions. The TPG acknowledge that the main benefits of a safe harbour approach is certainty and administrability (which can be translated as compliance relief for the concerned taxpayers and tax authorities).[65]On the other hand, the same TPG observe that safe harbour mechanisms may lead to distortionary effects on the pricing decisions of the concerned enterprises and, in some instances, even lead to base erosion phenomena.[66]In addition, unilaterally adopted safe harbours may potentially create international double taxation.[67]

3.2. Intra-group IP transactions

Predetermined formulas or rules of thumb have been used within the current transfer pricing framework, in particular with respect to transactions with intangibles.[68]A frequently used method to split the profit is the 75/25 split rule.[69]This rule, as suggested by a commentator, was born under the pen of Robert Goldscheider.[70]According to this simple rule of thumb, the licensor of an IP right obtains 25% of the profits generated from the related product. The rationale of this rule is to offer each party a remuneration that corresponds to the risks taken, as the licensee bears all the investment risk and the licensor is just a passive collector. Rules of thumbs only reflect rational practices and industry average, thus they do not have any theoretical merits, but offer an important starting point.[71]

Before the enactment of the "commensurate with income" requirement in 1986, "safe harbour" approaches were already used in the United States: the General Explanation of the Tax Reform Act of 1986, Pub. L. 99-514, 99th Cong., House of Representatives 3838 (JCS – 10 – 87) observed the following:

> Certain judicial interpretations of Section 482 have suggested that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a 'safe harbor' for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors.[72]While Congress was concerned that such decisions may unduly emphasize the concept of comparables even in situations involving highly standardized commodities or services, it believed that such an approach is sufficiently troublesome where transfers of intangibles are concerned that a statutory modification to the intercompany pricing rules regarding transfers of intangibles was necessary.[73]

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62. *See* OECD, *Transfer Pricing Guidelines* (2017), at p. 159.
63. An interim discussion draft of the revised section of the OECD, *Transfer Pricing Guidelines* devoted to safe harbours was released in the June 2012 for public consultation and the new section E of the Transfer Pricing Guidelines was adopted on 16 May 2013.
64. For further background on the survey, *see* OECD, *OECD updates Multi-Country Analysis of Existing Transfer Pricing Simplification Measures* (6 June 2012), available at http://www.oecd.org/ctp/transfer-pricing/oecdupdatesmulti-countryanalysisofexistingtransferpricingsimplificationmeasures.htm (accessed 24 June 2020).
65. *See* OECD, *Transfer Pricing Guidelines* (2017), at p. 208
66. Id., at p. 208-212.
67. Id.
68. Milewska and Hurtado De Mendoza, *supra* n. 28 .
69. M. Fiacadori, A. Mitra and R. Plunkett, *Licensor-Licensee Profit Split and the Income Approach* , International Tax Review (17 Dec. 2012), available at https://www.internationaltaxreview.com/Article/3132196/Licensor-licensee-profit-split-and-the-income-approach.html?ArticleId=3132196 (accessed 4 Oct. 2019).
70. A. Riedl and O. Protas, *Simple Solutions for Complex Transfer Pricing Cases: A Possible Comeback of Rules of Thumb?* , 26 Intl. Transfer Pricing J. 4, sec. 3. (2019), Journal Articles & Papers IBFD. For a recent survey of country practices in this area, *see* Taxand, *Global Tax & Transfer Pricing Guide on Licensing of Intangibles: TP Methods, Documentation & Practical Experience, Update 2019* (2019), available at http://www.taxand.com/wp-content/uploads/2019/09/Taxand-IP-Overview-2019-.pdf .
71. M. Erasmus-Koen, *Art. 9 of the OECD Model Convention* , in *Transfer Pricing and Business Restructurings: Streamlining all the way* p. 138 (A. Bakker, ed., IBFD 2009).
72. *See* e.g. US: Court of Appeals, 12 Mar. 1980, *United States Steel Corporation v. Commissioner* , 617 F. 2d 942 (2nd Cir. 1980).
73. Reported by J. Wittendorff, *Transfer Pricing and the Arm's Length Priciple International Tax Law* p. 394 (Kluwer Law International 2010).

This observation is an interesting one because it shows the dichotomy between transactions such as services or commodity-related transactions, where the door for safe harbours has been left open and other more complex transactions encompassing intangibles where the possibility to rely on safe harbour was not acknowledged.

Despite the above distinction, in some cases, tax courts in the United States have discussed the use of such rules of thumb. In the case of *Bausch v. Lomb* ,[74]a US MNE group engaged in the production of lenses, transferred intangible assets to its Irish subsidiary in exchange for a percentage of the subsidiary's sales. The US Tax Court readjusted this transaction. After considering the general 75/25 split rule, the US Tax Court held that the arm's length remuneration for this transfer amounted to 50% of the profit derived from the intangible.[75]In *Ciba-Geigy v. Commissioner* ,[76]the US Tax Court also referred to the 75/25 rule of thumb when assessing the arm's length royalty rate that a US subsidiary had paid to its Swiss parent company in exchange for an exclusive licence to develop, manufacture and sell herbicides in the United States. However, in *VirnetX v. Cisco Systems* ,[77]the US Court of Appeals mentioned the 75/25 rule as a potential starting point to estimate the damage, but finally rejected it. The OECD, too, rejects the utilization of the 75/25 split rule with regard to the apportionment of intangible returns and licence agreements.[78]The UK Her Majesty's Revenue and Customs (HMRC) follow a similar approach.[79]They first mention the 75/25 rule of thumb as potential starting basis, but point out that this rule might not account for market specificities and that the intangibles under examination may be more valuable than those generally found in that industry. Confronted with the ever-increasing complexity of the MNEs' value chains, tax administrations only have two options: intellectually conquer these value chains or adopt simpler ways to solve this problem.[80]

3.3. Intra-group services

Several issues arise in relation to the application of the *benefits test* . In order to reduce tax compliance costs, provide greater certainty for MNEs and simplify the task for tax administrations, the OECD TPG have come up with a simplified approach for low value-adding services (LVAS).[81]Such an approach had, in a way, already received an endorsement at the EU level by the Joint Transfer Pricing Forum.[82]The inclusion of this approach into the TPG has received a vast echo in several member and non-member countries.[83]

Essentially, the remuneration for the LVAS provider amounts to a fixed markup of 5% of the relevant costs.[84]In theory, if taxpayers comply with the simplified approach, tax administrations should refrain from reviewing or challenging the benefits test.[85]There seems to be a clear convergence, both in terms of rationale and concrete implementation, between such an approach and the simplified approaches observed in some domestic practices, examined in further detail in section 3.5.

At the same time, we would seem to be observing a fundamental point of departure with regard to flexibility and modularity: whereas, for instance, the Brazilian predetermined margins are differentiated by industry, the simplified approach applied to LVAS would apply in the same measure across the board. This circumstance may actually cause the application of the latter to be considered a derogation from the arm's length standard as it is doubtful that one margin for all costs would properly reflect an arm's length remuneration.[86]If this is the case and if the LVAS exception to the canonical understanding of the ALP has been

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74. US: Tax Court, 23 Mar. 1989, *Bausch & Lomb v Commissioner* , [1989] 92 525 (TC), p. 608.
75. Milewska and Hurtado De Mendoza, *supra* n. 28 .
76. US: Tax Court, 1 Aug. 1985, *Ciba-Geigy v. Commissioner* , [1985] 85 172 (TC), p. 229.
77. US: Federal Circuit, 16 Sept. 2014, *VirnetX v. Cisco Systems* , [2014] No. 13-1489 (Fed. Cir. 2014), 38-40. For a similar reasoning, *see* US: Federal Circuit, 4 Jan. 2011, *Uniloc USA, Inc. v Microsoft Corp* ., 632 F.3d 1292 (Fed. Cir. 2011), p. 1313.
78. OECD, *Transfer Pricing Guidelines* (2017), at paras. 2.10, 6.144.
79. HMRC, International Manual, Transfer pricing: types of transactions: intangibles: establishing an arm's length price for valuable intangibles: profit split method, Regulation 2016 (INTM440170), available at https://www.gov.uk/hmrc-internal-manuals/international-manual/intm440170 (accessed 24 June 2020).
80. Riedl and Protas, *supra* n. 70 .
81. OECD, *Transfer Pricing Guidelines* (2017), at para. 7.52; M. Bonekamp, D.Berry and B. Konings, *Remuneration of Intra-Group Services: One Size Fits All?* , 25 Intl. Transfer Pricing J. 1, p. 25 (2018), Journal Articles & Papers IBFD. LVAS are defined as services performed by a member of an MNE, which benefit another (or more) member(s) of the group. In addition, these services are of a supportive nature, do not constitute the core value-creating activity of the group, do not require the use or intend to create valuable intangibles, and do not trigger significant risks and the necessity to control them for the service provider.
82. *See* European Commission, Joint Transfer Pricing Forum (JTPF), *Guidelines on Low Value Adding Intra-Group Services* (Feb. 2010), available at: https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/jtpf_020_rev3_2009.pdf [hereinafter JTPF, *Guidelines on LVAS* (2010)]. The findings of the report are also possibly behind the 5% benchmark, where it is observed that "[i]n cases where it is appropriate to use a mark up, this will normally be modest and experience shows that typically agreed mark ups fall within a range of 3-10%, often around 5%." The JTPF, *Guidelines on LVAS* (2010) also noted that "[h]owever that statement is subject to the facts and circumstances that may support a different mark up."
83. In particular: Australia, Austria, Belgium, Czech Republic, Denmark, Finland, France, Hungary, Ireland, India, Israel, Italy, Japan, Liechtenstein, New Zealand, Norway, Mexico, Peru, Singapore, Spain, Sweden, Switzerland, United Kingdom and the United States. For more details, *see* OECD, *Transfer Pricing Country Profile* , question 16 (updated Oct. 2017), available at https://www.oecd.org/ctp/transfer-pricing/transfer-pricing-country-profiles.htm (accessed 4 Oct. 2019).
84. Bonekamp, Berry and Konings, *supra* n. 81 , at p. 25.
85. OECD, *Transfer Pricing Guidelines* (2017), at para. 7.54.
86. In this sense, *see* G. Maisto, *Transfer Pricing Aspects of Low Value Adding Services* , in *Transfer Pricing in a Post-BEPS World* p. 154 (M. Lang et al. eds., Kluwer Law International 2016).

absorbed in the latest version of the TPG, there would seem to be no reason why the same treatment should be denied to sectoral, transactional and rebuttable predetermined margins.

On a different but related note, India has also issued safe harbour rules in the form of minimum operating margins for high value-adding services. The categories included are, for instance, the provision of software development services, information technology enabled services (ITES), knowledge process outsourcing (KPO) services, contract research and development (R&D) services, manufacture and export of automotive components and so on.[87]

It may however be argued that the two models, albeit operating along similar lines, really adopt two radically different perspectives. For instance, there is a clear dichotomy between the European (and OECD) regime and the Indian regime. Where the former focuses on LVAS, the latter focuses on high value-adding services: in fact, the Indian safe harbour rule would appear to be designed to ensure a minimum taxation of the income-generating services rendered by Indian entities to related group entities, thus addressing the concern of possible instances of "underpricing". In contrast, the LVAS would seem to be designed to target the "overpricing" of the services that fall under its scope. In other words, the Indian initiative would seem to be primarily concerned with an anti-base erosion rationale, while the OECD LVAS regime would seem to be meant to prevent profit shifting practices.

3.4. Intra-group financing

In relation to intra-group financing, several countries have safe harbours with respect to determining interest rates for intercompany loans. Arguably, also for structural reasons due to the ease by which predetermined benchmarks can be established when it comes to interest rates, safe harbours in the area of financing constitute one of the most common and relatively standardized forms of transfer pricing safe harbours. For instance, the practice of safe harbours in the area of financing is followed in Australia,[88]India,[89]Korea,[90]Liechtenstein,[91]New Zealand,[92]Singapore,[93]Slovenia,[94]Switzerland[95]and the United

87. For more details on India's Income Tax Rules in relation to safe harbours, *see* IN: Income Tax Act, 1961, Rules 10A-10G and sec. 92CB, available at https://www.incometaxindia.gov.in/pages/rules/income-tax-rules-1962.aspx (accessed 4 Oct. 2019). *See also* India's Transfer Pricing Country Profile in OECD, *Transfer Pricing Country Profile* , question 24 (updated Feb. 2018), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-india.pdf (accessed 4 Oct. 2019). Moreover, *see* V. Krishnamurthy, *India Aims To Reduce Transfer Pricing Disputes through Safe Harbour Rules* , 68 Bull. Intl. Taxn 1, p. 47 (2014), Journal Articles & Papers IBFD; M. Agrawal, *One Step Towards a Non-Adversarial Tax Regime: Safe Harbour Rules in India* , 71 Bull. Intl. Taxn. 6, p. 515 (2017), Journal Articles & Papers IBFD; S.K. Bilaney, *New Safe Harbour Rules for Intra-Group Loans and Guarantees: How Safe Is the New Harbour?* , 19 Derivs. & Fin. Instrums. 6, sec. 1.1. (2017), Journal Articles & Papers IBFD.

88. Australia also adopted rules on thin capitalization. AU: Income Tax Assessment Act 1997, Division 820 (ITAA 1997) provides safe harbour debt levels below which the level of debt is not challenged. *See* J.P. Donga and P. Korganow, *Safe Harbour Not So Safe?* , 16 Asia-Pac. Tax Bull. 4, p. 284 (2010), Journal Articles & Papers IBFD.

89. Safe harbours fix the debt interest depending on the Indian subsidiary's creditworthiness. For instance, the safe harbour for a wholly owned subsidiary with a creditworthiness between AAA and A is 1.75% in Indian rupees (INR) and 1.5% in foreign currencies. For a complete overview, *see* the tables in Bilaney, *supra* n. 87 , at pp. 1-2.

90. Korea issued a safe harbour on arm's length interest rates through the Ministry of Strategy and Finance based on the interest rate in the international financial market. For more details, *see* KR: Enforcement Decree of the Adjustment of International Taxes Act, aArt. 6(7), available at https://elaw.klri.re.kr/kor_service/lawView.do?hseq=35965&lang=ENG (accessed 4 Oct. 2019). *See also* Korea's Transfer Pricing Country Pofile in OECD, *Transfer Pricing Country Profile* , question 24 (updated Apr. 2018), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-republic-of-korea.pdf (accessed 24 July 2019).

91. Liechtenstein has issued a circular regarding safe harbour rules for interest rates. For more details on Liechtenstein's regulation, *see Zinssätze für die Berechnung der geldwerten Leistungen* (German only), available at https://www.llv.li (accessed 4 Oct.2019). *See also* Liechtenstein's Transfer Pricing Country Profile in OECD, *Transfer Pricing Country Profile* , question 24 (updated Apr. 2018), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-liechtenstein.pdf (accessed 4 Oct. 2019).

92. New Zealand enacted its safe harbour regarding interest rates. For cross-border, small value intra-group loans (i.e. up NZD 10 million in total per year), the arm's length interest rate is fixed in advance and frequently revised (currently 3%). For more details on New Zealand's transfer pricing rules regarding financial cost, *see* New Zealand Inland Revenue, Transfer pricing practice issues, available at https://www.classic.ird.govt.nz/international/business/transfer-pricing/transfer-pricing/practice/transfer-pricing-practice-financing-costs.html#08 (accessed 4 Oct. 2019). *See also* New Zealand's Transfer Pricing Country Profile, in OECD, *Transfer Pricing Country Profile* , question 24 (updated Oct. 2017), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-new-zealand.pdf (accessed 4 Oct. 2019).

93. Singapore issued safe harbours for loans that do not exceed a maximum amount of SGD 15 million. For more details on Singapore's Transfer Pricing Guidelines, *see* sec. 13, available at https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/eTax_Guides/etaxguide_Income%20Tax_Transfer%20Pricing%20Guidelines_5th.pdf (accessed 24 July 2019). *See also* Singapore's Transfer Pricing Country Profile, in OECD, *Transfer Pricing Country Profile* , question 24 (updated Apr. 2018), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-singapore.pdf (accessed 4 October 2019).

94. The Slovenian Corporate Income Tax Act recognizes safe harbours for interest rates in intercompany loans. *See also* Slovenia's Transfer Pricing Country Profile, in OECD, *Transfer Pricing Country Profile* , question 24 (updated Oct. 2017), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-slovenia.pdf (accessed 4 Oct. 2019).

95. Switzerland has issued recognized interest rates for intercompany loans. For more details on Switzerland's Circulars, *see* Circular N. 6/6 June 1997 and the regularly updated circulars for interest rates, available at https://www.estv.admin.ch/estv/fr/home/direkte-bundessteuer/direkte-bundessteuer/fachinformationen/rundschreiben.html (accessed 4 Oct. 2019). *See also* Switzerland's Transfer Pricing Country Profile, in OECD, *Transfer Pricing Country Profile* , question 24 (Oct. 2017), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-switzerland.pdf (accessed 4 October 2019).

States.[96] Alternatively, some countries, such as Luxembourg[97] and Cyprus,[98] have issued guidelines on minimum interest spreads with respect to financing activities.

Moreover, predetermined splits or safe harbours appear in other intra-group financing arrangements. Consider the following case, in the context of intra-group financial guarantees. The parent company of Group F has an AAA credit rating. Its subsidiary S has a credit rating of BAA. On a standalone basis, the subsidiary could acquire a loan from an independent bank at an interest rate of 6%. Due to its affiliation to the group, however, the subsidiary's credit rating jumps up to an A rating and it can obtain an interest rate of 4%. Taking this even further, assume that the parent company guarantees the loan, which thereby raises the subsidiary's credit rating to AAA, and which allows it to obtain a 2% interest rate. Generally, the advantage linked to the group affiliation, i.e. the drop of the interest rate from 6% to 4%, qualifies as an incidental benefit. However, the benefit derived from the drop from 4% to 2% stems from a deliberate concerted group action. The question then arises as to how to split the 2% benefit between the parent and subsidiary? While several approaches exist to split the fees,[99] for simplification purposes rules of thumbs such as 50/50 splits are very common.[100]

Another area in which the OECD was considering simplification relates to determining credit ratings. The idea was to install a rebuttable presumption that the independently issued credit rating at the group level counts as credit rating for each group member.[101] The tax administration will use this credit rating as a starting point to establish the credit rating of the borrower and price an intra-group interest rate. In a given case, the taxpayer may always contend that a different credit rating should apply for a particular member. However, in the final report, the OECD highlights that MNE group ratings can be used only when the facts indicate that separate-entity ratings are not reliable.[102]

3.5. Other types of predetermined unilateral or bilateral approaches

Finally, it should be noted that a few countries have safe harbours for specific activities. For example, the Israeli transfer pricing rules provide for such a safe harbour regime. The rules (in the form of a Regulation) recognize a 3%-4% profitability margin for distribution activities and a 10%-12% margin for marketing activities[103] for entities operating in Israel. Although in most cases the adoption of safe harbours concerns primarily low-risk distribution or supply of services, as the examples mentioned so far illustrate, safe harbours have also been adopted in relation to more complex types of transactions. Italy, for instance, for a long time applied a safe harbour for royalties in its domestic administrative practice.[104]

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96. The United States issued a safe haven (harbours) interest rate in its regulations. For more details, ***see*** US: Enforcement Decree of the Adjustment of International Taxes Act, Treas. Reg. §§ 1.482-2(a)(2)(iii) and 1.482-9(b), available at https://www.irs.gov/retirement-plans/treasury-regulations (accessed 4 Oct. 2019). ***See also*** the United States' Transfer Pricing Country Profile, in OECD. *Transfer Pricing Country Profile* , question 24 (updated Oct. 2017), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-united-states.pdf (accessed 4 Oct. 2019).
97. For intra-group financing activities, Luxembourg issued a safe harbour for pure intermediary financing companies at 2% after tax return. For more details on Luxembourg's regulation, ***see*** Circular 56/1 – 56bis/1 of 27 Dec. 2016, available at https://impotsdirects.public.lu/content/dam/acd/fr/legislation/legi16/circulairelir561-56bis1-27122016.pdf . ***See also*** Luxembourg's Transfer Pricing Country Profile, in OECD, *Transfer Pricing Country Profile* , question 24 (updated Oct. 2017), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-luxembourg.pdf (accessed 4 Oct. 2019).
98. The Cyprus tax authorities recently issued a Circular on intra-group financing setting the arm's length interest rate at 2% after tax return, ***see*** https://www.ey.com/Publication/vwLUAssets/ey-its-newsletter-14-july-2017-eng/$FILE/ey-its-newsletter-14-july-2017-eng.pdf .
99. OECD, *Financial Transactions* (2020), at paras. 10.154-10.188.
100. M. Butani, *India* , in *Transfer Pricing and Intra-Group Financing: the Entangled Worlds of Financial Markets and Transfer Pricing* p. 279 (A. Bakker and M. Levey, eds., IBFD 2012).
101. OECD, *Financial Transactions* (2020), at para. 67 (question box).
102. OECD, *Financial Transactions* (2020), at paras. 10.81-10. 82.
103. For more details on transfer pricing profitability rates and range for certain transactions, ***see*** Circular 12/2018, available at https://home.kpmg/content/dam/kpmg/xx/pdf/2018/10/tnf-israel-12-oct9-2018.pdf (unofficial translation, accessed 4 Oct. 2019). ***See also*** Israel's Transfer Pricing Country Profile, in OECD, *Transfer Pricing Country Profile* , question 24 (updated May 2019), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-israel.pdf (accessed 4 Oct. 2019).
104. ***See*** IT: Circular Letter No. 32 of 22 Sept. 1980. The Circular Letter foresaw an interesting case of "floating" safe harbour, with different regimes foreseen for different rates of remuneration. In particular, as per the Circular Letter:

    (a) royalties of up to 2% of sales were accepted by the Tax Administration,

        (i) the transaction resulted from a written contract entered into before the payment of royalties; when:

        (ii) the utilization of the asset and the inherence of the cost incurred were adequately documented.

    (b) royalties ranging between 2 and 5% could be deemed as fair, subject to the following conditions, to be satisfied in addition to those set forth in item (a) above:

        (i) "technical" data justified the higher rate (performance of research and experiments, obsolescence shorter than one year, technical life, originality, results obtained, etc.);

        (ii) the higher rate was justified by "legal" data, emerging from the contract (exclusive right, right to sub-license, right to exploit discoveries or development of the intangible asset, etc.);

Even though the recent OECD work in the area of LVAS may promote a bilateral or multilateral development based on common frameworks, safe harbours are commonly associated with purely unilateral domestic measures. There are however instances of bilaterally agreed safe harbours. In this respect, the OECD approved several model Memorandums of Understanding aimed at establishing bilateral safe harbours in 2013.[105] In practice, it would be unlikely for countries to agree on the same predetermined margins or similar indicators,[106] except in some specific situations of geographic proximity and significant economic integration.[107] However, states could agree on a shared fundamental methodology and hence reciprocally acknowledge the outcomes, and punctual updates on the actual terms of the relevant safe harbours may be shared among jurisdictions by availing of the existing channels for automatic information exchange.

Besides safe harbours in the traditional sense, several countries, especially in the developing and emerging world have been adopting transfer pricing approaches based on normative or administrative predeterminations.[108] The most notable example in this regard may be the Brazilian transfer pricing rules.[109] The three transfer pricing methods available in Brazil approximately correspond to the comparable uncontrolled price (CUP), resale minus and cost-plus methods (the traditional methods), albeit with specific calculations. The law contains several safe harbours. The cost-plus margin must amount to 20%. Additionally, if the transfer price between related entities amounts to less than 90% of the average price for the same transaction within the Brazilian market, this transaction will be challenged. The main shortcoming associated with the current Brazilian approach would appear to lie in the (practically) (ir)rebuttable nature of the presumption which, legally speaking, constitutes the very substance of the predetermined margins. In this respect, while authoritative commentators of the Brazilian approach to transfer pricing stress that the predetermined margins are necessarily rebuttable presumptions, the position of the Brazilian tax administration, at least in the UN Transfer Pricing Manual,[110] would not seem to be as clear on this point. In fact, the taxpayer has the ability to prove, based on publications, research and reports, that its profits are different from those provided by safe harbours, although this appears difficult to achieve in practice.

(iii) the effective usefulness for the licensee was duly proved.

(c) royalties in excess of 5% of sales could only be accepted in exceptional circumstance only, in view of the high technological level of the industry in question or other facts and circumstances.

105. *See* OECD, *Transfer Pricing Guidelines* (2017), Annex to Section E on Safe Harbours in Chapter 4 including three sample Memoranda of Understanding to establish bilateral safe harbours, adopted by the Committee on Fiscal Affairs on 26 April 2013 [CTPA/CFA(2013)23] and approved by the Council on 16 May 2013 [C(2013)69]. In addition to the sample Memoranda, the Annex also contains an introductory chapeau exhaustively outlining the merits and the caveat to be observed with regard to this type of approaches. Besides the earlier mentioned role to be played by bilateral safe harbours in preventing international double taxation, the Annex also interestingly points out that "[f]or developing countries with serious resource constraints, bilateral MOUs entered into with a number of treaty partners could provide a means of protecting the local tax base in common transfer pricing fact patterns without an inordinate enforcement effort."

106. One notable exception may be the so-called sixth method, where predetermined approaches to pricing are made possible by international listings of trading commodities. For a contextualization of the "sixth method" as envisaged by the latest version of the OECD, *Transfer Pricing Guidelines* (2017) vis-à-vis national experiences in these areas, *see* A. Turina, *Back to Grass Roots: The Arm's Length Standard, Comparability and Transparency – Some Perspectives from the Emerging World* , 10 World Tax J. 2, pp. 325-330 (2018), Journal Articles & Papers IBFD.

107. In fact, one of the few concrete examples of bilateral safe harbours is the Memorandum of Understanding between Mexico and the United States on *maquiladora* operations concluded in 1999. In 2016, the Agreement was updated and currently provides that taxpayers may elect to apply a transfer pricing framework that the US and Mexican competent authorities have agreed in advance will produce arm's length results, while qualifying taxpayers that decline the election may apply the safe harbours provided by the 1999 Agreement or file a request for a bilateral APA with the US and Mexican competent authorities. Further details on this specific arrangement are provided in IRS News Release, *IRS Announces Position on Unilateral APA Applications Involving Maquiladoras* , IR-2016-133 (14 Oct. 2016), available at https://www.irs.gov/pub/irs-news/ir-16-133.pdf?_ga=1.134315953.1959233956.1449872249 (accessed 9 Sept. 2019). On the other hand, Mexico renovated its *maquiladora* regime to be compliant with BEPS Action 5 (OECD/G20, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report* (OECD 2015), Primary Sources IBFD), and this updated version allows for safe harbours around 6.5% under certain requirements. For more details on Mexico's regulations regarding *maquiladoras* , *see* MX: Income Tax Law, art. 182. *See also* Mexico's Transfer Pricing Country Profile, in OECD, *Transfer Pricing Country Profile* , question 24 (updated Oct. 2017), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-mexico.pdf (accessed 4 Oct. 2019).

108. For a reconstruction of the most notable experiences and their contextualisation in the current international tax policy debate, *see* S. Picciotto, *Problems of Transfer Pricing and Possibilities for Simplification* , ICTD, Working Paper 86 (2018) and Turina, *supra* n. 106 , at p. 295.

109. For more details on Brazil's transfer pricing rules, *see* BR: Law 9.430/1996, 27 Dec. 1996, art. 19 and 19-A, para. 4º, available at http://www.planalto.gov.br/ccivil_03/leis/L9430.htm (accessed 4 Oct. 2019). *See also* Brazil's Transfer Pricing Country Profile, in OECD, *Transfer Pricing Country Profile* , question 24 (updated Oct. 2017), available at https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-brazil.pdf (accessed 4 Oct. 2019). The domestic Brazilian literature on the mechanism of predetermined margins appears very extensive. Among the most selected contributions, in light of the main aims and scope of this study, *see* , specifically, the following essays contained in L.E. Schoueri, *Tributos e precos de transferência, Tributos e Preços de Transferência* , vol. II (Dialética 1999): A. Martins de Andrade, *Uma Critica e uma Proposição Alternativa ao Regime Legal Brasileiro do T.P* . in *Tributos e Preços de Transferência* p. 51 (L.E. Schoueri and V. de Oliveira Rocha eds., Dialética 1999); J.D. Rolim, *A adoção pelo direito brasileiro da Analise Economica dos Preços de Transferência e des Vantages dos acordos anticipados de preços* ; *see also* the monograph specifically devoted to the implications of the administrability of the Brazilian approach, R. Marozzi Gregorio, *Preços de Transferência e Practicabilidade* (Quartier Latin 2001). For a comprehensive and updated overview of the Brazilian transfer pricing regime, which, despite its reliance on "fixed margins" appears to be quickly evolving, reference can be made to L.E. Schoueri, *Preços de Transferência no Direito Tributário Brasileiro* , vol. III (Saraiva 2013) and to J.Barros Vita, *Preços de Transferencia* (Fiscosoft 2015). For an English language analysis of the Brazilian approach, *see also* T. Falcão, *Brazil's Approach to Transfer Pricing: A Viable Alternative to the Status Quo* ?, Transfer Pricing Report: News Archive (23 Feb. 2012); for a critical assessment, *see* R. Marozzi Gregorio, *Brazilian Transfer Pricing Rules: An Analysis of Effectiveness* , 46 Intertax 11, p. 914 (2018).

110. United Nations, *Practical Manual on Transfer Pricing for Developing Countries* (UN 2017) [hereinafter UN, *Transfer Pricing Manual* (2017)].

It is not obvious whether such approaches can be considered as safe harbours in the traditional sense. In this regard, a prima facie remark leading to a negative answer would be that the Brazilian predetermined margin approach for import and export transactions operates as a default mechanism.[111] Consequently, the idea of "waiving" the application of an otherwise ordinary, more complex regime – one of the defining features of the notion of "safe harbours" as conveyed by the TPG – would be absent.[112]

A more in-depth analysis would encompass the structural features of a safe harbour from a general theory viewpoint. In fact, one of the characteristics of a safe harbour is that it typically stands halfway between "standards" and "rules". The fundamental difference between rules and standards is the point at which each is given content:[113] a standard contains *ex post* normative content[114] while a rule contains *ex ante* normative content.[115] An intuitive example in this respect is the distinction between a "reasonable speed" requirement (a standard) and a "numerical speed limit" (a rule).[116] Safe harbours combine the features of a rule and a standard in that they provide that particular facts comply with the law and will not result in a penalty (a rule), while leaving other facts to be judged by a standard.[117] In such a structural sense, it may be argued that the simplified approaches to transfer pricing discussed in the previous section would seem to comply with such a characterization[118] or would at least have the potential to be developed in such a direction.[119]

A good illustration of the above distinction but also of the possibility for convergence between safe harbours and predetermined approaches is the following. In March 2019, the Australian Taxation Office (ATO) published a new Practical Compliance Guideline (PCG).[120] The regulation applies to all entities with Australian turnover over AUD 250 million in the domain of distribution operations.[121] Under this new PCG, MNEs are required to disclose their tax position, which will be examined by the ATO and compared to the ATO's own profit markers. The profit markers are the following: an earnings before interest and taxes (EBIT) margin of 2.1% and less involves a high risk of being challenged by the ATO, a margin between 2.1% and 5.3% involves a medium risk, and the margins above 5.3% involve a low risk.[122] The PCG explains that these margins do not constitute safe harbours and should not be used as such.[123] For instance, the PCG states that an entity operating in a particular risk zone should not diminish its margin even if it stays in the risk zone. The ATO warns that such drift will be carefully monitored.[124] The compliance approach of the ATO will change in accordance with the risk zone the taxpayer is placed in. The more risky the zone, the more resources the ATO will devote to monitoring the taxpayer's arrangements.[125] In light of the above, the Australian approach does not seem to qualify as a safe harbour but rather as a risk management approach based on what scholarship has conceptually defined as

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111. On the other hand, it is also possible to foresee predetermined approaches that would apply by default but, more in line with "traditional" safe harbour mechanisms, would cover only specific sectors. One of such examples is the Dominican Republic experience with all inclusive resorts. *See further* on this experience Turina, *supra* n. 106 , p. 330 et seq. and F. Velayos and A. Barreix, *Towards a New Form of International Taxation: The View from Latin America and the Caribbeans* , 41 Intertax 3, p. 138 et seq. (2013).
112. It is based on these considerations that the Brazilian section of the *UN Transfer Pricing Manual* makes the point that the Brazilian predetermined margins approach is not to be regarded as a safe harbour. *See* UN, *Practical Manual on Transfer Pricing for Developing Countries* p. 528 (UN 2017) [hereinafter *UN TP Manual* (2017)]. More recently, from an OECD perspective, *see also* the joint study OECD/Receita Federal do Brasil, *Transfer Pricing in Brazil. Towards Convergence with the OECD Standards, A Joint Assessment of The Similarities And Differences Between The Brazilian and OECD Frameworks* , para. 399 (2019), where it is observed that "[t]he fixed margins approach has been qualified as a safe harbour, or considered as an "adhesion model" or "adhesion APA". It should not, however, be confused with safe harbour regimes as described in the OECD Guidelines, which are generally optional and only available under narrowly defined conditions."
113. S. Dean, *Neither Rules nor Standards* , 87 Notre Dame Law Review 2, p. 543 (2012).
114. In more technical terms, it features a deferral of content specification. *See* L. Kaplow, *Rules Versus Standards: An Economic Analysis* , 42 Duke Law Journal 3, p. 567 (1992).
115. Id.
116. *See* R.E King and C.R Sunstein, *Doing Without Speed Limits* , 79 Boston University Law Review, p. 155 (1999) . *See* , more generally, C.R. Sunstein, *Problems with Rules* , 83 California Law Review 4, p. 953 (1995).
117. *See* S. Morse, *Safe Harbours, Sure Shipwrecks* , 49 University of California Davis Law Review, p. 1387 (2015).
118. This would apply, in the view of the authors, to the Brazilian experience, which could be considered, from a general theory perspective, to somehow be in between a rule and a safe harbour even though the latter characterization would seems to be prevailing if the approach is applied on the basis of a range. Based on most recent conceptual elaborations on the notion of safe harbours (*see* Morse, *supra* n. 117 , at p. 1385), it would seem that these predetermined margins have so far mostly operated as "sure shipwrecks", that is, pricing not in line with the predetermined margins would have led to situations that cannot be adequately described even as audit thresholds, provided that, in the absence of a clear avenue for rebutting the predetermined margin under specific conditions, transfer pricing adjustments would be required automatically.
119. With reference to the Argentinian experience with the "sixth method", it has been observed that "[t]he commodity pricing method has not yet evolved into a form of safe harbour method. Before this happens, it is likely that a body of domestic case law on this issue will be available in Argentina." *See* E. Baistrocchi, *Argentina* , in *The Future of Transfer Pricing* p. 105 (IFA Cahiers vol. 102B, IBFD 2017), Books IBFD.
120. EY, *Australian Taxation Office releases final guidance on compliance approach to distributor profit margins: Action required* , EY Global Tax Alert (19 Mar. 2019), available at https://www.ey.com/en_gl/tax-alerts/australian-taxation-office-releases-final-guidance-on-compliance-approach-to-distributor-profit-margins---action- (accessed 25 June 2020); Australian Taxation Office, Practical Compliance Guideline (PCG 2019/1): Transfer pricing issues related to inbound distribution arrangements (2019) [hereinafter Australian Taxation Office, PCG 2019/1].
121. EY, *supra* n. 120 .
122. Australian Taxation Office, PCG 2019/1, at para. 71.
123. Australian Taxation Office, PCG 2019/1, at paras. 7, 53.
124. Australian Taxation Office, PCG 2019/1, at para. 53.
125. EY, *supra* n. 120 .

"sure shipwrecks", that is, pricing not in line with the predetermined indicators would lead to situations that may, although not in an automatic way, trigger the audit thresholds.[126]

3.6. Advantages and caveats of predetermined approaches

Although resorting to predetermined formulas may not always provide an arm's length outcome, there are many advantages of using such rules. First, predetermined formulas have the advantage of certainty.[127]With them, it becomes much easier for taxpayers and tax administrations to anticipate the consequences and outcomes of taxes. Second, they also represent a practical way to enhance the efficiency of a tax system (compliance costs). In that matter, there is a link between certainty and efficiency. Improving certainty also improves efficiency.[128]For taxpayers, tax compliance costs should not exceed the economic benefit of a particular setup. For tax administrations, it is important to avoid situations where the enforcement cost of a tax is higher than its reward. Third, predetermined approaches offer a level playing field among various industries and across different types of transactions.[129]Fourth, another interesting point concerns developing countries: it could be argued that profit allocation based on predetermined approaches or safe harbours constitutes an appropriated tax mechanism for developing economies that often lack the administrative resources to enforce multiple case-by-case transfer pricing analyses.[130]From the perspective of developing countries, predetermined approaches also offer "revenue certainty", in that they may be used to secure and increase a certain target yield of corporate income tax revenues of taxing jurisdictions.[131]Fifth, predetermined approaches offer a way to maintain the ALP while tempering its main weakness. Indeed, the comparability analysis has been described as "the most serious challenge to transfer pricing implementation".[132]We can argue that, over time, the degree of complexity associated with the comparability analysis has increased, from five, relatively stylized, comparability factors to a full-fledged accurate delineation of the transaction as a pre-condition. Thus, safe harbours or predetermined approaches may represent a way to maintain the ALP paradigm while circumventing its biggest obstacle at the same time.[133]

All these positive characteristics of predetermined approaches or safe harbours would appear to resonate with the empirical evidence deriving from a longitudinal study conducted among transfer pricing professionals according to which:

> Over time, precedents and accepted practice have settled on approaches that are formulary in nature, in line with views that paying attention to using apportionment for individual remedies, rather than in a standard way, is a sensible way forward. Gradually, over time, aspects of a profit split approach, such as a certain percentage, become accepted as appropriate. As there is an increasing body of experience as to what tax authorities deem to be acceptable, such informal precedents are followed increasingly and so reinforced, rather than following a principled approach that reflects specific circumstances and market reality.[134]

In particular, these approaches translate, for instance, in the adoption of a set homogeneous margin for all distributors (for instance, 3% on sales for distributors).[135]

Such a demand for solutions maximizing certainty over accuracy would be met in a satisfactory and efficient way by a more widespread availability of approaches based on predetermined or safe harbour approaches.[136]

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126. *See* Morse, *supra* n. 117 , at p. 1387.
127. OECD, *Transfer Pricing Guidelines* (2017), at para. 4.105; Turina, *supra* n. 106 , at p. 323. This appears to have more recently been acknowledged, although indirectly and with some caveat, also by the OECD; in fact, the OECD argued that, while the predetermined margins approach ensures domestic certainty, this may not extend to the cross-border perspective. A possible avenue for reforming the predetermined margin stystem lies in transitioning towards a safe harbour approach. *See* OECD/Receita Federal do Brasil, *supra* n. 112 , at p. 130, where it is mentioned that "[t]he existence of the safe harbours contributes towards more tax certainty, as the eligible taxpayers will have their price charged or paid on qualifying controlled transactions accepted by the tax administrations. The tax administration would accept, with limited or no scrutiny, transfer prices within the safe harbour parameters which would contribute toward tax certainty in both domestic and cross-border situations. There may be limited instances where the existing safe harbours may not achieve tax certainty in cross-border situations, which could be cases where taxpayers wrongly determine the arm's length price and this is not accepted by the other tax administration that could still challenge the outcome of the application of the safe harbor." In this regard, *see also* the policy and implementation considerations on how to foster such transition set forth by L.F. Neto, *Transfer Pricing and Deemed Arm's Length Approaches: A Proposal for Optional Safe Harbour Methods Based on Accurate Predetermined Margins of Profitability* , 2 Intl. Tax Studies 7 (2020), Journal Articles & Papers IBFD.
128. OECD, *Transfer Pricing Guidelines* (2017), at para. 4.105; Turina, *supra* n. 106 , at p. 323.
129. Turina, *supra* n. 106 , at p. 323.
130. C. Silberztein, *OECD: Transfer Pricing Safe Harbours* , 20 Intl. Transfer Pricing J. 2, pp. 63, 71 (2013), Journal Articles & Papers IBFD.
131. In this sense, *see* A. Ezenagu *, Safe Harbour Regimes in Transfer Pricing: An African Perspective* , ICTD Working Paper 100, p. 7 (2019). *See also* A.W. Oguttu, *Challenges of Applying the Comparability Analysis in Curtailing Transfer Pricing: Evaluating the Suitability of Some Alternative Approaches in Africa* , 48 Intertax 1, p. 74 (2020).
132. Turina, *supra* n. 106 , at pp. 295, 323.
133. L.E. Schoueri, *Arm's Length: Beyond the Guidelines of the OECD* , 69 Bull. Intl. Taxn. 12, p. 716 (2015), Journal Articles & Papers IBFD.
134. H. Rogers and L. Oats, *Emerging Perspectives on the Evolving Arm's Length Principle and Formulary Apportionment* , BTR 2, p. 156 (2019).
135. Id. Based on the same piece of anecdotal evidence, it would seem that these safe harbour or formulary approaches override even the most basic functional characterizations, as some of the interviewees are reported as saying "[n]ow you're almost forcing consistency where they're not consistent because it's too dangerous to have different margins and stuff even when the facts are different."
136. Quite interestingly, the same set of properties appears to have been acknowledged by the OECD in relation to its assessment of the Brazilian transfer pricing system within the framework of the process of accession of Brazil to said international organization. In particular, in OECD/Federal Government of Brazil, *Joint Statement on the OECD-Brazil Transfer Pricing Project* , p. 4 (11 July 2019), available at http://www.oecd.org/tax/transfer-pricing/joint-statement-oecd-brazil-

4. Digitalization of the Economy: The Profit Allocation Debate

4.1. The profit allocation issue

The issue of the allocation of taxing rights has been the subject of extensive literature and policy analyses.[137]One of the most important issue that needs to be solved in the context of Pillar 1 relates to the design of new profit (loss) allocation rules.[138]In

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transfer-pricing-project-july-2019.pdf , it is stated that "[t]he Brazilian system is characterised by its ability to bring simplicity and practicality to the process of performing a transfer pricing analysis. The methodology applied in Brazil allows to overcome challenges related to the lack of information available on comparable uncontrolled transactions and profitability levels and requires only limited administrative and financial resources to be applied, and reduces costs and time involved in litigating transfer pricing cases. Brazil has implemented a system that has the benefit of protecting the Brazilian tax base to a certain extent, ensuring predictability and certainty in some respects, and of being practical as demonstrated by areas where ease of tax administration and compliance was observed." On the other, in the same report, it is observed that "[h]owever, in some cases, the key features contributing to simplicity may undermine the primary objectives of transfer pricing rules, leading to potential double taxation and BEPS risks". While the expression of these concerns is understandable, in the view of the authors, such pitfalls do not appear to be the result of certain inherent inadequacies of the Brazilian system (which nonetheless exist) but, as far as these two specific objections are concerned, from a lack of international coordination, the Brazilian approach is a purely unilateral stance that, lacking any type of derivative relationship from international recommendations, may or may not be accepted by other countries when its application may render the introduction of secondary adjustments necessary in said other countries in order to relieve international double taxation. Similarly, a unilateral safe harbour by definition provides some room for international tax arbitrage, so it is no surprise in this sense that the EU DAC 6 (Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements , OJ L 139/1 (5 June 2018), Primary Sources IBFD) expressly indicates "unilateral safe harbours" as one of the specific hallmarks concerning transfer pricing that would trigger reporting obligations. Both issues could however be overcome, in the first place, by granting predetermined approaches international recognition by means of their consecration into an international recommendation (which the OECD, *Transfer Pricing Guidelines* (2017) can be qualified as from the point of view of a public international law taxonomy) and, secondly, by further promoting institutional fora for the conclusion of bilateral and multilateral safe harbours.

137. For literature on this issue from international policymaking organizations, *see* the following: OECD, *Electronic Commerce: Taxation Framework Conditions* , Report by the Committee on Fiscal Affairs (OECD 1998); OECD, *E-Commerce: Transfer Pricing and Business Profits Taxation* , OECD Tax Policy Studies, No. 10 (OECD 2005); *Action 1 Final Report* (2015); OECD/G20, *Tax Challenges Arising From Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* , para. 34 (OECD 2018), Primary Sources IBFD [hereinafter OECD, *Interim Report* (2018)]; ; IMF, *Corporate taxation in the global economy* , IMF Policy Paper, pp. 8-9 (IMF 2019); and UN Committee of Experts on International Cooperation in Tax Matters, *Tax Issues related to the Digitalization of the Economy: Report* , para. 15 (Apr. 2019).
For literature from national policymakers, *see* : US: Selected Tax Policy Implications of Global Electronic Commerce, Department of Treasury (1996); UK: HM Treasury, *Corporate tax and the digital economy: position paper update,* (2018); IN: Ministry of Finance of India, *E-commerce and Taxation Report* , Circular No.1/2004, pp. 146-147 (2 Jan. 2004) and IN: Central Board of Direct Taxes (CBDT), Income department – Government of India, *Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment* (CBDT 2019) [hereinafter CBDT, *Proposal* (2019)]; NZ: New Zealand Government, *Options for Taxing the Digital Economy – a Government Discussion Document* , para. 4.19 (June 2019).
For literature from scholars, *see* : R.S. Avi-Yonah, *International Taxation of Electronic Commerce* , 52 Tax Law Rev., p. 507 (1997 *)* ; D. Pinto, *E-Commerce and Source-Based Income Taxation* (Doctoral Series, 2003); P. Hongler and P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* , White Paper (IBFD 2015); M. Olbert and C. Spengel, *International Taxation In The Digital Economy: Challenge Accepted?* , 9 World Tax J. 1, p. 3 (2017), Journal Articles & Papers IBFD; Y. Brauner and P. Pistone, *Adapting Current International Taxation to New Business Models: Two Proposals for the European Union* , 71 Bull. Intl. Taxn. 12 (2017), Journal Articles & Papers IBFD; W. Schön, *Ten Questions about Why and How to Tax the Digitalized Economy* , 72 Bull. Intl. Taxn. 4/5, p. 278 (2018), Journal Articles & Papers IBFD; R. Danon, *Can Tax Treaty Policy Save Us? The Case of the Digital Economy* , in *Tax Treaties after the BEPS Project* : *A Tribute to Jacques Sasseville* (B.J. Arnold, ed., Canadian Tax Foundation 2018); L. Spinosa and V. Chand, *A long-term Solution For Taxing Digitalized Business Models: Should the Permanent Establishment Definition Be Modified to Resolve the Issue or Should The Focus Be on a Shared Taxing Rights Mechanism?* , 46 Intertax 6/7, p. 476 (2018); A. Turina, *Which 'Source Taxation' for the Digital Economy?* , 46 Intertax 6/7, p. 495 (2018); M. Devereux and J. Vella, *Taxing the Digitalised Economy: Targeted or System-Wide Reform?* , BTR 4, p. 387 (2018); R. Mason, L. Parada, *Digital Battlefront in the Tax War* , 92 Tax Notes International 12, p. 1183 (2018); I. Grinberg, *International Taxation in the Era of Digital Disruption* : *Analyzing the Current Debate* pp. 20-22 (28 Oct. 2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3275737 (accessed 25 June 2020); P. Oosterhuis and A. Parsons, *Destination Based Income Taxation: Neither Principled Nor Practical?* , 71 Tax Law Rev., p. 515 (2018); R.S. Avi-Yonah, *Designing a 21st century Taxing Threshold: Some International implications of South Dakota vs. Wayfair* , Public Law and Legal Theory Research Paper Series, Paper 611 (2018), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3201418 (accessed 25 June 2020); J. Nogueira, *The compatibility of the EU digital services tax with EU and WTO law: requiem aeternam donate nascenti tributo* , 2 Intl. Tax Stud. 1 (2019), Journal Articles & Papers IBFD; J. Becker and J. Englisch, *Taxing Where Value Is Created: What's 'User Involvement' Got to Do with It?* , 47 Intertax 2, pp. 163-164 (2019); P. Pistone, J. Nogueira and B. Andrade, *The 2019 OECD Proposals for Addressing the Tax Challenges of the Digitalization of the Economy: an Assessment* , 2 Intl. Tax Stud. 2 (2019), Journal Articles & Papers IBFD; A. Baez and Y. Brauner, *Taxing the Digital Economy post BEPS…Seriously* , 59 Colum. J. Transnat'l L. (2019); W. Schön, *One Answer to Why and How to Tax the Digitalized Economy* , Max Planck Institute for Tax Law and Public Finance, Working Paper 2010-10, pp. 3-12 (2019); L. Parada, *The Unified Approach Under Pillar 1: An Early Analysis, Tax Notes International* , p. 983 (2019); S. Postler, *The OECD's Work on Profit Allocation and Nexus Rules for a Digitalized Economy – A Potential Improvement of the International Taxation Framework?* , 74 Bull. Intl. Taxn., 76 (2020), Journal Articles & Papers IBFD; S. Greil and A. Hilse, *Taxing Digital Economy – The OECD Secretariat's New Transfer Pricing A-B-C and Alternative Courses of Action* , 27 Intl. Transfer Pricing J. 3 (2020), Journal Articles & Papers IBFD; A.P. Dourado, *The OECD Unified Approach and the New International Tax System: A Half Way Solution* , 48 Intertax, p. 3 (2020); M. Floris de Wilde, *On the OECD's 'Unified Approach' as Frankenstein's Monster and a Dented Shape Sorter* , 48 Intertax, p. 9 (2020); F. Chadwick, *Addressing the Largest Hurdles to Pillar 1 Consensus* , Tax Notes Federal, p. 1445 (2020); R. Finley, *General Agreement May Not Be Enough in OECD'S Pillar 1 Work* , Tax Notes (2020); R. Finley and S.S. Johnston, *The U.S 'Safe Harbor' Proposal: Rocking the OECD's Pillar 1 Boat?* , Tax Notes International, p. 979 (2019); R. Finley, *Pillar 1 Profit Formula Should Approximate Arm's Length Standard* , Tax Notes International, p. 838 (2019); A. Turina *, The Progressive Policy Shift in the Debate on the International Tax Challenges of the Digital Economy: A "Pretext" for the Overhaul of the International Tax Regime?* , 36 Comput. Law Secur. Rev., Special online issue (Apr. 2020); K. Singh, W.J. Murphy and G.J. Ossi, *The OECD's Unified Approach – An Analysis of the Revised Regime for Taxing Rights and Income Allocation* , Tax Notes International, p. 549 (2020); M. Herzfeld, *The OECD Project That Shall Not Be Named* , Tax Notes International (2020).

138. OECD/G20, *Addressing the Tax Challenges of the Digitalisation of the Economy – Public Consultation Document* (OECD 2019) [hereinafter OECD, *Public Consultation Document* (2019)].

the first half of 2019,[139] the OECD was contemplating the following three approaches to allocate profits (or losses) to the market or user jurisdiction: the modified residual profit split method, the fractional apportionment method and the distributions-based approach. In the second half of 2019, these three approaches have been merged into the "unified approach"[140] developed by the OECD Secretariat, the latest practical configuration of which can be derived from the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy, which was released in January 2020.[141]

The following section will analyse these three approaches. Thereafter, section 5. will deal with the unified approach. Please note that the numbers used to illustrate all the approaches are for illustrative purposes only. We are fully aware that a proper economic/ statistical analysis will be required to justify any numbers. On the other hand, such numbers could be the result of a political compromise.

4.2. The modified residual profit split method (MRPSM)

4.2.1. Background

This profit allocation method seems to be a part of the market-related intangibles proposal.[142] The proponents of this approach argue that a traditional or digital MNE may have a significant presence in the market country on a remote basis or through limited local presence to develop market-related intangibles such as brands, trade names, customer data, customer lists and customer relationships. Under the current framework, the taxing rights related to the profit linked to such intangibles that are arguably "sourced"[143] to the market jurisdiction, are not taxed by that jurisdiction. Accordingly, the market-related intangibles proposal seeks to allocate profits to a new "source" or a new concept of taxable income.[144] This proposal seems to be more neutral than the other proposals, i.e. the user participation proposal or the significant economic presence proposal. In order to allocate profits, the MRPSM follows a "top-down" methodology, which consists in the following steps:[145]

(1) determine the total profits of the MNE group;

(2) calculate routine profits allocable to all MNE group members either by resorting to a facts and circumstances transfer pricing analysis or by using a mechanical approach (simplified conventions). Then the routine profits will be deducted from the overall profits in order to arrive at the residual profit;

(3) split the residual profit between profit allocable to trade intangibles and profit allocable to market-related intangibles. In order to evaluate the contribution of market-related intangibles to the residual profit, we may implement several approaches such as using a facts and circumstances transfer pricing analysis or predetermined formulas (simplified conventions); and

(4) reallocates the profit allocable to market-related intangibles to the market country on the basis of an allocation key such as sales or depending on the business model.

4.2.2. Illustration

4.2.2.1. Basic facts

To understand the application of this approach, consider the following example.[146] MS Group, which has its listed ultimate parent entity in Country R, provides cloud-computing services in five countries (this is the only business). According to its consolidated financial statements for year 2021, MS Group has: (i) consolidated group operating revenue of USD 1 billion and (ii) consolidated expenses of USD 600 million. These expenses comprise of USD 150 million in cost of revenues, USD 200 million in research and development (R&D) costs, USD 150 million in marketing and sales (M&S) costs and USD 100 million in other operating costs.

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139. OECD/G20, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy* (OECD 2019) [hereinafter OECD, *Programme of Work* (2019)].
140. OECD/G20, *Secretariat Proposal for a "Unified Approach" under Pillar One* (OECD 2019) [hereinafter OECD, *Secretariat Proposal* (2019)].
141. OECD/G20, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD 2020), available at http://www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf [hereinafter OECD, *Statement on the Two-Pillar Approach* (2020)].
142. OECD, *Public Consultation Document* (2019), at para. 47. At the same time, it should be remarked that the proposal of revisiting the profit split for the purposes of addressing the tax challenges arising from the digitalization of the economy had already been raised in scholarly proposals. *See* Hongler and Pistone, *supra* n. 137 . That original proposal was already set forth within a different normative framework compared to the approach under discussion in this section, as it was not concerned with residual profit split but, rather, it envisaged an upfront income allocation of a partial profit to the market jurisdiction.
143. P. Oosterhuis and A. Parsons, *Destination Based Income Taxation: Neither Principled Nor Practical?* , 71 Tax Law Rev., pp. 522-524 (2018) . *See also* R. Vann, *Taxing International Business Income: Hard Boiled Wonderland and the End of the World* , 2 World Tax J. 3, pp. 336-337 (2010), Journal Articles & Papers IBFD.
144. OECD, *Programme of Work* (2019), at paras. 39-40. *See also* V. Chand, *Allocation of Taxing Rights in the Digitalized Economy: Assessment of Potential Policy Solutions and Recommendation for a Simplified Residual Profit Split Method* , 47 Intertax 12, pp. 1032-1035 (2019).
145. OECD, *Programme of Work* (2019), at para. 28.
146. The example is based on the example presented in New Zealand Government, *Options for Taxing the Digital Economy – a Government Discussion Document* , p. 36 (June 2019).

Therefore, the group operating profits amount to (iii) USD 400 million (we will assume that this amount represents the group's EBT). We will furthermore assume that the group generates 20% of its global revenue from Country S (USD 200 million). It has a subsidiary in Country S which operates as an M&S service provider and this entity is compensated on a cost-plus basis. All of MS Group's residual profit is returned in Country R under the current transfer pricing rules as the parent entity is the owner of the relevant trade and market-related intangibles. In order to allocate profits to Country S, under a facts and circumstances analysis or a predetermined approach, the MRPSM would apply as set out in the following sections.

4.2.2.2. Corporate profit reallocation using a facts and circumstances analysis

Step 1: The group's profit amounts to USD 400 million. This amount appears in the consolidated financial statements as prepared in compliance with Country R's accounting requirements.

Step 2: A routine return remunerates all key functions carried out by the MNE group.[147]

- Under the current profit allocation system, benchmarking of routine returns is done on a separate-entity basis. For example, if an MNE operates with a related low-risk R&D entity (tested party) in India, its return will be compared to similar third-party low-risk R&D entities in India. Essentially, we undertake a comparability analysis on independent databases (if internal comparables do not exist) with the objective of drawing up a *comparable set.* Usually, we derive an interquartile range from the comparable set. If the margins of the tested party fall within the range, the transaction will be considered to be at arm's length.
- The MRPSM can carry out a similar analysis for this step, although it would be a global benchmarking exercise. For example, if an MNE carries out R&D operations in two countries and incurs related costs, the return on those operations will be compared to a *comparable set* of similar third-party entities operating in those two countries. The consolidated comparable set would consist of third-party comparables operating in both jurisdictions. We could derive an interquartile range from the comparable set and we could then consider the median of the range as a routine return for the R&D function. For instance, if the comparable set indicates that the routine return for R&D costs is 10%, the return on total R&D costs of USD 200 will amount to USD 20. We can carry out these global benchmarking exercises for other functions performed by the MNE such as purchasing, manufacturing, marketing and sales as well as administrative activities.
- Another approach involves looking into the activity carried out by the MNE in each country and determining a routine return on that cost. Consider the situation of an MNE that carries out R&D operations in two countries. In Country A, the costs amount to USD 100 and comparable average return is 7%. In Country B, the costs amount to USD 100 and comparable average return in 10%. In this case, the aggregated routine return on combined R&D costs of USD 200 is USD 17. We can also carry out this exercise for other functions performed by the MNE such as purchasing, manufacturing, marketing and sales as well as administrative activities (up to the extent relevant).
- At this point, we would like to highlight that deploying a facts and circumstance analysis in this step could lead to several disputes, particularly multilateral disputes relating to a comparability analysis. Each country in which the MNE performs operations could demand for a higher return.
- For the purpose of our example, we will assume that a transfer pricing analysis fixes the return on all operating costs at 10%. This would imply that the routine profit is USD 60 million (USD 600 million × 10%). The residual profit would then amount to USD 340 million (USD 400 million – USD 60 million).

Step 3: We need to determine the proportion of residual profit attributable to trade intangibles and market-related intangibles. This could be done by resorting to various intangible valuation related approaches.[148]

- One approach involves resorting to a pure market-based approach.[149]However, as this approach requires heavy reliance on external data comparables, it may not be possible to apply it. Under the market-based approach, another possibility is to apply a premium profit method that is typically used for marketing intangibles such as brands or trademarks.[150]However, this approach is not used when dealing with unique intangibles.[151]Therefore, MNEs may have to look into internal data in order to arrive at a ratio to split the residual profits between trade and market-related intangibles.

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147. For another perspective on the calculation of routine returns, *see* M. Devereux et al., *Residual Profit Allocation by Income* , Saïd Business School Working Paper 19/01, pp. 23-28 (2019). At a broader level, for a conceptual reconstruction of the demarcation between routine and non-routine functions, *see* Tavares, *supra* n. 7 , at p. 273.
148. For a detailed discussion on intangible valuation techniques, *see* European Commission, *Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross Border Transactions between Members of Multinational Enterprise Groups in the EU* (EU Publications 2016), available at https://publications.europa.eu/en/publication-detail/-/publication/e7dbd290-c682-11e6-a6db-01aa75ed71a1 (accessed 25 June 2016) [hereinafter EU Commission, *Economic Valuation Techniques* (2016)].
149. Id., at pp. 64-65.
150. For an overview of this method, *see* EU Commission, *Economic Valuation Techniques* (2016), at pp. 179-180.
151. Id., at pp. 74-77.

- A second approach that could be used relates to an income-based valuation approach such as a residual value method.[152] This method starts by determining the value of the entire enterprise and then splits that value between tangible and intangible assets. While doing so, it also follows the routine versus residual logic. In fact, several tax administrations within and outside the European Union already use such an approach.[153] This method involves using a discounted value of projected future income streams or cash flows.[154] However, the TPG recognize that several issues arise with respect to such income-based approaches such as accuracy of financial projections, assumptions regarding growth rates, discount rates, useful life of intangibles and taxes paid.[155] Although possible, it may be rather difficult to determine the value of trade and market-related intangibles at an MNE group or MNE business line level under this approach.
- A third approach relates to a cost-based valuation approach such as a historical cost method or replacement cost method,[156] although the TPG do not recommend the use of such an approach for fully or partly developed intangibles as the value attributable to an intangible may have no or limited connection to the costs incurred in its development.[157] Nevertheless, it is recognized that such an approach could be considered in limited situations.[158] However, we would like to highlight that this approach could lead to several issues, especially (i) issues relating to the identification of costs; (ii) issues surrounding capitalized costs; and (iii) issues relating to the weights to be allocated to R&D costs compared to M&S costs as in some sectors of the economy the former costs are recovered over a longer period of time and so on.[159]
- At this point, we would like to highlight that deploying a facts and circumstance analysis in this step could lead to several disputes, particularly multilateral disputes relating to splitting residual profits. Thus, multilateral consensus will need to be reached in order to tackle the various issues that arise under an income or cost-based valuation technique.
- For purposes of illustration, assume that the cost-based approach is selected. In our simplified example, the MNE group's R&D costs amount to USD 200 million, whereas the M&S costs amount to USD 150 million. Moreover, assume that the weight allocated to the R&D costs is twice that of M&S costs (similar to an R&D step). Thus, the residual profit allocable to market related intangibles will amount to:

$$\frac{USD\ 340\ million\ (residual\ profit)\ \times\ USD\ 150\ million\ (M\&S\ costs)}{USD\ 550\ million\ ((R\&D\ costs\ \times\ 2)\ +\ M\&S\ costs}$$

$$= 92.7\ million\ (approximately)$$

Step 4: We allocate MS Group's market-related intangibles profit between its market countries in proportion to MS Group's revenue from each country. Country S contributes 20% of MS Group's total revenue, so Country S will be allocated 20% of MS Group's market-related intangibles profit. This means that Country S will be allocated 20% × USD 92.7 million = USD 18.54 million profit (approximately). Country S will tax this profit, regardless of whether MS Group has a physical presence in Country S.

4.2.2.3. Corporate profit reallocation using predetermined allocation keys

As a facts and circumstances analysis could lead to multilateral disputes on routine versus residual profits, the use of predetermined approaches could be considered as discussed below.

Step 1: MS Group's profit amounts to USD 400 million and the profit margin amounts to 40% (profit / operating revenues).

Step 2: Simplified conventions could be agreed on a multilateral basis to determine routine returns.

- One approach is to adopt a standard return for all costs, for example, a return of 7.5% as suggested by a research group.[160]

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152. For an overview of this method, *see* id., at pp. 182-184.
153. For a discussion on this method, *see* id., at pp. 70-74.
154. OECD, *Transfer Pricing Guidelines* (2017), at paras. 6.153-6.157.
155. Id., at paras. 6.158-6.178.
156. For an overview of this method, *see* EU Commission, *Economic Valuation Techniques* (2016), at pp. 180-182.
157. Id., at pp. 64-65.
158. OECD, *Transfer Pricing Guidelines* (2017), at paras. 6.143-6.144.
159. For a critical analysis of using a cost-based approach for splitting residual profits, *see* I. Grinberg , *International Taxation in the Era of Digital Disruption* : *Analyzing the Current Debate* , Georgetown Law Faculty Publications, pp. 33-34 (2019).
160. *See* R.S. Avi Yonah, K. Clausing and M.Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt Formulary Profit Split* , Michigan Law Working Paper, pp. 54-55 (Dec. 2008).

- A second approach would entail the design of predetermined returns for each type of function. For example, countries could agree that the MNE group's costs incurred on R&D attract a 10% return; manufacturing costs a return of 8%; M&S costs a return of 8%; administrative costs a return of 5% and so on.
- A third approach would be to simply state that a certain percentage of the overall profit margin of the MNE group is deemed to be a routine return margin. For example, if an MNE group has an overall profit margin of 40% (as in this example), then 3% of that margin will be considered to be a deemed routine profit margin and 37% will be deemed to be residual profit margin. For the purposes of this example, we will assume that a predetermined formula along these lines is developed. This would imply that if an MNE group has a profit margin of less than 3%, then the tax administration will not allocate any profits to the market jurisdiction.

Step 3: Continuing with the above, countries may agree upon a predetermined split. For example, a 75/25 split which divides the residual profit margin between trade intangibles and marketing intangibles. For example, if an MNE group has a residual profit margin of 37% (as in this example), 75% of that will be allocated to trade intangibles and 25% to market-related intangibles.[161]This comes down to 9.25% of the overall profit margin being allocated to market-related intangibles.

Step 4: MS Group's market-related intangibles profit is determined to be 9.25% of the overall revenues, which amounts to USD 92.5 million (USD 1 billion × 9.25%). Country S will be allocated USD 18.5 million ((92.5 × 200) / 1000 = 18.5) of that profit. Country S will tax this profit, regardless of whether MS Group has a physical presence in Country S. This approach could be considered as a "rough" allocation approach.

4.3. Fractional apportionment method

4.3.1. Background

This method seems to relate to the significant economic presence (SEP) concept.[162]The concept works on the assumption that an enterprise, through digital means, can actively intervene in the economic life of another country without having physical presence therein.[163]Under the current framework, the market jurisdiction has no taxing rights, as a PE does not exist therein. Accordingly, the proposal seeks to allocate profits to a new SEP PE or a virtual PE.[164]With respect to the nexus or new taxing right, the proposal applies to a non-resident enterprise (NRE) that exceeds a revenue threshold combined with one or more of the following "plus" factors: user-based factors, digital factors or other factors such as responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services as well as sustained M&S promotion activities. It also seemed that this proposal applied only to highly digitalized businesses (HDBs).[165]Thus, it was argued that it could amount to being a ring-fenced solution.[166]

With respect to resolving the profit attribution issue, the proposal suggested to adopt a fractional apportionment method.[167]While the details of the profit allocation mechanism were not publicly disclosed,[168]reference could be made to a draft report of the Indian tax administration to understand the application of this approach to HDBs.[169]At the same time, it seems that the SEP concept appears to be concerned primarily with nexus, so that it may arguably be combined with other profit allocation approaches other than the fractional apportionment method.[170]

4.3.2. Illustration

4.3.2.1. Basic facts

FB Group, which has its listed ultimate parent entity in Country R, engages in the business of providing online advertisement services in several countries (social network model). According to its consolidated financial statements for year 2019, FB Group has: (i) consolidated group operating revenue of USD1 billion and (ii) consolidated operating expenses of USD 600 million.

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161. *See* Grinberg, *supra* n. 159, at pp. 37-38.
162. OECD, *Public Consultation Document* (2019), at para. 52. Unlike other proposals currently on the table, this proposal was set forth by the G24, a coalition of developing and emerging countries.
163. Id., at para. 50.
164. OECD, *Programme of Work* (2017), at paras. 39-40.
165. For instance, (i) businesses selling digitalized (intangible) products and content through an online platform such as Netflix; (ii) businesses providing an online marketplace for the sale of goods and services such as eBay, Booking.com, Uber and Airbnb; (iii) businesses providing online services such as online advertising services (Facebook or Google), online payment service providers (PayPal), online gaming services (partypoker.com) or cloud computing companies (Microsoft Azure). It should be noted that corporations could also be engaged in all the above-mentioned businesses (such as Amazon or Alibaba) or a combination thereof.
166. UN Committee of Experts on International Cooperation in Tax Matters, *Tax Issues Related to the Digitalization of the Economy: Report* , para. 15 (Apr. 2019). *See* New Zealand Government, *Options for Taxing the Digital Economy – a Government Discussion Document* , para. 4.50 (June 2019).
167. OECD, *Public Consultation Document* (2017), at para. 52; OECD, *Programme of Work* (2017), at paras. 30-31.
168. OECD, *Programme of Work* (2017), at paras. 30-31.
169. CBDT, *Proposal* (2019).
170. *See* in this sense Pistone, Nogueira and Andrade, *supra* n. 137 , at p. 6.

Therefore, the group operating profits (iii) amount to USD 400 million (assume this represents the group's EBITDA). Accordingly, the MNE group to which Company R belongs makes a consolidated operating profit margin of 40% (consolidated operating profit / consolidated sales). Assume that Company R sells its advertisement services on a remote basis in India (based on data collected from Indian users who also happen to view the advertisements promoted on the platform) and derives revenues of USD 200 million. Moreover, one tenth of its global user base is in India (the global user base is 1 billion and users in India total 100 million).

4.3.2.2. Corporate profit reallocation using predetermined allocation keys

Assuming that the online advertiser triggers an SEP, the Indian tax administration proposes in its draft report the following formula to allocate profits to highly digitalized businesses.[171]

$$Profits\ attributable\ to\ operations\ in\ India = Profits\ derived\ from\ India\ \times \left(\left(0.3\ \times \frac{SI}{ST}\right) + \left(0.125\ \times \frac{NI}{NT}\right) + \left(0.125\ \times \frac{WI}{WT}\right) + \left(0.25\,\mathrm{X} \frac{AI}{3 \times AT}\right) \right) + 0.2$$

The application of the formula to the case is discussed below.

Step 1: First, we need to determine the profit derived from India. The proposal contemplates that this could be calculated by applying the global operating profit margin rate[172]to the revenues generated in India. This would imply that profit derived from India would amount to 40% of USD 200 million, i.e. USD 80 million.

Step 2: Second, we must determine allocation keys to split the profit. In the case of fixed place or dependent agent PEs, the draft Indian report contemplates to give equal weight, that is, one third each to employees, tangible assets and sales (destination of sales).[173]However, in the context of certain digitalized businesses, the Indian tax administration argues that users play an important role and thus proposes to allocate a certain weight to users.[174]Essentially, sales will be allocated a weight of 30%, users 10% or 20% (depending on whether they are passive or active users) and the balance will be allocated to assets and employees.[175]The Indian tax administration considers that users play an active role in a social network business. Accordingly, the higher percentage (20%) should be allocated to user participation.

Step 3: On a high level basis, this would mean that out of USD 80 million, 50% of the profit will be allocated to Country R (due to the presence of employees and tangible assets) and 50% will be allocated to India (on the basis of sales and users). Thus, approximately half of USD 80 million, i.e. USD 40 million (approximately), will be the profit of the SEP on which India will levy corporate taxes.

It should be noted that the Indian tax administration is of the view that profits should be allocated to India even if the MNE group makes a loss at the global level. All facts remaining the same, assume that FB Group's consolidated operating profit margin is negative (-30%). Even in such situations, the proposal of the Indian tax administration contemplates that the profits derived from India should be equal to 2% of Indian revenues. Thus, profits derived from India will amount to USD 4 million and a part of those profits will be allocated to the SEP, over which corporate taxes will have to be paid.

It should also be noted that under the current profit allocation system, when sales are made through a related distributor, the related on-seller usually reports an arm's length operating profit margin. However, the report of the Indian tax administration does not provide a clear-cut answer to the question on profit allocation when the MNE sells in India through a local on-seller. This fact shows that this proposal cannot approach the tax challenges of the digitalization of the economy in an isolated way.

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171. "Where: SI = sales revenue derived by Indian operations from sales in India; ST = total sales revenue derived by Indian operations from sales in India and outside India; NI = number of employees employed with respect to Indian operations and located in India; NT = total number of employees employed with respect to Indian operations and located in India and outside India; WI= wages paid to employees employed with respect to Indian operations and located in India; WT = total wages paid to employees employed with respect to Indian operations and located in India and outside India; AI = assets deployed for Indian operations and located in India; AT = total assets deployed for Indian operations and located in India and outside India". *See* CBDT, *Proposal* (2019), at paras. 199-200.
172. The EBITDA margin is to be taken as the global operational profit margin. *See* CBDT, *Proposal* (2019), at para. 159. It is not clear if this represents the EBIDTA margin of the MNE or the selling entity. For the purpose of our example, it will be assumed that it represents the former.
173. CBDT, *Proposal* (2019), at paras. 152-158.
174. In the authors' opinion, users do not create value. Several commentators support this position. *See* Devereux and Vella, *supra* n. 137 , at pp. 20-22; I. Grinberg, *User Participation in Value Creation* , 4 BTR, pp. 413-417 (2018); W. Schön, *Ten Questions about Why and How to Tax the Digitalized Economy* , Max Planck Institute for Tax Law and Public Finance, Working Paper 2017-11, p. 26 (2018); Becker and Englisch, *supra* n. 137 , at pp. 166-170; M. Olbert and C. Spengel, *Taxation in the Digital Economy – Recent Policy Developments and the Question of Value Creation* , 2 Intl. Tax Stud. 3 (2019), Journal Articles & Papers IBFD.
175. CBDT, *Proposal* (2019), at paras. 176-178.

4.4. Distribution-based approach

4.4.1. Background

The distribution-based approach follows a proposal made by Johnson & Johnson[176]and seems to relate to the market-related intangibles proposal. The proposal follows a "bottom-up" methodology. To understand this approach, we must highlight a difference between two situations: (i) when an NRE operates with a local taxable presence in the market country, that is, through a separate entity or a PE that could be characterized as a distributor, and (ii) when an NRE operates in the market country on a remote basis.

4.4.2. Illustration

4.4.2.1. Basic facts

Consider the following example. JJ Group, which has its listed ultimate parent entity in Country R (Company R), engages in the business of selling consumer facing goods in five countries. According to its consolidated financial statements for 2019, JJ Group has: (i) consolidated group operating revenue of USD 1 billion and (ii) consolidated operating expenses of USD 600 million. Therefore, the group operating profits amount to (iii) USD 400 million (this represents the group's EBT). Assume that the group generates 20% of its global revenue from Country S (USD 200 million). Specifically, the MNE has a subsidiary in Country S which qualifies as a distributor. The staff in the distributor purchases the products from Company R and sells the products to local clients. The local marketing expenses incurred by the distributor amount to 20% of local sales. Moreover, the MNE generates 10% of its global revenue from Country S1 (USD 100 million). The sales in Country S1 are made on a remote basis. All of JJ Group's residual profit returns to Country R under the current transfer pricing rules as the parent entity is the owner of the relevant trade and market-related intangibles. In order to allocate profits to Country S or Country S1, the distribution approach would apply as follows:

4.4.2.2. Corporate profit reallocation in Country S

Step 1: With respect to this situation, the proposal allocates a baseline profit (or a minimum routine return) to the distributor for its marketing or distribution-related activities. This baseline return could be a predetermined fixed percentage, for example, 3% on sales made in that country (or could be based on industry or market-related margins). This would imply that the minimum profit of the distributor in Country S is USD 6 million (USD 200 million × 3%). One advantage of this approach is that it reduces disputes with respect to distributor structures.

Step 2: Thereafter, the baseline profit could be increased or decreased based on the MNE group's overall profitability. In this way, we could reallocate a portion of the residual return (or loss). For example, countries could agree that if the operating profit margin of an MNE group exceeds a certain predetermined percentage (for instance, 12%), a portion of that excess (for instance, 20%) should be allocated to the market country. Conversely, if the operating profit margin of an MNE group is lower than a certain predetermined percentage (for instance, 12%), a portion of that lower amount (for instance, 20%) should be deducted from the baseline profit. Applying this approach to our example leads to the following result. JJ Group's operating profit margin amounts to 40%. The predetermined margin or lever is 12%. The excess or residual margin is 40% – 12% = 28%. A portion of that excess (28 × 20% = 5.6% on sales) should be allocated to the market jurisdiction. Essentially, 5.6% of USD 200 million = USD 11.2 million should be allocated to Country S.

Step 3: Subsequently, the profit could be increased or decreased based on an MNE group's local country marketing spend or expenditure (LCMS) as a percentage of local sales (revenue) compared to a target. For example, countries could agree that if the LCMS / local sales exceeds a certain predetermined target (for instance, 10%), a portion of that excess (for instance, 20%) should be allocated to the market country. On the contrary, countries could agree that if the LCMS / local sales is less than a certain predetermined target (for instance, 10%), a portion of the lower amount (for instance, 20%) should be deducted from the profit percentage determined in the previous steps. Applying this to our example leads to the following result. The LCMS / local sales is 20%. The predetermined margin or lever is 10%. The excess or residual margin is 20% – 10% = 10%. A portion of that excess (10 × 20% = 2%) should be allocated to the market jurisdiction. Essentially, an additional 2% of USD 200 million = USD 4 million should be allocated to Country S. The logic behind this step is that a higher degree of marketing spend related to a country indicates that the MNE has made substantial efforts to develop market-related intangibles in that Country. Accordingly, the higher the marketing spend as a percentage of local revenue, the higher the profit allocation to the market. Moreover, this step would account for differences in margins between brand-focused business-to-consumer (B2C) products versus less brand-focused business-to-business (B2B) products.

In conclusion, the distributor will report a routine return or base profit of USD 6 million (Step 1) plus an excess return of USD 11.2 million (Step 2) + USD 4 million (Step 3), which amounts to USD 21.2 million on an overall basis.

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176. *See* Public Comments by Johnson & Johnson to the OECD, *Secretariat Proposal* (2019), at pp. 1-5, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-possible-solutions-to-the-tax-challenges-of-digitalisation.htm (accessed 1 Mar. 2020).

4.4.2.3. Corporate profit reallocation in Country S1

At the time of writing, it was not quite clear as to how this solution allocates profits for sales made on a remote basis. The programme of work raises this issue and states “an issue that will need to be explored is whether the amount of profit (including any baseline profit) taxable by that market jurisdiction would be the same as for locally-based marketing and distribution activities, or whether that amount should be reduced in some formulaic manner”.[177] Most likely, a new nexus to pin down the allocation of the income on a formulaic basis would need to be introduced, which shows that this proposal cannot approach the tax challenges of the digitalization of the economy in an isolated way.

4.5. The unified approach

4.5.1. Assessing the three approaches: Is there room for unification?

The application of the facts and circumstances ALP approach is inherently subjective. Arguably, the fractional apportionment method brings more objectivity in the MNE profit allocation system. However, the adoption of this method as contemplated by the Indian tax administration (*see* section 4.3.2.2.), at this stage, seems rather unlikely as it is linked to the SEP proposal which seems to be applicable only to HDBs. Moreover, the method does not provide satisfactory answers when a MNE sells into a market country through a related distributor.

The ALP can also fit into the MRPSM. For instance, the ALP could be used to calculate group routine returns (Step 2) or to calculate group residual returns allocable to market-related intangibles (Step 3). However, the analysis could be rather subjective and could lead to multilateral tax disputes. Thus, the use of simplified conventions in the form of predetermined formulas could be considered in its various steps. In fact, out of all the three methods that have been analysed, the MRPSM seems to be the only method which could be applied to traditional as well as HDBs.

In comparison to the MRPSM, the distribution-based approach seems less complex. It does not require the determination of group-wide routine and residual returns. Moreover, it also does not require the determination of an allocation key to arrive at a split between trade and market-related intangibles. However, it is difficult to ascertain as to whether this method will operate within the ALP framework through the use of safe harbours or whether it will allocate routine and residual profits based on predetermined formulas. Moreover, the method seems to apply to traditional businesses (for instance, consumer goods) that operate with distribution structures in the market country as opposed to HDBs that operate remotely. On the positive side, by adopting simplified formulaic approaches to determine the return assigned to the destination sale market, such an approach could closely approximate the arm’s length result for most limited risk distribution transactions and yet provide some formulaic profit participation beyond a current arm’s length result for the destination sales market where the MNE group’s profits are above normal returns. Such an approach would significantly reduce the reliance on subjective professional judgment.

The different profit allocation regimes do not appear mutually exclusive and may be combined to reflect a two-tiered “unified”[178] approach along a continuum, with formulaic approaches being of suitable adoption in those situations where they represent a more efficient alternative or in all those situations where the comparability analysis cannot be conducted in a suitable way for intrinsic or extrinsic reasons. This finding seems to be consonant with anticipations from more remote but still topical scholarly contributions, according to which “[t]he international norm [i.e. as reflected by the Associated Enterprise provision to be found in tax treaties] is the use of comparable prices when they are available and some blend of intuitive, informal ad hoc methods when they are not”.[179]

In fact, several commonalities exist between the various approaches. First, all three approaches make a reference to MNE group profits. Second, the MRPSM and the distribution-based approach discuss the concept of routine and residual profits. In this regard, both approaches discuss the possibility of using simplified mechanisms (formulas) in calculating residual as well as routine profits. Third, the fractional apportionment method and the distribution-based approach, in one way or another, seek to find a solution within the separate-entity approach (but somehow the approaches are linked to MNE group profits). In light of this discussion, the question then arises as to what can a coordinated approach concretely look like?

4.5.2. What does the “unified approach” towards profit allocation look like?

As highlighted previously, among the three methods, the MRPSM seems to be the only method which could be applied to traditional businesses as well as HDBs. However, using the ALP in this solution creates significant uncertainty (*see* section 4.2.2.2.). Therefore, one possibility would be to base the MRPSM on predetermined formulas to reallocate a part of the residual profits. Ideally, the formulas should be in the form of a safe harbour. However, they could lead to significant compliance costs for the taxpayer and the tax administration if the potential case ends up in a tax dispute. This could be the case when, for instance,

177. *See also* OECD, *Programme of Work* (2019), at para. 35.
178. To use the expression first adopted in the OECD, *Programme of Work* (2019) and then crystallized in the OECD, *Secretariat Proposal* (2019).
179. *See* S.I. Langbein, *The Unitary Method and the Myth of Arm’s Length* , Tax Notes Special Report, p. 653 (1986).

the taxpayer does not agree with the safe harbour and puts forward its facts and circumstances analysis. Therefore, the authors propose to find an MNE group solution purely on the basis of formulas, that is, on the basis of deemed profit margins (*see* section 4.2.2.3.). The MNE group solution would seek to reallocate a part of the MNE group's residual profits to the market country. Such an approach will meet the Pillar 1 expectations of a greater allocation to the market jurisdictions where above normal routine returns exist. Moreover, by using predetermined formulas, a much more administrable system may be created, and tax certainty might be significantly increased, while at the same time fostering the depoliticization of international tax disputes – a desirable goal[180]that the current highly subjective system does not adequately guarantee. Clearly, this approach will go beyond the ALP framework as it is currently understood and may signal, although with important deviations, convergences towards certain national experiences based on predetermined approaches (*see* section 3.5.). In the OECD's terminology, this approach seems to reflect Amount A.[181]

At the same time, the application of the ALP can be retained at the separate-entity level, especially with respect to the allocation of profits to marketing/distribution-related activities. This is where a simplified distribution-based approach could come into play. For example, under this approach a distributor, which carries out routine marketing and distribution activities, will be allocated a guaranteed routine return, perhaps derived as a percentage of sales (for instance, 3% of sales – *see* the discussion with respect to Step 1 in section 4.4.2.2.). However, if the facts and circumstances indicate that the distributor should be entitled to a higher or lower return (for example, because it carries out activities in excess of the routine activities), that return should be allocated to it: such a recharacterization could closely approximate the arm's length result for most transactions and would thus foster the reconciliation of the concerned approach with the ALP. In the OECD's terminology, this approach seems to reflect Amount B and Amount C.[182]

The final section of this article will focus on these approaches, that is, the simplified MRPSM and the distribution-based approach.

5. Answers to Several Key Questions on Profit Allocation within MNEs in the New Decade

5.1. The MNE group approach and Amount A

5.1.1. Determination of MNE group profits (losses)

In relation to the simplified MRPSM, at the outset, the question arises whether the profit of the whole MNE group or the profit of a relevant MNE business line (if the MNE has more than one business line) is subject to a potential solution.[183][184]Arguably, devising a potential solution with respect to a consolidated group income seems simpler and more predictable. However, such an approach may not provide accurate results as different businesses could be mixed with each other. Accordingly, it would intuitively make sense to have a relevant MNE business line approach in order to obtain more accurate results.[185][186]But is it easy to obtain this accuracy?

If an MNE business line approach is followed, an initial question that arises is what is an MNE business line? MNEs could be structured on the basis of a functional structure, divisional structure or a matrix structure.[187]In other words, some MNEs may operate with a centralized business line, that is, through a centralized entrepreneur in one country. Others may have decentralized business lines with local entrepreneurs. Some other MNEs may disclose a particular business line in their consolidated financial statements on a regional basis (United States or North America, Europe, Asia-Pacific and so on). Thus, it would be difficult to define a business line. A related issue is the extent to which an MNE could go granular with respect to its business line information. Consider the following example:

- If an MNE (L) is engaged in selling wine and spirits as well as fashion and leather goods, what are its business lines? In this situation, it is straightforward to say that the MNE has two different businesses lines.

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180. Depoliticization appears to be an important trend in international economic law at large, primarily, but not limited to, the area of investment disputes. Since transfer pricing is likely to qualify as one of the most dispute-inducing areas of international tax law, depoliticization would appear also in this case a policy objective particularly worth pursuing. For an introduction to the concept of depoliticization, *see* P. Picone, G. Sacerdoti, *Diritto internazionale dell'economia* (II ed., Franco Angeli 1986); D. Carreau, P. Julliard, *Droit International économique* (IV ed., Dalloz 1998); A. Lowenfeld, *International Economic Law* (II ed., OUP 2008); A. Qureshi and A. Ziegler, *International Economic Law* (III ed., Sweet & Maxwell 2011).
181. OECD, *Secretariat Proposal* (2019), at para. 30 and paras. 51-61.
182. Id., at para. 30 and paras. 62-65.
183. Id., at para. 32.
184. J. Andrus and P. Oosterhuis, *Transfer Pricing After BEPS: Where Are We and Where Should We Be Going* , 95 Taxes: The Magazine 3, p. 97 (2017).
185. OECD, *Secretariat Proposal* (2019), at paras. 30, 51 and 53. *See also* Public Comments to the OECD, *Secretariat Proposal* (2019), in particular, Booking.com, p. 6; Danon, Chand, pp. 20-24, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
186. *See also* , OECD, *Programme of Work* (2019), at para. 36.
187. *See* *UN TP Manual* (2017), at paras. A.3.3.1-A.3.3.3.

- What if the fashion and leather goods business of MNE L is divided between goods for men and women? Will the men and women business constitute two different business lines or are they part of the same business line?
- Within the men goods business, goods could be developed for teenagers and working professionals. Do they represent two different business lines or the same business line?
- Within the working professionals goods business line, the operating margins could be different for the US market in comparison with the European market. In this regard, should this business line be further segmented into a regional business line?

The next issue relates to the determination of consolidated profits (or tax base) of that business line. Currently, every country has its own way to assess the taxable income of a taxpayer resident in its jurisdiction. Specifically, countries have different approaches regarding revenue assessment, cost recognition, depreciation or amortization of tangible and intangible property and so on. Essentially, harmonization does not exist among countries.[188]Although the EU Commission had made efforts to develop a common tax base in its CCCTB project, this has not yet been implemented and several countries have expressed their disagreement with some of its provisions.[189]Therefore, developing a common measurement of taxable income among all the members of the inclusive framework, which comprises almost 130 countries, seems unlikely at this stage and other solutions may need to be developed.

In order to overcome the foregoing challenges, one possible simplification approach to implement the simplified MRPSM involves referring to consolidated financial statements (in particular, consolidated income statements) that have been prepared in accordance with the rules mandated by the jurisdiction of the ultimate parent company of the MNE Group.[190][191]These statements could be considered as a starting point for the analysis (local GAAP or IFRS).[192]This said, although consolidated statements provide a good overview of the MNE, they may not contain detailed information about an MNE's business line. Accordingly, we do acknowledge that it could be challenging to obtain MNE business line profit (loss) details simply by looking into consolidated financial statements. Thus, this information needs to be gathered perhaps by looking into internal data such as managerial accounting records. However, the information from such records is less regulated than financial accounting information that is prepared for external stakeholders. Consequently, the information obtained from such managerial records will need to be cross-checked with the consolidated financial statements to ensure consistency with the numbers that are being reported. In this regard, one possibility is to give the taxpayer the option to report MNE business line information. This information could then be audited by an independent auditor of the jurisdiction of the ultimate parent company of the MNE group.

Under the above-mentioned possibilities, policymakers could develop further guidance on this matter by resorting to IFRS 8 , which deals with reporting operating segments.[193]However, the authors are of the opinion that, if the level of details that is required for applying an MNE business line approach become extremely cumbersome, the consolidated business line approach should be considered[194](at least as a safe harbour or gateway for Amount A).[195]

Another important question arises with respect to determining the appropriate profit margin indicator for the application of the MRPSM. First, should gross or net profits be considered? As the objective of the proposal is to allocate profits to market countries, we believe that net profit (or operating profit) information should be considered.

Second, if net or operating profits, should these profits be based on an earnings before taxes (EBT), EBIT or earnings before interest, taxes, depreciation and amortization (EBITDA) figure? In other words, what is the numerator for determining the overall profit margin? In this regard, it should be noted that in BEPS Action 4, it seems that the OECD gave a preference towards using EBITDA as it reflects an objective measure of economic activity.[196]Also, India, in the context of discussing the fractional apportionment method, showed a preference towards EBITDA.[197]More generally, the choice of EBITDA as a profit indicator to represent group profits appears to be suggested also by the circumstance that EBITDA is not affected by potential disalignments

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188. Andrus and Oosterhuis, *supra* n. 184 , at p. 97.
189. For an update of the state of play of the CCCTB Project within the European Union, *see* https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en (accessed 4 Oct. 2019). For a selected assessment of the criticalities of the proposal over time, *see* C. Spengel, Y. Zoellkau, *Common Corporate Tax Base (CC(C)TB) and Determination of Taxable Income: An International Comparison* (Springer 2012); M. Grandinetti, *Corporate Tax Base in the Light of the IAS/IFRS and EU Directive 2013/2014: A Comparative Approach* (Kluwer Law International 2016); D. Weber, J.L. van de Streek, *The EU Common Consolidated Corporate Tax Base* (Kluwer Law International 2018). With regard to the most recent developments in terms of political framework, *see* L. Aumayr, G. Mayr, *CCTB – Is There a Chance of Breakthrough?* , 59 Eur. Taxn. 4, p. 153 (2019).
190. Avi Yonah, Clausing and Durst, *supra* n. 160 , at pp. 33-35; Devereux et al., *supra* n. 147 , at pp. 86-90.
191. OECD, *Secretariat Proposal* (2019), at para. 53.
192. OECD/G20, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report* , paras. 121-126 (OECD 2015), Primary Sources IBFD [hereinafter *Action 4 Final Report* (2015)].
193. *See* https://www.iasplus.com/en/standards/ifrs/ifrs8 (accessed 25 June 2020).
194. Uber, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 3, available at: https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
195. Chand, *supra* n. 144 , at sec. 6.3.
196. *Action 4 Final Report* (2015), at para. 141.
197. CBDT, *Proposal* (2019), at para. 159.

on how depreciation is accounted for tax purposes or what interest can be offset against taxable profits.[198]On the other hand, EBIT figures are commonly used in a transfer pricing analysis.[199]

While there are pros and cons towards using the foregoing two indicators, we believe that consideration should also be given to EBT as it is the most appropriate indicator to determine the true profitability of a business. In fact, several commentators to the public consultation on the "unified approach" support the use of this indicator,[200]and so does the OECD.[201]In order to determine the EBT, several issues could arise on the "revenue" side as well as the "expenses" side. Specifically, issues could arise with respect to determining revenues or splitting costs when some business lines of a large MNE are within the scope of Amount A and others are not.[202]Moreover, certain adjustments will be required for exceptional or extraordinary income or expenses as the true profitability of the business as a continuing business should not be hampered by one-off or non-recurring events (for example, gains or expenditure connected with acquisitions, changes in a one-off valuation of intangible assets, etc.).[203]In this regard, one possibility is to give the MNE the option to report MNE business line information on a "just and reasonable basis" (as discussed in the guidance on the UK DST).[204]

Third, what should the numerator be weighed against in order to obtain a profit margin? As the objective of this new taxing right is to reallocate profits to the market jurisdiction on the basis on sales, an appropriate denominator would be sales[205](for an illustration, *see* section 4.2.2.3.).

5.1.2. Treatment of losses

Principles of taxation warrant relief for losses.[206]At the outset, we submit that carry-forward of losses should be considered as opposed to a carry-back system as the latter approach raises several administrative issues. Moreover, carry-back systems could raise budgetary concerns for governments.[207]Ideally, the MRPSM should consists of a mechanism which provides relief for losses. Two types of losses can be considered, that is, pre-existing losses that need to be brought into the Amount A regime and losses earned within the Amount A regime.[208]

With respect to the latter type of losses, consider the following additional key facts in relation to the case study discussed in section 4.2.2.3. that deals with the MS Group, which provides only cloud computing services. In 2020, MS Group has a loss margin of 20%. Its global sales are USD 1 billion. In 2021, the group has a profit margin of 40%. Its global sales are USD 1 billion. The application of the simplified MRPSM in year 2020 would lead to the following conclusion:

Step 1: The business lines consolidated loss amounts to USD 200 million and the consolidated operating loss margin amounts to 20%.

Step 2: Simplified conventions could be agreed on a multilateral basis. Assume that a deemed routine margin is fixed at 3%, which would equally apply to losses. This would imply that if an MNE group has an operating profit margin loss, this fixed percentage will be added to the loss amount. This would amount to 20% + 3% = 23%.

Step 3: Continuing with the above, countries may agree upon a predetermined split for the residual profit (loss). For example, assume that countries agree to a 75/25 split, which divides the residual operating loss margin between trade intangibles and marketing intangibles. For example, if an MNE group has a residual operating loss margin of 23% (as in Step 2 of this example), 75% of that is allocated to trade intangibles whereas 25% is allocated to market-related intangibles. Essentially, 5.75% of the overall operating loss margin will be allocated to market-related intangibles.

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198. *See* in this sense R. Murphy and P. Sikka, *Unitary Taxation: The Tax Base and the Role of Accounting* , in *Taxing Multinational Enterprises as Unitary Firms* pp. 85-86(S. Picciotto, ed., ICTD 2017). *See also* J. Gadwood and P. Morton, *General Report* , in *Interest Deductibility: The Implementation of BEPS Action 4* (IFA Cahiers vol. 104a, IBFD 2019).
199. To calculate net profits (although in a separate-entity context), *see* OECD , *Transfer Pricing Guidelines* (2017), at paras. 2.83-2.91 (with an emphasis on para. 2.86). The United Kingdom also seems to prefer using this indicator in order to determine the operating margin. *See* HM Treasury, *Digital Services Tax Draft Guidance* (2019), pp. 47-48.
200. *See* Nestle, in Public Comments to the OECD, *Secretariat Proposal* (2019, at p. 10; Booking.com, at p. 10; PwC, at pp. 13-16; EY, at p. 9; Deloitte, at p. 5. All available at: https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
201. OECD, *Statement on the Two-Pillar Approach* (2020), at para. 44.
202. HM Treasury, *supra* n. 199 .
203. For a discussion on this matter, *see* HM Treasury, *supra* n. 199 , at p. 48; *See also* Unilever, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 10; Amazon, at p. 6; Skadden, at p. 8. All available at: https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
204. *See* HMRC, *Digital Services Tax Manual* (Mar. 2020), available at https://www.gov.uk/hmrc-internal-manuals/digital-services-tax/dst20000 (accessed 1 July 2020).
205. *See also* OECD, *Transfer Pricing Guidelines* (2017), at paras. 2.96-2.97.
206. *See* OECD, *Corporate Loss Utilisation through Aggressive Tax Planning* p. 26 (OECD 2011).
207. In this regard, *see also* Skadden, in Public Comments to the OECD, *Secretariat Proposal* (2019), at pp. 10-11; Danon and Chand, at pp. 28-30. Both available at: https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
208. OECD, *Statement on the Two-Pillar Approach* (2020), at para. 44.

Step 4: MS Group's market-related intangibles loss is determined to be 5.75% of the overall revenues, which amounts to USD 57.5 million (USD 1 billion × 5.75%). This loss will be carried forward for set-off against profits for future years. Thereafter, the profit (after taking into consideration the losses) will be reallocated to the market jurisdiction.

To illustrate, in 2021 (*see* section 4.2.2.3.), applying the four-step approach will lead to the conclusion that the market-related intangibles profits amount to USD 92.5 million. This amount will be reduced by the year 2020 loss of USD 57.5 million, thus amounting to a profit, which can be reallocated, of USD 35 million.

Appropriate consideration should be given to pre-existing losses that need to be brought into the Amount A regime before it becomes operational. For example, MS Group could be making losses at a consolidated level before entering into the Amount A regime in the past four years, with losses of 30 million in 2016, 40 million in 2017, 50 million in 2018 and 60 million in 2019. One possible simple approach to deal with such losses is to simply state that the loss carry-forward available to the MNE group before entering into the regime amounts to the sum total of the losses incurred in the past four years.[209] This would amount to USD 180 million. This loss amount can then be carried forward on an unlimited basis for set-off against profits for future years. Thereafter, the profit (after taking into consideration the losses) will be reallocated to the market jurisdiction.

5.1.3. Determination of location of sales or revenue sourcing

5.1.3.1. Preliminary remarks

The simplified MRPSM (as well as the new nexus rules) also requires the determination of the market country[210] that could exercise its taxing right. As recent scholarship has poignantly observed, "[t]he number one technical question for any 'Pillar 1' proposal is defining the destination of sales […]. The destination of sales is the gating issue: without an answer to this question, no 'Pillar 1' solution is viable".[211]

In order to determine this, one possibility would be to refer to direct tax legislation/guidance of certain countries that allocate unitary corporate business profits based on several factors, such as the United States. Several US states have used the so-called "Massachusetts formula", which allocates the income or profit of a multi-state corporation among US states by assigning equal weight to factors such as payroll, assets and sales.[212] However, over a period of time, several US States have moved away from a three-factor formula to a single-factor formula, that is, sales.[213] Naturally, the question arises as to how should the state of sales for a multi-state corporation operating in the United States be determined? In this regard, the Multistate Tax Commission[214] has developed a common set of rules, in particular with respect to the receipts (sales) factor. Specifically, rules have been put forward to determine the location of sales of tangible property[215] and market-based sourcing rules have been developed with respect to transactions that deal with services and intangibles (including franchising). These rules determine the location of sales by using certain approximations.[216]

Another possibility would be to refer to VAT principles[217] that use proxies to determine the jurisdiction in which the final consumption occurs.[218] VAT legislations contain place-of-supply or place-of-taxation rules for B2B or B2C transactions with respect to goods, services and intangibles. For instance, a reference could be made to the work already done by the OECD in the context of its International VAT/GST Guidelines.[219]

Moreover, for certain HDBs, reference could be made to the work done by the European Commission[220] or national governments (such as the United Kingdom)[221] in the context of DSTs.

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209. An MNE prefers a time period of ten years. *See* Uber, in Public Comments to the OECD, *Secretariat Proposal* (2019), p. 6, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
210. OECD, *Statement on the Two-Pillar Approach* (2020), at para. 41; *see* Danon and Chand, in Public Comments to the OECD, *Secretariat Proposal* (2019), at pp. 30-36, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
211. *See* I. Grinberg, *Stabilizing "Pillar One": Corporate Profit Reallocation in an Uncertain Environment* , Georgetown University Working Paper, p. 41 (2019).
212. A similar system also exists in Canada, in particular in its provinces. *See* European Commission, Taxation Papers, *Formulary Apportionment and Group Taxation In the European Union: Insights From the United States and Canada* , Woking Paper No 8 2005, pp. 10-15 (2005). *See also* Avi Yonah, Clausing and Durst, *supra* n. 160 , at pp. 54-55.
213. *See* Federation of Tax Administrators, State Apportionment of Corporate Income (2020), available at https://www.taxadmin.org/assets/docs/Research/Rates/apport.pdf .
214. For instance, *see* Multistate Tax Commission, Model General Allocation & Apportionment Regulations With Amendments Submitted for Adoption by the Commission February 24, 2017, available at http://www.mtc.gov/getattachment/Events-Training/2017/Special-Meeting/FINAL-APPROVED-2017-Proposed-Amendments-to-General-Allocation-and-Apportionment-Regulat.pdf.aspx .
215. Id., at pp. 50-52.
216. Id., at pp. 52-100.
217. Amazon, in Public Comments to the OECD, *Secretariat Proposal* (2019), at pp. 4 and 9, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
218. *See* W. Hellerstein, *A Hitchhiker's Guide to the OECD's International VAT/GST Guidelines* , 18 FLA. Tax Rev., p. 598 (2016).
219. OECD, *International VAT/GST Guidelines* (OECD 2017).
220. European Commission, Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services , COM(2018) 148 final, art. 5 (2018), Primary Sources IBFD.

Several commonalities emerge from the above three different frameworks. The first commonality pertains to the use of approximations or proxies to determine the location of sale. Second, the rules focus on the location of the customer (user) and/or the use or consumption by that customer (user). It should be noted that use or consumption could have different meanings in different business models. Therefore, for the purpose of developing sourcing rules we suggest that proxies/approximations be considered which could determine the location of the purchaser (customer location) or the final place of use or consumption (consumer consumption location or user location).[222]We elaborate on this point in the following sections.

5.1.3.2. Consumer-facing businesses

At the outset, if the MRPSM is based on an MNE business line approach, the focus should be placed on the core commercial activity of that business line. For example, if an MNE (headquartered in Country R) is in the business of making and selling branded handbags, the focus should be on ascertaining the location in which the branded handbags are sold to unrelated customers. Consequently, intercompany transactions among related entities will need to be discarded.[223]

With respect to determining the sales location, as a starting point, the location of the third-party unrelated purchaser (customer location) could be considered as a reasonable proxy.[224]For instance, if Company R of State R, which belongs to MNE Group R, sells goods/services/franchises to an unrelated business (A) or a private customer (Mrs B) in State S then the sales location is State S. This would be the case even if Company R sells to A or Mrs B through related parties or associated enterprises.

An issue could arise when, for example, the unrelated business A (who is in State S) purchases goods from Company R for its various establishments, for instance, its PEs or subsidiaries in Country S1, S2, S3, etc. In this case, the question arises as to whether the consumption location proxy should be preferred over the customer location proxy? Ideally, this should be the case. To illustrate, assume that Company R, which is a tax resident of State R and which belongs to MNE Group R, enters into a contract for sale of goods with an unrelated client A (who is a tax resident in State S). According to this contract, MNE Group R is required to deliver the goods to A’s PE in State S1. In this case, the market country for MNE Group R would be State S1 and not State S, as the goods are shipped to the former. On the other hand, if MNE Group R ships the goods to A in State S and A subsequently moves the products by his own means to State S1, the market country from MNE Group R’s perspective should be State S. MNE Group R (who will be subject to Amount A) likely does not have this information on what is to be the final destination of the goods supplied. This said, if MNE Group R would have this information, the market country may be State S1. Similar issues arise with respect to services and intangibles. Thus, this is one area in which reasonable approximation rules/proxies (giving preference to consumption location) will need to be developed either by referring to the US market-based sourcing rules or VAT legislations.

Also, in some situations (mostly B2B transactions), MNE Group R may wish to avoid taxes by taking advantage of the customer location proxy.[225]For example, there could be situations where an MNE group engaged in selling products could engage in tax planning or tax avoidance strategies such as routing sales through an independent distributor which is established in a no-tax or low-tax jurisdiction. In such a case, a specific anti-avoidance rule could be developed (SAAR). For instance, such a rule could deem the unrelated enterprise (the independent distributor) to be closely related if it substantially depends economically on the MNE.[226]The SAAR could also be backed by a new general anti-avoidance rule (GAAR).

5.1.3.3. Automated digital businesses: The case of online advertisers and online marketplaces

Special attention should be given to HDBs that create user networks as the customer location proxy may not be helpful in this area. Accordingly, specific revenue sourcing rules will need to be developed linked to user location or activities of the user.

A first example pertains to online advertisers that engage in targeted advertising. Consider the following triangular situation. Company I, which belongs to Group I, is a tax resident in Country R for its European operations and the users that maintain their profiles on the online platform live in Country U. Essentially, Company I gives its users the right to maintain their profiles on the platform and in return users contribute their personal data. Thereafter, the employees in Country R process that raw data and

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221. HM Treasury, *supra* n. 199 .
222. M. Devereux and R. De la Feria, ***Designing and Implementing a Destination Based Corporate Tax*** , Oxford University Center for Business Taxation, WP 14/07, pp. 14-18 (2014); A. Auerbach et al., ***Destination-Based Cash Flow Taxation*** , Saïd Business School Working Paper 2017/09, pp. 80-82 (2017); M. Devereux et al., ***Residual Profit Allocation by Income*** , Saïd Business School Working Paper 2019/01, pp. 86-90 (2019); ***see also*** U. Schreiber and L. Fell, *International Profit Allocation, Intangibles and Sales-Based Transactional Profit Split* , 9 World Tax J. 1, pp. 111-114 (2017), Journal Articles & Papers IBFD.
223. Amazon, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 4, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
224. Procter and Gamble, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 9; Amazon, at p. 4. Both available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
225. J.C. Fleming, R.J. Peroni and S. Shay, ***Formulary Apportionment in the US International Tax System: Putting Lipstick on a Pig?*** , 36 Mich. J. Int'l L. 1, pp. 39-46 (2014).
226. Some commentators have argued that they will not engage in such strategies as the cost of transporting products becomes more expensive. *See* Procter and Gamble, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 9, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).

sell targeted advertising services to clients (Company B) in Country B. The service pertains to displaying Company B's product/ services to Country U users. The contract stipulates that Company B will pay advertisement fees to Company I based on the number of times a user clicks on the advertisement. In this situation, the payor of the advertisement fee is in Country B (customer location) and the users/viewers of the advertisement are in Country U (viewing location).

The question arises as to whom should the taxing right on Amount A be allocated – to Country U or to Country B? One possibility is to allocate the income to Country U as these businesses (Company I) create and exploit user networks. In other words, the income could be sourced to Country U. Thus, a possible approach to determine Country U relevant revenues is to ascertain whether the advertising is intended to be viewed by a Country U user. In the above example, all the revenue is linked to Country U as the advertisements are intended to be displayed only for Country U users.[227]The analysis becomes more complex when Company B pays Company I for promoting their product/service in more than one user country (assume Country U1 and Country U2) or if Company I has multiple clients (which is usually the case). The question then arises as to how do you determine revenues linked to different user countries? In this regard, as discussed in the context of the UK DST, the revenue could be apportioned to each country based on certain criteria which could range from the contractual requirements, the relative volume of users in each jurisdiction, the revenue per user in each jurisdiction, the relative engagement of users in each jurisdiction, the size and maturity of the platform in each jurisdiction, the average profitability or revenue performance in each jurisdiction and so on.[228]However, such criteria could complicate the analysis. Thus, to ease administration, a safe harbour could be developed and could be based on the number of users. For instance, the safe harbour would assume that one user equals one display.[229]As an alternate, in order to overcome the challenges associated with determining the user location,[230]commentators have suggested to allocate the income to Country B.[231]This conclusion could also be supported by the fact that Country B allows Company B a deduction for the fees paid to Company I.[232]We do not agree with this latter approach.

The second example pertains to online marketplaces. Such marketplaces could connect users with each other for a wide range of underlying activities such as a service (an accommodation service, a transportation service, etc.), sale of goods activity or matchmaking (dating) and so on. At the outset, a general rule could be developed which could source the revenue to the location of the user.[233]In fact, the UK HMRC also follows a similar position.[234]On the other hand, the general rule could be set aside for a specific rule depending on the underlying transaction. Consider the following example.

Company B, which belongs to Group B, is headquartered in Country B and runs an online marketplace platform that connects accommodation seekers to accommodation providers. Accommodation providers (users, i.e. owners of apartments or more broadly owners of immovable property) from Country C list their real estate property on the platform. At the same time, Mr A from Country A maintains his profile on the platform. Mr A books an apartment in Country C through the Country B platform. Mr A uses his credit card for the transaction, which amounts to USD 100. Company B retains a commission of USD 10 and passes on the balance to the accommodation provider in Country C. It should be noted that the accommodation provider is taxable on USD 90. The question now arises as to which country constitutes the location of sale for Amount A from Group B's perspective? Is it Country A or Country C, or both?[235]The EU Commission, in the context of DSTs, considers that taxing rights could be allocated to both "user" locations – in other words, the number of users having concluded a transaction in a given Member State.[236]On the other hand, the UK HMRC states that a special rule applies with respect to the property (land) in the United Kingdom even if the owner of the property is outside the United Kingdom and a non-UK user utilizes that property.[237]In such a case, the revenue is sourced to the United Kingdom. Thus, we believe that specific rules should be developed for transactions that involve the use of property (even moveable property such as cars) in the sense that the revenues associated to such transactions could be

227. European Commission, COM(2018) 148 final, *supra* n. 220 , at art. 5.
228. HM Treasury, *supra* n. 199 , at pp. 35-36.
229. *See* European Commission, Impact Assessment Accompanying the document Proposal for a Council Directive laying down rules relating to the Corporate Taxation of a Significant Digital Presence and Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services, SWD(2018) 81 final/2 (21 Mar. 2018), Annexure 12, pp. 150-153 available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018SC0081&from=EL (accessed 22 July 2020) [hereinafter European Commission, Impact Assessment (2018)].
230. *See* Digital Economy Group, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 7, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
231. *See* Amazon, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 5, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
232. *See* Digital Economy Group, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 7, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
233. European Commission, Impact Assessment (2018), at pp. 153-155.
234. HM Treasury, *supra* n. 199 , at p. 37.
235. *See* Booking.com, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 9, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
236. European Commission, *Impact Assessment* , at pp. 153-155.
237. HM Treasury, *supra* n. 199 , at p. 38.

sourced mainly to the country where the property is situated or used (which, by default, could be the consumption location from the perspective of the consumer who is availing the service on the platform).[238]

In cases such as online dating or selling goods through a marketplace, the revenues could be sourced to the location of the users who have concluded an underlying transaction.

5.1.4. Information reporting: Country-by-country reporting and exchange of information mechanisms

In order to implement the simplified MRPSM, the aforementioned information (for example, business line profits or losses as well as location of sales) will need to be exchanged among tax administrations. The OECD has already done substantial work in relation to country-by-country reporting (CBCR) and aims to complete a revision of the CBCR as set out in the BEPS Action 13 Final Report in 2020.[239]Accordingly, one possibility would be to modify the current version of CBCR documentation in such a way that it would facilitate a possible integration into collecting the necessary information to implement the new taxing right. More concretely, such a review would need to deal with a fundamental option on whether the information should be handled in a consolidated or, as is currently the case, in an aggregated way. The former option would of course prove to be more complex as it would presuppose a common global standard for corporate tax consolidation but would have the advantage of overcoming some of the current dysfunctionalities associated with CBCR.[240]

As has already been addressed in this contribution, there is a further layer of complexity to be taken into consideration: in particular, when it comes to the implementation of the approaches discussed earlier in this paper, it becomes clear that a relevant MNE business line approach could be followed in order to have more accurate results. This circumstance implies that, in order to serve its “new” purpose of supporting a consensus solution addressing the challenges arising from the digitalization of the economy, the revised CBCR would have to require the MNE to report information at a business line level based on global consolidated income. Besides sales information, some profitability indicator at the business line level would need to be provided in order to facilitate implementation: as has already been discussed in section 5.1.1. , most likely the profitability indicator would have to be presented in the form of EBT. These informational needs pose quite a challenge to the ready implementation of the proposed solution and a consensus platform with the concerned MNEs would most likely need to be set up.

Another issue to be addressed would be the publicity of the CBCR, a view publicly expressed by corporate tax directors of some prominent MNEs is that a greater reliance on simplified ex ante approaches would make the publicity of CBCR data less critical than under the current framework[241]but, at the same time, as already mentioned, a revised CBCR aiming at facilitating the implementation of the approach suggested by this contribution would need to contemplate business line financial and profitability information that would appear extremely sensitive for most businesses and whose public disclosure would appear intrinsically problematic.

Once the new CBCR template is defined to reflect the peculiarities associated with the proposed approach, the automatic information exchange framework would need to be amended accordingly. As it has been observed, such rules could be adopted either as an amendment to the existing country-by country reporting architecture, or as an entirely separate multilateral competent authority agreement under the auspices of the Administrative Assistance Convention.[242]In the view of the authors, the former approach would appear more appropriate as the proposed solution would precisely try to overcome ad hoc or targeted approaches and would instead signal a fundamental revision of the way transfer pricing rules are currently applied. The rules would not be

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238. A common question in the aforementioned examples pertains to the definition of the term “user”. Once again, a reference could be made to the various DST proposals to determine the meaning of this term. *See* HM Treasury, *supra* n. 199 , at pp. 31-33; European Commission, COM(2018) 148 final, *supra* n. 220 , at art. 2.

239. OECD/G20, *Transfer Pricing Documentation and Country-by-Country Reporting – Action 13: 2015 Final Report* (OECD 2015), Primary Sources IBFD.

240. As has been observed within the framework of Seminar G (devoted to “Tax Transparency/Enhanced Cooperation/CbCR Experience and Tax Certainty”) held on 11 Sept. 2019 at the IFA 73rd Annual Congress in London, current CBCR data does not readily inform the government because the aggregate country data does not consolidate or have accounting eliminations. *See* A. Turina, *Seminar G: Tax transparency/enhanced cooperation/CbCR experience* (11 Sept. 2019), News IBFD. For further considerations on some criticalities associated with CBCR as well as with proposals for its review, *see* V. Chand and S. Picariello, *The Use of Country-by-Country Reporting for Tax Risk Assessment: Challenges and Potential Solutions* , 2 Intl. Tax Stud. 1 (2020), Journal Articles & Papers IBFD. A public consultation meeting on the review of CBCR was convened by the Inclusive Framework and scheduled for May 2020. The text of the consultation and the comments received are available at https://www.oecd.org/tax/beps/public-consultation-meeting-review-country-by-country-reporting-beps-action-13-may-2020.htm (accessed 22 July 2020). For updated CBCR outcomes per jurisdiction, *see also* OECD, *Important Disclaimer Regarding The Limitations Of The Country-By-Country Report Statistics* (OECD 2020), available at https://www.oecd.org/tax/tax-policy/anonymised-and-aggregated-cbcr-statistics-disclaimer.pdf . For the actual statistics, *see* the data aggregates available at https://stats.oecd.org/Index.aspx?DataSetCode=CBCR_TABLEI (accessed 22 July 2020).

241. Id.

242. With reference to the latter scenario, *see* Grinberg, *supra* n. 174 , at p. 32. On the other hand, with reference to the former scenario, changes would then have to apply also to the regional frameworks for automatic exchange of CBCRs, so that, for instance, an amendment to Council Directive (EU) 2016/881 of 25 May 2016 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, OJ L 146/8 (3 June 2016), Primary Sources IBFD (the so-called DAC 4) or perhaps even a brand new directive (DAC 8, if the current proposal for a DAC 7 will be approved) amending Directive 2011/16/EU would be warranted.

changed per se, if not for a stabilization of profit split and an ex ante definition of suitable safe harbours but a new order in which they should apply would be defined. Similarly, once the CBCR template is modified, the rules governing its automatic exchange among tax administrations would not necessarily need to be modified; at the same time, provided that the new CBCR template would incorporate even more complex and sensitive information (such as business line level aggregated data), measures meant to ensure the safety of the exchange would perhaps need to be further enhanced and monitored.

5.1.5. Collection of Amount A taxes by market countries

Another important question that may be beyond the scope of this paper, arises with respect to how market countries can collect taxes for Amount A.[243]One possible answer is to give the MNE the option to nominate a constituent entity (as discussed in the EU DST[244]) or a responsible member[245]as discussed in the UK DST. This configuration will basically rely on a "one-stop shop" compliance model as already observed in European VAT and whose application has also been discussed with regard to the possible implementation of coordinated approaches to digital service taxes.[246]Within this framework, the concerned entity will be liable with other entities of the MNE (to the extent they are there) in the market jurisdiction to remit taxes to the local government.[247]Such an approach would necessarily imply the need of a major enhancement of the current available channels for administrative cooperation between states in the area of collection along the lines of what happened with exchange of information when the automatic exchange model became prevalent, raising issues that are so far unprecedented. Where Amount A applies in the absence of a physical presence in the market country, another possibility would of course be for this country to impose a withholding tax. The problem with this latter approach however is that taxes would then be collected on a gross instead of on a net basis. It is also questionable whether such a policy would be consistent with the rationale pursued by the allocation of non-routine or residual profits under Amount A. Moreover, in several instances, the adoption of a withholding tax mechanism would imply a reliance on intermediaries for the withholding of the necessary amounts which may prove particularly arduous to implement on a global scale. Conceptually as well as practically, therefore, it would seem inconsistent to switch to gross basis taxation under Amount A,[248]so a "one-stop shop" approach, despite all its implied challenges in the area of administrative cooperation, would appear to be the most desirable course of action.

5.1.6. Stabilization of the new profit allocation approach and dispute mechanisms for Amount A

The two most meaningful alternatives to implement the simplified MRPSM component appear to be, on the one hand, an "add-on" to the existing Multilateral Instrument (MLI),[249]which could concretely be implemented by means of a multilateral protocol following the same logic of the MLI and thus relying on a web of bilateral relationships modifying the existing treaty network and that would be shaped by a system of opt-ins and opt-outs.[250]On the other hand, another approach would be to develop a separate ad hoc standalone legal instrument, which would operate outside the boundaries of the existing global treaty network and would constitute an example of a (potentially worldwide) multilateral treaty dealing with substantive matters and not merely administrative ones, as in the case of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[251]In addition to a new

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243. In other words, this is the fundamental question aimed at ensuring that enforcement jurisdiction is ensured in order to match the foreseen substantive jurisdiction. The literature is very extensive on this point; with specific reference to tackling the issue of "remote supplies" in the digital economy, *see* W. Hellerstein, *Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments* , 68 Bull. Intl. Taxn 6/7 (2014), Journal Articles & Papers IBFD. With regard to specific issues surrounding the unified approach, *see* Danon and Chand, in Public Comments to the OECD, *Secretariat Proposal* (2019), at pp. 36-37, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
244. European Commission, *Impact Assessment* , at p. 156.
245. HM Treasury, *supra* n. 199 , at p. 52.
246. *See* in this regard C.A. Herbain and S. Pierrée, *The One-Stop Shop for VAT and Digital Services Tax* , in *Taxing the Digital Economy* (P. Pistone and D. Weber, eds., IBFD 2019), Books IBFD. For instance, the Mini One-Stop Shop mechanism introduced in 2015 in European VAT allows taxable persons to register only in one Member State and to declare and pay in that tate the VAT due in all of the Member States. While this experience has indeed been positive, it may be argued that the same model may be expanded to the implementation of the unified approach, provided that it would imply a degree of administrative cooperation in the area of collection that currently does appear to be present outside of specific regional integration experiences. For a plea in favour of a "one – stop shop" solution within the framework of the unified approach, *see* R. Finley, *Practitioners Call for One-Stop Shop Approach to Pillar 1* , Tax Notes (2019).
247. Unilever, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 4; Digital Economy Group, at p. 8. Both available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
248. Concurring: *See* Spotify, in Public Comments to the OECD, *Secretariat Proposal* (2019), at pp. 8-9; Uber, at p. 12; Unilever, at p. 8; Amazon, at p. 8; Digital Economy Group, at p. 7; KPMG, at p. 10. All available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
249. *Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (7 June 2017), Treaties & Models IBFD [hereinafter MLI].
250. On the somewhat unique role and configuration of reservations in the MLI compared to other multilateral agreements in light of public international law considerations, *see* R. Garcia Anton, *Untangling the Role of Reservations in the OECD Multilateral Instrument: The OECD Legal Hybrids* , 71 Bull. Intl. Taxn. 10 (2017), Journal Articles & Papers IBFD.
251. *Convention between the Member States of the Council of Europe and the Member Countries of the OECD on Mutual Administrative Assistance in Tax Matters* (25 Jan. 1988) (as amended through 2010), Treaties & Models IBFD. *See* R. Garcia Anton, *The 21st Century Multilateralism in International Taxation: The Emperor's New Clothes?* , 8 World Tax J. 2, p. 147 (2016), Journal Articles & Papers IBFD.

legal instrument, certain aspects of the contemplated proposal would have to be dealt with at an administrative level and may perhaps be handled more effectively through administrative fora inspired by the Global Forum institutional model.

In the first place, once a political consensus over the substantive rules and the exercise of the new taxing right (what we could define as the "BEPS Action 1" core) envisaged by the proposal has been reached, the Inclusive Framework or any other institutional forum vested with the necessary legitimacy[252]should promote, ideally, a new multilateral treaty implementing the new rules or, alternatively, the incorporation of said new substantive rules in the MLI laid down under BEPS Action 15[253]by means of a protocol.

The answer to the question on which of these two different but nonetheless both hard law-based outcomes transcends the scope of this paper. The authors nonetheless take note that the issue has been critically explored in scholarship.[254]In their view, the most critical argument in favour of a new multilateral tax treaty lies in the circumstance that such an approach would allow to "fill the gaps" in the existing international treaty network as it would not presuppose existing bilateral tax treaties. Moreover, given how important the emphasis on multilateral coordination appears to be for the successful implementation of the contemplated proposal, the adoption of a full-fledged multilateral instrument would give a clear signal in that direction. Furthermore, only a new multilateral treaty with binding rules on dispute resolution would provide an answer to the possible disruption arising from the new framework.

Other potential advantages of a multilateral treaty lie in hypothetical pitfalls associated with an MLI approach. Namely, on a fundamental level, since the contemplated proposal would modify the scope of the fundamental body of rules that shape the international tax regime, it may prove difficult to achieve the same results by relying on a legal instrument that is meant to modify existing rules that keep the fundamental framework intact. Moreover, as has been observed, on a more micro level, the bilateral perspective embedded in the MLI approach would make it more difficult to tackle certain issues, such as, for instance, the treatment of losses.[255]Prima facie, a revision of the MLI by means of the negotiation of a protocol intuitively appears a smoother path when it comes to catalysing international consensus as the same exercise that led to its adoption and entry into force could likely be replicated. At the same time, should the outcome of the MLI revision fail to meet the expectations of a certain constituency of economies which, for the sake of simplicity, could be lumped together as "market jurisdictions", it cannot be excluded that instances of what has been defined as "contested multilateralism"[256]may emerge: this scenario would of course endanger the whole Inclusive Framework construction and may solidify the centrifugal forces that drive the current proliferation of unilateral measures into a full-fledged fragmentation of the international tax regime.

Regardless of the actual outlet, it appears clear that, within the framework of the contemplated proposal, the fundamental questions of a new scope, new nexus and new relief rules would need to be implemented through a treaty (domestic law changes will also be required). This would constitute the legal basis for the new fundamental rules of the international tax regime so that it could not possibly rely on a mere international recommendation even when coupled with an institutional framework for peer review. Given this common baseline, the different approach undertaken (namely, a full-fledged multilateral treaty vis-à-vis a protocol to the MLI) may have some implications in terms of dispute resolution mechanisms that should ensure the effectiveness and justiciability of the system. If an MLI approach is chosen, most likely the existing framework based on mutual agreement procedures coupled with an arbitration appendix would presumably be upheld.[257]

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252. This topic is central from an institutional viewpoint but transcends the scope of this paper; for an in-depth analysis, *see* I.J. Mosquera Valderrama, *Legitimacy and the Making of International Tax Law: The Challenges of Multilateralism* , 7 World Tax J. 3, p. 343 (2015), Journal Articles & Papers IBFD.
253. OECD/G20, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15: 2015 Final Report* (OECD 2015), Primary Sources IBFD.
254. *See* Grinberg, *supra* n. 174 .
255. Id., at p. 41. As Grinberg convincingly remarks "[i]n the MLI+ Approach, the relevant international law in a profit allocation dispute will often be a bilateral tax treaty between an intermediate holding company jurisdiction and a market jurisdiction. Such instruments are ill-suited to a rule that creates an exception based on the loss position of an MNC headquartered in a third country that is not a party to the relevant bilateral treaty. Special rules for loss companies are easier to imagine both being negotiated and remaining operative in a true multilateral instrument. The loss company concern is not a secondary issue: approximately 20% of multinational firms globally have negative earnings before interest and taxes in any given year."
256. Contested multilateralism is a concept that was developed primarily in international relations theory and can be defined as a situation where states, multilateral organizations, and non-state actors use multilateral institutions, existing or newly created, to challenge the rules, practices or missions of existing multilateral institutions. In particular, "[i]t occurs when coalitions dissatisfied with existing institutions combine threats of exit, voice, and the creation of alternative institutions to pursue policies and practices different from those of existing institutions. Contested multilateralism takes two principal forms: regime shifting and competitive regime creation." *See* R. Kehoane and J.C. Morse, *Contested Multilateralism* , 9 Rev. Int. Organ. 4, p. 385 (2014). Such risk may be appreciated bearing in mind the latest developments, most notably the letter sent on 12 June 2020 by US Treasury Secretary Mnuchin to the Finance Ministers of France, Italy, Spain and the United Kingdom requesting a pause in the ongoing negotiations. For further analysis, *see* J.L. Harrington, *The Unsurprising Stalemate on Digital Taxation* , Bloomberg Tax (8 July 2020), available at https://news.bloombergtax.com/daily-tax-report-international/insight-the-unsurprising-stalemate-on-digital-taxation?fbclid=IwAR16zaNsf8G7MV799mlzfW90HvClpxR1AknyCVX3eEl1yF0Z7UcnLhqRo5U (accessed 22 July 2020). On the other hand, the latest Communiqué released by the G20 Finance Ministers on the occasion of their 18 July 2020 meeting appears to reconfirm a commitment to further pursue the project, stating in particular: "We stress the importance of the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS) to continue advancing the work on a global and consensus-based solution with a report on the blueprints for each pillar to be submitted to our next meeting in October 2020. We remain committed to further progress on both pillars to overcome remaining differences and reaffirm our commitment to reach a global and consensus-based solution this year." *See* *G20 Finance Ministers & Central Bank Governors Meeting* (18 July 2020), *Communiqué* , p. 4, available at https://g20.org/en/media/Documents/Final%20G20%20FMCBG%20Communiqu%C3%A9%20-%20July%202020.pdf .
257. The literature on the topic has been increasingly expanding. For a critical analysis of the status of international tax arbitration under the MLI, *see* , among many, H.M. Pit, *Arbitration under the OECD Multilateral Instrument: Reservations, Options, Choices* , 71 Bull. Intl. Taxn. 10, p. 568 (2017) Journal Articles &

At the same time, unlike what is currently foreseen under the MLI, in order to ensure greater certainty of the process, it appears desirable that binding arbitration becomes, to use the original BEPS jargon, a minimum standard. It may even be found that, if a full-fledged multilateral tax treaty is entered into, it may assist in the setting up of an international ad hoc tax tribunal,[258]so far often invoked in policy literature but the realization of which has always appeared problematic.[259]In this respect, regardless of whether the approach to binding dispute settlement will eventually rely on an ad hoc binding mandatory arbitration model or, prospectively, on something close to an international tax tribunal, it seems appropriate to envisage an intermediary stage between dispute prevention and full-fledged adjudication. In other words, it is possible to envisage three situations: on one end, a situation where the parties try to avoid future disputes (which would be handled under an ex ante dispute prevention framework), and on the other end, a situation where a dispute is ongoing and intervention by a third party is needed to adjudicate the dispute. In between, however, there could be a situation where a dispute has already emerged and the parties to the dispute may not be in a position to solve it but may need external facilitation by a third party even without adjudication prerogatives.[260]

In light of the above, the authors favour the adoption of a new multilateral treaty which would provide for mechanisms not only for dispute prevention but also binding mechanisms for dispute resolution. At the current stage, the only viable incremental solution in this regard would appear to provide that the new multilateral treaty incorporates a mandatory clause establishing mandatory binding arbitration for all issues of methodology and quantification. This would in particular concern cases of interaction and potential overlap between Amount A and Amount C. For instance, when envisaging an MNE group falling within the scope of application of the Amount A rules, the interaction between Amount A and Amount C may occur each time its activities in scope are subject to a transfer pricing reassessment, as such reassessment would change the profitability of separate entities within the group, which has been used to identify those entities that would have to pay Amount A, and the jurisdictions that will have to allow relief from double taxation. In the authors' view, in order to enhance the transparency and predictability of the system, and so to ensure that the issues arising from divergences in the application of the various amounts or arising from their overlap be addressed consistently on a global scale, a reasoned opinion approach should be favoured over a "last best offer" one.

Also in light of analogous considerations, it appears clear that the suggestion formulated in December by the US Secretary of Treasury to the OECD Secretary General[261]to adopt the "Pillar 1" proposal in the form of a safe harbour (and thus optional) regime.

Papers IBFD; N. Bravo, *Mandatory Binding Arbitration in the BEPS Multilateral Instrument* , 47 Intertax 8/9, p. 693 (2019). For a challenge of the conventional view according to which "last best offer" arbitration would be the most suitable approach to deal with transfer pricing disputes, ***see*** L.F. Neto, *Baseball Arbitration: The Trendiest Alternative Dispute Resolution Mechanism in International Taxation* , 1 Intl. Tax Stud. 8 (2019), Journal Articles & Papers IBFD. For the very important issue of institutional platforms supporting and enabling arbitration procedures, ***see*** H. Mooij, *Arbitration Institutes: An Issue Overlooked* , 47 Intertax 8/9, p. 737 (2019). On the other hand, available statistics display that after the introduction of last-best offer arbitration in the Canada-US treaty, the number of pending mutual agreement procedures was reduced very remarkably and very rapidly. ***See*** the speech by T. McDonald (VP Global Taxes, Procter & Gamble) at the CIAT Panel: Towards Effective Resolution and Prevention of Disputes on Cross-Border Taxation (6 July 2020), in particular at 24:25, available at https://www.youtube.com/watch?v=yL_4L8qpfCg&feature=youtu.be (accessed 22 July 2020).

258. Much along the lines of what has been foreseen for the International Law of the Sea, where the Montego Bay Convention established the International Tribunal for the Law of the Sea, whose statute constitute an annex to the same Convention. For further analysis on the legal nature of the Tribunal and on the historical path that led to its establishment, ***see*** M. García García-Revillo, *The Juridical Personality and Nature of the International Tribunal for the Law of the Sea* , in *The Law of the Sea, from Grotius to the International Tribunal for the Law of the Sea, Liber Amicorum Judge Hugo Caminos* p. 608 (L. Del Castillo, ed., Brill 2015). When adopting the International Law of the Sea as a parameter, it is to be hoped that the path to fundamental reform of the International Tax Regime may take a smoother pace and swifter pace, considering that the current codification of the Law of the Sea was reached after three long and complex UN conferences. On this process, ***see further*** T. Treves, *Codification du droit international et pratique des États dans le droit de la mer* , 223 Recueil de Cours de l`Académie de droit international de La Haye (1990).

259. The proposal to establish some form of international body having jurisdiction over international tax matters emerged at the scholarly level even before the current international tax regime consolidated; ***see*** A. Garelli, *Il diritto internazionale tributario* p. 253 (Roux Frassati 1899) and was also taken into consideration by the League of Nations in the 1920s. More recently, calls to this desidered outcome have been voiced at regular intervals. ***See*** , among many, W.R. Emmen-Riedel, *Judicial Interpretation of conventions on double taxation and the necessity or advisability of establishing international fiscal jurisdiction* (IFA Cahiers vol. 18, IFA 1951) and, more recently, Z.D. Altman, *Dispute Resolution under Tax Treaties* (IBFD 2005), Books IBFD and P. Baker, *Establishing a New International Framework* , in *International Arbitration in Tax Matters* p. 475 (M. Lang and G. Owens, eds., IBFD 2015), Books IBFD. For a critique of the merits and difficulties of such an approach, ***see*** R. Garcia Anton, *The Fragmentation of Taxpayers' Rights in International Dispute Resolution Settings: Healing Anxieties through Judicial Dialogue* , 10 World Tax J. 1, p. 151 et seq. (2017), Journal Articles & Papers IBFD. On the other hand, the reasons that surround scepticism around such a development are in a way the same that for many years ruled out the arbitrability of tax matters, namely the importance states place on tax sovereignty. ***See*** in this sense Grinberg, ***supra*** n. 174 , at p. 31.

260. This tripartite structure is well reflected by the seminal work on dispute resolution models developed by F. Glasl, *Konfliktmanagement* (Paul Haupt, 1980). ***See*** in this regard also the further considerations developed in *infra* n. 294 . Such a perspective would appear to also be considered by the Inclusive Framework; in the *Statement on the Two-Pillar Approach* (, it is mentioned that "[i]t is agreed to explore an innovative approach under which tax administrations of the IF would provide early tax certainty for Amount A, for instance through the establishment of representative panels which would carry on a review function and provide tax certainty. This would require work on the process and governance of such panels to ensure appropriate representation of Members and effective, transparent, and inclusive processes. The design of the process would also need to address the challenge of delivering binding agreements by all tax administrations". ***See*** *Statement on the Two-Pillar Approach* (2020), at paras. 71-72. In the purview of the two-stage dispute resolution framework envisaged therein (to which, as earlier mentioned, a third preliminary layer purely aimed at preventing and minimizing the arising of disputes could also be added), the establishment of the earlier evoked "representative panels" entrusted with a "review function" may perhaps operate under the auspices of the Forum of Tax Administration, provided the nature of the envisaged procedure. In this regard, some inspiration may perhaps be derived from the experience of the World Customs Organization, whereas the latter has established an ad hoc committee that can issue rulings on, inter alia, customs classification of goods, which has significantly promoted the prevention of disputes in this critical area.

261. Letter of 3 December 2019 by Steven Mnuchin to Angel Gurría; for a further analysis of the background, ***see*** R. Finley and S.S. Johnston, *The U.S 'Safe Harbor' Proposal: Rocking the OECD's Pillar 1 Boat?* , Tax Notes International, p. 979 (2019).

Such a proposal was arguably motivated by the circumstance that the OECD's proposals would represent a departure from the arm's length principle. While the political implications of such a caveat transcend the scope of this paper,[262]it is worth trying to understand what a "safe harbour approach" to Pillar 1 may look like. Assuming such optionality would encompass both Amount A as well as Amount B, a safe harbour proposal could allow an MNE to avoid profit reallocation to a market country under Amount A if it is already reporting taxable profits in that country that are equal to or exceed an objective metric tied to sales revenue arising from customers there. With regard to Amount B, a company could then show that its return from actual M&S activities in a given country would be less than the fixed return under Amount B.[263]As discussed at greater length in section 5.2. , if the fixed returns are carefully designed, the need of implementing Amount B through a system of rebuttable presumptions would lose its appeal and justification: at least in the first place, disputes surrounding Amount B would not be about the " *quantum* " but rather about the " *an* ",[264]i.e. on whether the objective criteria for including certain transactions in the scope of Amount B would be justified and not on how much profit should be attributed. The need to overcome a logic based on a system of rebuttable presumptions is even more strongly to be rejected with regard to Amount A, whereas a level playing field and a consistent implementation could be achieved only once consensus on the underlying formula is reached. Making the application of such formula an election would severely undermine the sustainability of the whole system.

5.2. The separate-entity approach: Amounts B and C

5.2.1. Amount B: Fixed return based on the ALP

After the release of the OECD Secretariat proposal on the unified approach, it is now clear that the OECD has set forth a view according to which this model and, in particular, the profit allocation approach encompassed by Amount B would apply only in the case of some form of physical presence in the market country, so that instances of application of this approach to remote transactions would have to be excluded. The January 2020 document is very clear on this point, foreseeing that "Amount B aims to standardise the remuneration of distributors (whether constituted as a subsidiary or a traditional PE) that buy products from related parties for resale and, in doing so, perform defined 'baseline marketing and distribution activities'".[265]

Within the framework of the "unified approach", the design of Amount B will need to ensure that the baseline distribution and marketing activities are only remunerated once in order to avoid any undue overlaps with other amounts encompassed by the said approach. In light of this goal, the clear definition of what constitutes baselines activities appears of key relevance. In order to define such activities,[266]policymakers could look into the approach, as discussed previously, adopted by the tax administration in Israel (*see* section 3.5 .).[267]Their guidance contains a detailed discussion on such activities. Moreover, the Israeli guidance states that a 3%-4% (return on sales) profitability margin applies for distribution activities and a 10%-12% (return on costs) margin applies for marketing activities. We would concur with the use of such profit level indicators for an Amount B allocation.

Interestingly, the question arose as to whether Amount B is a minimum profit allocation regime or a safe harbour which could be rebutted.[268]Although many commentators to the unified approach supported the use of safe harbour regimes,[269]the OECD has put forward the idea that Amount B is a "fixed return that is based on the ALP". The underlying rationale of the approach, as per the same words of the Inclusive Framework shows that Amount B "is designed to remunerate a market jurisdiction with a fixed return for baseline distribution and marketing activities".[270]In this light, making the fixed return remuneration subject to the possibility of being rebutted by either states or taxpayers would indeed jeopardize this fundamental policy objective. In the authors' view, the issues that are typically addressed through rebuttable presumptions would qualify as an attempt to correct ex post certain dysfunctionalities that could have been addressed ex ante through a more careful design and calibration of the applicable predeterminations. Thus, the predeterminations envisaged by the so-called Amount B should, in principle, constitute legal presumptions of a non-rebuttable nature for both taxpayers and governments.

262. *See* , in this regard, generally on Pillar 1, F. Chadwick, *Addressing the Largest Hurdles to Pillar 1 Consensus* , Tax Notes International (2020).
263. *See* in this sense the consideration set forth by Jefferson VanderWolk in Finley and Johnston, *supra* n. 261 .
264. Where *quantum* deals with the quantification of a certain hypothesis and *an* with the likelihood ("whether") of said hypothesis.
265. *See* OECD, *Statement on the Two-Pillar Approach* (2020), at para. 58.
266. Id., at para. 61.
267. *See* Israel Tax Authorities, Income Tax Circular No. 12/2018 of 5 Sept. 2018, pp. 1-11, available at https://home.kpmg/content/dam/kpmg/xx/pdf/2018/10/tnf-israel-12-oct9-2018.pdf (unofficial translation, accessed 4 Oct. 2019).
268. For a discussion on safe harbours or presumptions, *see* OECD, *Transfer Pricing Guidelines* (2017), at paras. 4.95-4.133; Turina, *supra* n. 106 , at pp. 332-336; Picciotto, *supra* n. 108 , at p. 29 (Box 4).
269. *See* Spotify, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 7; Amazon, at p. 5; Digital Economy Group, at p. 12; Maisto e Associati, at p. 12; KPMG, at p. 11; Deloitte, at p. 8. All available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
270. OECD, *Statement on the Two-Pillar Approach* (2020), at para. 55.

Fixing a return based on the ALP would also make sense as such distribution and marketing structures have been prone to disputes. For instance, consider the various decisions rendered by Indian Courts on advertising, M&S promotion expenses.[271] If this path is followed, the authors are of the opinion that different margins need to be proposed for different businesses[272] as the margins applied for baseline distribution or marketing activities differ from one industry to the next.[273] For example, the margins applicable to distribution structures in the fast-moving consumer goods sector is different from the margins applicable in the luxury goods sector or the pharmaceutical sector. Moreover, different margins will need to be proposed for different regions or countries.

To elaborate, it appears clear that in order to minimize the instances of international double (non-)taxation, the setting of the fixed return should not be left to individual jurisdictions but should be developed under the auspices of an ad hoc forum as it has been foreseen with regard to the information exchange and transparency agenda or BEPS minimum standard implementation. Such an ad hoc forum should in particular ensure adherence to the predeterminations within the broader ALP and monitor this on a regular basis. The Secretariat of such a forum should, moreover, have access to know-how from the OECD Tax Policy and Statistics Division. The primary goal of said ad hoc forum would be to define and maintain a range of returns that would be differentiated[274] based, fundamentally, on the following key drivers:

- The relevant industry or segment, based on a to-be-defined internationally agreed taxonomy.[275] It should be noted, as anticipated, that in order to ensure accuracy and meaningfulness of the predetermination of the return, the analysis may have to be conducted at a business line level. It is the authors' view that, in some instances, identifying the correct industry segment may not be straightforward. In order to ensure greater stability, the identification of the relevant applicable industries and the segmentation of the business lines may perhaps be supported by some form of certification rendered by independent auditors.
- The relevant geographic area (typically, on a regional basis, even though some countries may be identified, due to their peculiarities, as standalone markets or even be broken down into subnational markets).

Establishing such a differentiation in determining the predetermined returns would be necessary from a methodological viewpoint in order to ensure – insofar as possible – the adherence of the relevant predetermination to the ALP.

At the same time, it may be speculated that, effectively, such a differentiation would not necessarily yield significant divergences across regions and industries. In this regard, according to an economic analysis conducted by KPMG on a global scale with respect to distributors,[276] Europe, the Middle East and Africa have converging results across industries, while slight deviations are observed in Africa and the Americas: the average median operating margin was 3.5% for Europe, the Middle East, and Africa; 3.8% for the Americas; and 3.6% for the Asia-Pacific region. With the exceptions of technology services and plastic products, most industries were closely clustered around the 3.6% global average.[277]

In light of the foregoing, in order to ensure greater flexibility and adaptability, the earlier envisaged ad hoc forum could also see the participation, on a consultative basis, of industry representatives and would be responsible to address, on a consensus-minus-one basis, any fundamental disputes arising on the determination of the returns as well as their periodic revision (typically, two or three times per decade).

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271. *See* IN: High Court of Delhi (HC Delhi), 1 July 2010, *Maruti Suzuki India Ltd. v. Addl. CIT TPO* , [2010]; IN: ITAT Delhi, 8 Dec. 2014, *LG Electronics India (P.) Ltd. v. A CIT* , [2014]; IN: (HC Delhi, 16 Mar. 2015, *Sony Ericsson Mobile Communications India (P.) Ltd. v. CIT* , [2015]; IN: HC Delhi, 23 Dec. 2015, *Bausch & Lomb Eyecare India (P.) Ltd. v. Addl. CIT* , [2015]; IN: HC Delhi, 22 Dec. 2015, *CIT-LTU v. Whirlpool of India Ltd.* , [2015].
272. *See* OECD, *Statement on the Two-Pillar Approach* (2020), at para. 60.
273. See PwC, in Public Comments to the OECD, *Secretariat Proposal* (2019), at pp. 27-30, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
274. While the OECD, *Secretariat Proposal* (2019) acknowledges on several occasions the possibility and perhaps even the need to "go beyond the arm's length standard", a differentiation in the predetermined margins would appear justifiable, if not desirable, in light of an incremental approach to the reform of the arm's length principle. In fact, the adoption of undifferentiated margins would ipso facto signal a clear departure from the arm's length principle. *See* , in this regard, Maisto, *supra* n. 86 , at p. 154, where the author argues, in relation to the LVAS (at the time, pending) amendment to the OECD, *Transfer Pricing Guidelines* (2017) that "[it is] doubtful that one margin for all costs would properly reflect an arm's length remuneration".
275. The "Global Industry Classification Standard" (GICS) developed by rating agencies and commonly adopted by financial market operators could represent a possible source of inspiration, even though it appears of key importance that a public, independent and globally agreed taxonomy be ideally agreed upon. In an interim phase, a generally accepted taxonomy, such as the GICS, could perhaps fill the vacuum.
276. The analysis was elaborated by KPMG upon request by Microsoft, in order to prepare a fact-based economic analysis using comparables data of the arm's length returns to sales, marketing, and distribution. Reported by R. Finley and S. Soong Johnston, *KPMG Study Casts Doubt on Key OECD Global Tax Deal Design Issue* , Tax Notes International, p. 1024 (2020), "[t]he analysis compares operating margins — operating profit divided by total revenue — drawn from 4,285 sets of five to 50 limited-risk distributors that perform routine sales, marketing, and distribution functions".
277. Id. It should also be remarked that anedoctal evidence suggests that a major portion of transfer pricing mutual agreement procedures currently pending, apparently in the range of 60%, revolve around distributor margins. See the speech by Mr Tim McDonald (VP Global Taxes, Procter & Gamble) at the CIAT Panel Towards Effective Resolution and Prevention of Disputes on Cross-Border Taxation, in particular at 27:30. Retrievable at the following link: https://www.youtube.com/watch?v=yL_4L8qpfCg&feature=youtu.be . It is thus clear that moving to a pre-determined approach would address a major capacity issue in this area.

Lastly, the authors would argue that Amount B should only be applicable to taxpayers (local PE or separate related entity) that mainly do simple marketing or distribution activities or a combination of them.[278] It should be noted that these activities should not (i) amount to "unique and valuable contributions",[279] especially activities that create valuable local intangibles; (ii) be classified as "highly integrated"[280] operations; or (iii) lead to a "shared assumption of economically significant risks"[281] or a "separate assumption of closely related risks".[282] If they do, the activities will need to be analysed under Amount C. For example, the proposal should not apply to multifunctional entities such as a full-fledged or licensed manufacturer (or a local entrepreneur) of the MNE group that buys raw materials, makes the products and markets/distributes/sells them. Similarly, the proposal should not apply to full-fledged distributors that carry out activities beyond baseline functions. The normal transfer pricing rules should continue to apply to such entities or establishments. In these specific situations that would qualify them as systematic outliers vis-à-vis the fixed return benchmarks (e.g. in situations of market penetration or cases of peculiar functional characterization of the distributor concerned that would be irreconcilable with the fixed remunerations), taxpayers would have the opportunity to rebut the predetermined margins as discussed in the following section.

5.2.2. Amount C: Facts and circumstances-related returns and potential overlaps with Amount A

Amount A is concerned with allocating a portion of deemed residual profits whereas Amount B is concerned with allocating routine or baseline returns. Accordingly, the chance of an overlap between these amounts seems minimal.[283] On the other hand, overlaps between Amount A and Amount C could surely exist as both amounts deal with non-routine profits (or losses). This could then lead to double counting.[284] Several situations could exist.

First, consider the example of a local full-fledged distributor that carries out activities that go beyond Amount B baseline activities or a licensed manufacturer that performs all key activities in its value chain. These entities, as a result of their entrepreneurial efforts, could be booking residual profits (losses) linked to locally developed marketing intangibles. Second, if such entities do not report income linked to such intangibles or underreport such income, the tax administration may allocate some additional income to such entities in the course of tax assessments (by making a primary adjustment under article 9 of the OECD Model). Third, these adjustments could also arise due to comparability adjustments made by tax administrations. One such adjustment relates to the Chinese approach towards the interpretation of the ALP. For example, China allocates market premium in the hands of a local distribution and sales entity. In the UN Transfer Pricing Manual, the Chinese tax administration states as follows:[285]

> The Chinese SAT has come across many other cases of market premiums for Chinese taxpayers, particularly in the luxury goods, pharmaceutical and automotive industries. These three industries have gained significant momentum over the past decade with booming demand from the market. Many MNEs have set up sales subsidiaries which have been involved in heavy M&S activities to build the brand image among Chinese customers and cultivate their appetite for the MNEs' products. The exponential growth in sales revenue has brought in additional profits for the MNEs…. *Given that taxation should follow value creation, the Chinese SAT takes the view that the additional profits should be taxed in China if they are derived from the unique characteristics of the Chinese market. For example, the Chinese subsidiaries of some luxury brands have undertaken significant promotion activities to educate Chinese customers who had known nothing about the brands before. With more and more Chinese customers now familiar with the brands and products, sales revenue has experienced a great increase for the Chinese subsidiaries*…. On the other hand, deterred by the high prices set by the MNE groups in the Chinese stores, some Chinese customers who would have gone to luxury stores in China have instead chosen to go abroad. The money spent by Chinese shoppers in overseas luxury stores has been growing at a steady rate of more than 50% in recent years and has constituted a sizeable portion of the sales revenue of overseas affiliates. In the case of one brand (as an example) the products sold to Chinese nationals in stores located in countries other than China accounted for 12% of the total sales generated in these areas for the brand. This portion of the sales revenue and the profits realised should be attributed to the marketing contribution made by Chinese subsidiaries and taxed in China. [Emphasis added.]

Similar approaches are also reported in India[286] and South Africa.[287] While analysing whether or not market premiums are within the scope of the ALP is beyond the scope of this contribution, it could nevertheless be argued that such an approach allocates residual returns to the market countries.

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278. *See* Johnson and Johnson, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 7, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (ast accessed 1 Mar. 2020).
279. OECD, *Transfer Pricing Guidelines* (2017), at ch. 2, para. 2.4.
280. Id.
281. OECD, *Revised Guidance on the Application of the TPSM* (2018), at ch. 2, para. 2.121.
282. Id.
283. *See* OECD, *Statement on the Two-Pillar Approach* (2020), at para. 55.
284. Id., at paras. 56-57.
285. *See* UN, *Transfer Pricing Manual* (2017), at paras. D.2.4.4.10-D.2.4.4.12.
286. Id., at para. D.3.10.1.
287. Id., at para. D.5.8.4.

In the foregoing situations, there could be an overlap between Amount C and Amount A. The question then arises as to how do we solve this overlap? One possibility would be to start with Amount C. If the local taxpayer operates with an Amount C structure (for example, full-fledged distributor[288]or licensed manufacturer[289]), Amount A should not apply. Another possibility is that Amount A could be compared to Amount C. If the local entity's or establishment's actual taxable profit, which also includes a part of the residual profit, is higher than the Amount A liability, no taxes will be required to be paid on Amount A. Another possibility would be to start with Amount A. In that scenario, an amount that is linked to non-routine margins could be reduced from Amount A. These matters are further discussed in the case studies analysed in the following section (section 5.3.).

5.2.3. Stabilization of this regime and dispute prevention and resolution

Amount B could initially be implemented in a "soft law" approach that would essentially encompass a revision of the OECD TPG in order to crystallize the new guidance on the implementation of a system of formulas.[290]As anticipated, some flexible administrative infrastructure, in the form of the setting up of an ad hoc forum where tax administrations and business representatives could interact, would seem to be essential to implement a smooth transition. A pilot project building upon the existing ICAP experience would, in the view of the authors, represent the most viable alternative at this stage.[291]Once a consensus has been reached and consolidated, the resulting multilateral set of ALP oriented formulas could first be crystallized into a multilateral Memorandum of Understanding that could be attached to the new multilateral convention. At a later stage, the content of the Memorandum of Understanding could perhaps be further incorporated into the new binding legal instruments, although it is foreseen that the actual quantification of the fixed returns may have to be revisited and adjusted over time; in this regard, a Memorandum of Understanding, while not technically binding, may ensure sufficient commitment and stability while, at the same time, displaying greater flexibility. Any dispute concerning the application of the fixed return could be addressed within the earlier mentioned international administrative forum, where an ad hoc committee[292]may be called to issue rulings on the classification of goods and services in order to identify the applicable fixed returns as well as on the revision of said margins where appropriate. This would be the only outlet available for states to troubleshoot and harmonize divergences concerning the application of Amount B and, at the same time, it would create a robust dispute prevention infrastructure for the benefit of taxpayers as a result.

While the incorporation of simplified approaches in the proposed multi-tier solution should likely reduce the opportunity for disputes, the facts and circumstances element will clearly not be removed from the system and will be used to address more complex situations which, in turn, are the ones most likely to constitute a possible source of disputes. It is also important to note that, where applicable, such a procedure should not automatically lead to increased scrutiny on the part of the tax administrations of the jurisdictions concerned (and hence to disputes) but should rather foster a debate which would ideally be conducive to bilateral or multilateral dispute prevention mechanisms, such as advance pricing agreements (APAs). It may be anticipated that such a simplified procedure should cover most situations that, under the Secretariat proposal on the unified approach, would be conducive to triggering the so-called Amount C, thus greatly diminishing the relevance of the latter.[293]

On the other hand, unlike Amount B, Amount C would clearly need to be implemented through a multilateral convention and, in this sense, as well as to ensure that there is no overlap with Amount A, the most viable alternative would seem to devise a single international legal instrument for both Amount A and Amount C.

When it comes to the handling of disputes, without prejudice to all the necessary efforts to ensure dispute prevention,[294]it may be remarked that, while the actual underlying methodology and eventually the quantification of the predetermined returns may form the object of multilateral regional and/or sectoral APAs, "Amount C" issues, which would most typically revolve around the definition of the perimeter of baseline activities, so ultimately, around the scope of application of Amount B, would hardly be

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288. *See* Nestle, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 9, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
289. *See* Unilever, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 3, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
290. This has been acknowledged, as of late, in the Jan. 2020 Inclusive Framework Statement (IF Statement), which mentioned that "[t]he expectation is that treaty changes will not be required to implement the Amount B regime, which should simplify its implementation. Rather, as the Amount B regime, as set forth in section 4, is expected to be in accordance with the ALP, existing treaty provisions should suffice to support its adoption"; *see* para. 63 of the IF Statement. *See* OECD/G20, *Statement on the Two-Pillar Approach* (2020).
291. On the relevance of ICAP for the digital economy tax agenda, *see also* M. Herzfeld, *ICAP as a Tool for Addressing the Digital Economy* , Tax Analysts (2019) .
292. Also in this regard, as already envisaged for Amount A, *see supra* n. 260 ; the World Customs Organization may provide inspiration, as it has established an ad hoc committee that can issue rulings (inter alia) on customs classification of goods, which has significantly promoted the prevention of disputes in this critical area. Unlike the World Customs Organization, however, the proposed institutional framework would entail a less structured forum to which not only tax administrations but also business representatives may be invited to contribute.
293. *See further* on this P. Pistone et al., *The OECD Public Consultation Document "Secretariat Proposal for a 'Unified Approach' under Pillar One": An Assessment* , 74 Bull. Intl. Taxn. 1 (2020), Journal Articles & Papers IBFD.
294. Between dispute prevention efforts and actual dispute resolution remedies, further consideration should also be given to possible alternative dispute resolution approaches involving the use on mediation. In this regard, a cooperative research project has been conducted by the International Bureau of Fiscal Documentation with regard to a "flexible multi-tier dispute resolution approach". Reference shall be made to the results of this project and its future publication.

susceptible to an APA as they do not entail a question of methodology or quantification. For this reason, this type of dispute may need to be handled ex post through the traditional mutual agreement procedures and, namely, by means of an interpretive mutual agreement procedure, revolving, in particular, as already mentioned, around the "baseline" qualification of certain marketing and distribution activities under specific circumstances. Prima facie, it may seem dubious whether such a question may be suitable to be handled by mandatory binding arbitration. In the authors' view, this should be the case as this outlet would basically be meant as a remedy for the taxpayer to substantiate why certain activities would not fall under the scope of Amount B rather than a traditional interpretive mutual agreement procedure or, even less so, an outlet for states to engage in negotiation between themselves on the segmentation of Amount B. It thus appears clear that the current rigid taxonomy carving out interpretive procedures may need to be revisited. Given the need to ensure an effective remedy, unlike the favour typically displayed towards the "last best offer" model,[295]such an interpretive question would perhaps most suitably be addressed within the framework of a "reasoned opinion" procedure. On the other hand, once the interpretive question has been addressed and it has been determined that a given transaction or set of transactions would fall outside the scope of Amount B, the issue of quantification would remain to be addressed. Structurally, this would seem to be the core of Amount C as outlined in the Secretariat proposal on the unified approach. It appears clear that, in this case, a full-fledged facts and circumstances analysis would be reintroduced, which would arguably be based on the OECD TPG. Indeed, such issues could form the object of an arbitration procedure, which, for the reasons of transparency and predictability outlined above, should, in the view of the authors, be based on the "reasoned opinion" model. The outcomes may then be relevant also to establish ex ante guidelines and, even, where applicable, targeted APAs. In other words, the flowchart from Amount B to Amount C would typically encompass:

- A robust system of dispute prevention relying on extensive guidance, based on which advance pricing agreements could also be settled.
- If no agreement is reached, some third-party facilitation, for instance based on mediation models, may be needed.
- Such a facilitation may take place during or before a mutual agreement procedure is initiated to determine whether the concerned transactions fall within the scope of "baseline marketing and distribution activities". Despites its inherently interpretive nature, such a procedure should be allowed to lead to an arbitration procedure, ideally provided in the form of an "independent opinion arbitration".
- If the outcome of the procedure is that the concerned activities should not be included in the scope of application of Amount A, a facts and circumstance analysis based on the TPG would need to be conducted. Such an analysis may form the object of an arbitration procedure, which, once crystallized, may serve as the basis for future bilateral or multilateral APAs concerning analogous transactions.

5.3. Putting it together: Impact on multinationals in selected business models

5.3.1. Corporate profit reallocation for centralized business models dealing with goods

This section discusses three cases to illustrate Amounts A, B and C and the interaction between them.

A centralized MNE usually operates with (one or more) "centralized" entities and (one or more) "assisting" entities. The centralized entities usually make key decisions and control key risks pertaining to the MNE's value chain. In many cases, such entities also own the valuable intellectual property. On the other hand, the assisting entities usually perform their activities under the supervision and guidance of the centralized entity. They (may) also bear low risks. Moreover, in many circumstances, the assisting entities do not own valuable intellectual property. Examples of such assisting entities include (but are not limited to) (i) contract research and development (R&D) entities that assist in performing research services; (ii) procurement service entities that assist in buying raw materials; (iii) contract or toll manufactures that provide manufacturing services; and (iv) low risk distributors that assist in selling the finished product.

The current profit allocation principle, i.e. the ALP, is based on the philosophy that an entity is entitled to higher returns (profits or losses) when it controls key risks in its value chain. Therefore, if the centralized entity controls key risks through its personnel, then it will in principle be entitled to higher returns. This also implies that assisting entities or low-risk entities are entitled to returns that commensurate with the lower functions performed and lower risks assumed. Typically, service providers are remunerated on a cost-related basis and limited risk distributors on the basis of a certain percentage of their sales. Essentially, one-sided transfer pricing methods are used to remunerate low-risk entities.

Consider the following example[296]of MNE Group R that operates in Country R through its ultimate parent, Company R. This entity has developed all trade and marketing intangibles. Company R sells its products in the Country R market. Assume that

295. For the many policy and legal hurdles raised by this type of procedure, *see* Neto, *supra* n. 127 .
296. This example is based on a blog post written by one of the authors to this contribution. *See* V. Chand, *Impact of Pillar I on Centralized Consumer Facing (Goods) Business Models: An Initial Assessment Through an Illustration* , Kluwer International Tax Blog (27 Feb. 2020), available at http://

Company R, which makes use of contract manufacturers in other countries to process its goods, sells its finished products in three countries in addition to its home Country R. In Country S1, the products are sold on a remote basis. As a PE does not exist in that country (under the current nexus rules), Company R is not subject to corporate taxation there. In Country S2, the products are sold through an entity (Company S2) that carries out baseline distribution activities. Assume that the arm's length compensation of this entity amounts to 4% on sales made in that country. In Country S3, the products are sold through an entity (Company S3) that carries out full-fledged distribution activities which go beyond the baseline activities. For the purposes of this example, assume that Company S3 reports a taxable profit that amounts to 10% on local sales. This profit is at arm's length.

Further, assume that MNE Group R operates only one consumer-facing business falling within the scope of application of the rules of Amount A, e.g. automobiles.[297] According to its consolidated financial statements for 2021, MNE Group R has: (i) consolidated group operating revenue of USD 1 billion[298] and (ii) consolidated expenses of USD 600 million. Therefore, the group's profits amount to (iii) USD 400 million. This amount represents the group's EBT. Additionally, assume that the group generates 10% of its global revenue from Country S1 (USD 100 million), 20% of its global revenue from Country S2 (USD 200 million) and 30% of its global revenue from Country S3 (USD 300 million). The balance revenue is generated from Country R.

Furthermore, also assume that MNE Group R has generated similar revenues from each market jurisdiction for the past three years. Moreover, it invests heavily in advertising, marketing and promotion-related activities in all these jurisdictions. Accordingly, it is considered to satisfy the new "nexus" test[299] and is considered to have "significant and sustained engagement" in each country. In order to allocate profits to market countries, the MRPSM[300] would apply, as follows (using a 20% over 10% approach):

- Step 1: The group's EBT amounts to USD 400 Million and EBT margin amounts to 40% (EBT / operating revenues).
- Step 2: The deemed routine EBT margin is fixed at 10% (through multilateral negotiations) and thus 30% will be deemed to be non-routine EBT margin.
- Step 3: The non-routine EBT margin of 30% is split between production activities/intangibles (80%) and market activities/ intangibles (20%). This split is also agreed through multilateral negotiations. Essentially, 6% of the EBT margin will be allocated to market-related activities.
- Step 4: Group R's market-related profits are determined to be 6% of the overall revenues, which amounts to USD 60 million (USD 1 billion × 6%).

The reallocation for Amount A will work as follows (the sales made in Country R will not be analysed):

- Country S1: As 10% of the global sales are derived from Country S1, it will be allocated USD 6 million ((60 × 100) / 1000 = 6) of that profit.
- Country S2: As 20% of the global sales are derived from Country S2, it will be allocated USD 12 million ((60 × 200) / 1000 = 12) of that profit.
- Country S3: As 30% of the global sales are derived from Country S3, it will be allocated USD 18 million ((60 × 300) / 1000 = 18) of that profit.

Ideally, the Amount A deemed profit should be taxable at ordinary corporate tax rates applicable in each jurisdiction. However, given the fact that countries are sovereign, it may well be possible that some countries could enact a higher tax rate for the Amount A profit or may not tax that deemed profit at all. At this stage, we would tend to argue that national corporate taxes for Amount A should be linked to the ordinary corporate tax rates. Appropriate non-discrimination clauses will need to be incorporated into the full-fledged multilateral treaty.

Further, as Company S2 carries out baseline activities, Country S2 will be given an Amount B allocation. For the rest of the example, we will assume this to be 4% on local sales.

As Company S3 carries out activities that go beyond baseline activities, it will fall under the scope of Amount C. Coming back to our example, in Country S3, Company S3 reports an arm's length operating margin of 10% on sales. Thus, the Amount C taxable

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kluwertaxblog.com/2020/02/27/impact-of-pillar-i-on-centralized-consumer-facing-goods-business-models-an-initial-assessment-through-an-illustration/ (accessed 1 July 2020).

297. The proposal is applicable to businesses that carry out Automated Digital Services (ADS) or businesses that are consumer-facing businesses. For a discussion on the scope, *see* OECD, *Statement on the Two-Pillar Approach* (2020), at paras. 14-32 (OECD 2020).

298. It is expected that Amount A will only apply to MNE groups whose revenue exceeds EUR 750 million. For a discussion on the revenue threshold, *see* OECD, *Statement on the Two-Pillar Approach* (2020), at para. 35.

299. For a discussion on the new nexus, *see* OECD, *Statement on the Two-Pillar Approach* (2020), at paras. 36-41.

300. For a discussion on Amount A, *see* OECD, *Statement on the Two-Pillar Approach* (2020), at paras. 42-47.

base, as per the current transfer pricing rules, is equal to 10% on local sales. This amounts to USD 30 million ((300 × 10) / 100 = 30). Moreover, based on the above example, the Amount A taxable base in Country S3 is USD 18 million.

To a certain extent, there is some overlap between Amount A and Amount C. Thus, in order to reduce this overlap, one possibility, as contemplated by some commentators to the unified approach (for instance, by Johnson & Johnson and by others)[301]is to state that Amount A should not be applicable in countries in which an MNE operates full-fledged entities as those entities book a part of the residual profits. Another option would be to start with Amount C (USD 30 million). Amount A (USD 18 million) could then be compared to Amount C. As the local entities' actual taxable profit, which also includes a part of the residual profit, is higher than the deemed taxable profit, no taxes will be required to be paid on Amount A. Another possibility is to reduce from Amount A an amount that is linked to non-routine margins. Assume that the routine ALP margin for baseline functions is fixed at 4% on sales (Amount B). Thus, the amount that will be reduced from Amount A will be linked to the non-routine margin, that is, 6% on Country S3 sales which amounts to USD 18 million ((300 × 6) / 100=18). Thus, the taxable amount under Amount A in Country S3 amounts to USD 18 – 18 = 0.[302]

5.3.2. Corporate profit reallocation for decentralized business models dealing with goods

A decentralized MNE business usually performs its activities with local entities. In terms of functions, the local entity usually takes key decisions and controls key risks pertaining to its value chain. In many circumstances, the local entity could also be responsible for development-related activities for either trade or marketing intangibles. Thus, such entities could also own valuable intellectual property (IP).

A typical structure[303]relates to a case where an MNE (MNE Group R), which has its ultimate parent in one jurisdiction, sets up a full-fledged business in another jurisdiction. For example, consider the situation of Company R in Country R that has developed all trade and marketing intangibles with respect to certain products. Company R manufactures and sells its products in the Country R market. For its operations in Country S1, Company R establishes a local entrepreneur (Company S1) that is in charge of manufacturing and selling products in that territory. Company S1 is also responsible for selling the products in neighbouring territories (for example, Country S2). Company R licenses its intangibles to Company S1. Company S1 uses the intangibles for its operations and derives business income. Company S1 pays an arm's length royalty to Company R. From a transfer pricing perspective, depending on their exact functional profile, both entities could be classified as "entrepreneurs" from a functional analysis (accurate delineation) standpoint.

Assume the following further facts of MNE Group R which operates only one consumer-facing business falling within the scope of Amount A, such as a fast-moving consumer goods business.[304]According to its consolidated financial statements for 2021, MNE Group R has: (i) consolidated group operating revenue of USD 2 billion and (ii) consolidated expenses of USD 1.5 billion. Therefore, the group's profits amount to (iii) USD 500 million. This amount represents the group's EBT.

In addition, assume that MNE Group R generates 40% of its global revenue from Country S1 (USD 800 million) and 20% of its global revenue from Country S2 (USD 400 million). These sales are booked by Company S1 in Country S1. On this turnover, Company S1 reports a 5% taxable profit on sales (post royalties). The corporate tax rate in Country S1 is 20%. Thus, under the existing framework, Company S1 pays corporate taxes amounting to USD 12 million on a taxable base of USD 60 million (1200 × 5% × 20%) in Country S1. As the sales in Country S2 are made on a remote basis, under the existing framework, Company S1 does not pay any corporate taxes in that country. Further, assume that Country S1 applies withholding taxes authorized by domestic law and tax treaties (10%) on the arm's length royalties (5% on sales) that have been paid out. The royalties paid out from Country S1 by Company S1 amount to USD 60 million (1200 × 5%) and the withholding taxes amount to USD 6 million (60 × 10%).

Furthermore, assume that MNE Group R has generated similar revenues from each market jurisdiction for the past three years. Moreover, Company S invests heavily in advertising, marketing and promotion-related activities in Country S1 and Country S2. Accordingly, the entire MNE Group is considered to have "significant and sustained engagement" in both market countries and hence it satisfies the "new nexus" test. In order to allocate profits to market countries, assume the MRPSM (using a 20% over 10% approach) would apply as follows:

- Step 1: The group's EBT amounts to USD 500 million and its EBT margin amounts to 25% (EBT / operating revenues).

301. *See* Johnson and Johnson, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 5; Skadden, at p. 4. Both available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
302. *See* Skadden, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 4, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
303. *See* Unilever, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 5, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
304. This example is based on a blog post written by one of the authors to this contribution. *See* V. Chand, *Impact of Pillar I on Decentralized Consumer Facing (Goods) Business Models: An Initial Assessment Through an Illustration* , Kluwer International Tax Blog (28 Feb. 2020), available at http://kluwertaxblog.com/2020/02/28/impact-of-pillar-i-on-decentralized-mne-consumer-facing-goods-business-models-an-initial-assessment-through-an-illustration/?print=print&doing_wp_cron=1595684166.9614369869232177734375 (accessed 1 July 2020).

- Step 2: The deemed routine EBT margin is fixed at 10% (through multilateral negotiations) and thus 15% will be deemed to be non-routine EBT margin.
- Step 3: The non-routine EBT margin of 15% is split (after multilateral negotiations) between production activities/intangibles (80%) and market activities/intangibles (20%). Essentially, 3% of the EBT margin will be allocated to market-related activities.
- Step 4: MNE Group R's market-related profits is determined to be 3% of the overall revenue, which amounts to USD 60 million (USD 2 billion × 3%).

The reallocation for Amount A will work as follows (the sales made in Country R will not be analysed):

- Country S1: As 40% of the global sales are derived from Country S1, it will be allocated USD 24 million ((60 × 400) / 2000 = 24) of that deemed profit.
- Country S2: As 20%of the global sales are derived from Country S2, it will be allocated USD 12 million ((60 × 400) / 2000 = 12) of that deemed profit.

Amount B should not be relevant to our case as both Company R and Company S1 perform activities that go beyond baseline activities. On the other hand, Company S1 will fall under the scope of Amount C. Thus, there could be an overlap between these Amounts.

Several options emerge to address the issue of an overlap between Amount A and the residual profits that are booked by the licensed manufacturer. One option is to state that Amount A should not be applicable in the jurisdiction of the licensed manufacturer as such manufacturers already report residual profits in the local jurisdiction.[305]Thus, Amount C takes precedence over Amount A. Another possibility would be to start with the taxable profit of the Company S1. The Amount A liability could then be compared to this amount. If the local entity's actual taxable profit, which also includes a part of the residual profit, is higher than the deemed taxable profit (Amount A), no taxes will be required to be paid on Amount A. A more nuanced approach would be to extend the scope of Amount B (in order to provide fixed returns for baseline manufacturing activities). The returns exceeding the baseline activities would be classified as residual returns. The residual return or the tax paid on this residual return will be reduced from the Amount A tax liability.

Another matter which merits consideration concerns the withholding taxes on royalties. We would argue that if the royalty paid by Company S1 is subject to a withholding tax on a gross basis, that amount should be reduced from the Amount A allocation with respect to those countries. This is because the withholding tax captures a part of the IP profit at source. For example, the withholding tax could be credited against the Amount A tax liability.[306]In the aforementioned situations, by reducing the actual corporate tax as well as the withholding tax liability, it could well be possible that the tax liability under Amount A is not payable.

5.3.3. Corporate profit reallocation for an online advertiser

The business model of a social network supported by advertising revenue has already been discussed in the OECD's 2018 Interim Report on Tax Challenges Arising from Digitalisation.[307]Consider the highly simplified situation of MNE Group F that operates in Country R through its ultimate parent, Company R. This entity has developed all trade and marketing intangibles. Specifically, Company R has developed a user base of 500 million users in Country U1. Company R sets up a wholly owned subsidiary, Company T, in Country T. This entity markets the online targeted advertising services of Company R in the Country T market and is remunerated on a cost-plus basis as a result of its limited functional profile. Several business owners of various products or services in Country T enter into advertising contracts with Company R. The advertisements are intended to be targeted at users living in Country U1. These simplified facts indicate that under the current framework, a PE of Company R does not exist in either Country U1 and Country T (assuming the Country R-Country T Tax Treaty is based on the 2014 OECD Model[308]as it was not updated by the MLI).

Further, assume that MNE Group F operates only one automated digital business falling within the scope of Amount A, such as online advertising.[309]According to its consolidated financial statements for 2021, MNE Group F has: (i) consolidated group operating revenue of USD 1 billion and (ii) consolidated expenses of USD 700 million. Therefore, the group's profits amount to (iii) USD 300 million. This amount represents the group's EBT. In addition, assume, for the sake of simplicity, that the group generates all its revenues from a Country T client. Furthermore, assume that MNE Group F has generated similar revenues from Country T

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305. *See* Unilever, in Public Comments to the OECD, *Secretariat Proposal* (2019), at p. 3, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
306. *See* Digital Economy Group, in Public Comments to the OECD, *Secretariat Proposal* (2019), at pp. 9-10; Maisto e Associati, at pp. 6-7. Both available at https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm (accessed 1 Mar. 2020).
307. OECD, *Interim Report* (2018), at paras. 100-129 .
308. *OECD Model Tax Convention on Income and on Capital* (26 July 2014), Treaties & Models IBFD.
309. *See* OECD, *Statement on the Two-Pillar Approach* (2020), at para. 22.

for the past three years. Accordingly, it is considered to satisfy the new "nexus" test[310] and is considered to have "significant and sustained engagement". In order to allocate profits to market countries, the deemed MRPSM (using a 50% over 10% approach) would apply as follows:

- Step 1: The group's EBT amounts to USD 300 million and EBT margin amounts to 30% (EBT / operating revenues).
- Step 2: The deemed routine EBT margin is fixed at 10% (through multilateral negotiations) and thus 20% will be deemed to be non-routine EBT margin.
- Step 3: The non-routine EBT margin of 20% is split between production activities/intangibles (50%) and market activities/ intangibles (50%). This split is also agreed through multilateral negotiations which takes into account the so called "digital differentiation",[311] that is, a higher reallocation of profits to the market country for selected HDBs. In fact, such a differentiation has been proposed by the Indian tax administration (*see* section 4.3.). Essentially, 10% of the EBT margin will be allocated to market (user)-related activities.
- Step 4: MNE Group F's market (user)-related profits is determined to be 10% of the overall revenue, which amounts to USD 100 million (USD 1 billion × 10%).

This Amount A deemed profit of USD 100 million will be allocated to Country U1 in light of its user base.[312] Although it is not clear in this case, it may well be possible that Company T would fall under the scope of Amount B and would be entitled to a fixed cost-plus return on its marketing activities. If the activities exceed the baseline activities, Amount C could also be applicable.

6. Conclusion

Unilateral measures, in particular DSTs, are on the rise. While the merits and demerits of DSTs have been discussed extensively, in the authors' view, they (i) are not based on a sound policy rationale as "users" *per se* do not create value; (ii) may conflict with the ability-to-pay principle as they are applied on gross revenues; (iii) conflict with one of the most commonly cited tax policy principle, that is, the principle of neutrality, since they apply only to a select number of digital businesses (online advertisers or online marketplaces); (iv) may conflict with selected provisions of tax treaties, the Treaty on the Functioning of the European Union [313] (for instance, freedom of establishment) as well as International Trade Law. It is only a matter of time before Courts rule against the application of such taxes. Accordingly, such taxes, which are spreading across the world quite rapidly, should not be pursued and policymakers should focus on multilateralism and a consensus-based solution.

Thus, taken as a whole, the unified approach, seems to be a step in the right direction. Undoubtedly, Amount A and the deemed reallocation percentages used therein (20% over 10% or 10% over 10%, or different percentages for HDBs) will be subject to intense political negotiations, especially in light of the COVID-19 crisis.[314] It is quite obvious that developing countries will argue for a higher income reallocation to market countries whereas investment hubs would like to surrender as little as possible. Eventually, a "2020s compromise" will need to be struck to maintain the balance between residence and source countries. In this regard, the use of predetermined approaches/formulas in Amount A as opposed to a facts and circumstances analysis is particularly welcome and is likely to enhance tax certainty. These latter considerations also extend to Amount B, which, although not necessarily inseparable from Amount A, will contribute to greater predictability and administrability in the pivotal area of transfer pricing. Amount C, while really consisting of a process rather than an amount, will provide, insofar as this is possible given the magnitude of the changes to be brought about by the Pillar 1 proposal, an incremental approach to the envisaged reform and greater continuity with the present framework, also contributing to enhance overall certainty. In light of these considerations, it thus appears that one characteristic of the proposed reform that may warrant its long-term sustainability against all the technical complexities and political odds would seem to lie in the circumstance that the whole proposal would have tax certainty as one of the key goals.

Moreover, other aspects of the Amount A proposal need to be based on objective rather than subjective standards. In other words, the facts and circumstances elements (interpretation elements) of Amount A need to be kept to a minimum to prevent disputes. In this regard, objectivity can be achieved vis-à-vis the "scope" of Amount A by providing an exhaustive list of examples of businesses that fall under the "consumer facing" or "automated digital services" categories. The list needs to be flexible in the sense that it can be updated on a periodic basis to take into considered new technological developments. Alternatively, quantitative tests

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310. Id., at para. 38.
311. Id., at para. 46.
312. Id., at paras. 41 and 47.
313. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), Primary Sources IBFD. Among comments in the literature, see in particular, Nogueira, *supra* n. 137 ; Mason and Parada, *supra* n. 137 ; and Turina, *supra* n. 137 . With regard to the more policy-oriented arguments and, in particular, the questionable premise of user participation, *see* the considerations developed and the literature cited in *supra* n. 174 .
314. With specific reference to the interrelation between the digital tax debate and the COVID-19 emergency, *see* R. Collier, A. Pirlot, J. Vella, *Tax policy and the COVID-19 Crisis* , Oxford CBT Working Paper 20/01 (June 2020), available at https://www.sbs.ox.ac.uk/sites/default/files/2020-07/WP20-01.pdf) and A. Christians, T. Diniz Magalhães, *It's Time for Pillar 3: A Global Excess Profits Tax for COVID-19 and Beyond* , Tax Notes International (4 May 2020).

linked to consolidated balance sheet figures could be used to determine whether or not an MNE or an MNE's business line is within the scope of Amount A.

With respect to nexus, objectivity could be achieved by resorting only to fixed sales-related thresholds to determine "significant and sustained engagement". The use of "plus" factors within the "consumer facing" category should not be pursued if the factors are not objective.

Likewise, objective standards would be required to identify the surrendering jurisdiction and the relevant taxpayer which would eliminate double taxation. This said, this area seems to be the most complicated aspect of Amount A as a thorough understanding of an MNE's business model coupled with an equally thorough understanding of how profits are allocated within the MNE under the existing ALP is required to understand the jurisdictions in which the MNE is booking residual profits. Thus, from a broader perspective and putting aside the profit allocation debate, the application of a facts and circumstances test may need to be balanced with predetermined approaches.

Predetermined approaches also constitute the backbone of Amount B. In this respect, the authors argue that making the fixed return remuneration subject to the possibility of being rebutted by either states or taxpayers would indeed jeopardize this fundamental policy objective. In the authors' view, the issues that are typically addressed through rebuttable presumptions would qualify as an attempt to correct ex post certain dysfunctionalities that could have been addressed ex ante through a more careful design and calibration of the applicable predeterminations. Thus, the predeterminations envisaged by the so-called Amount B should, in principle, constitute legal presumptions of a non-rebuttable nature for both taxpayers and governments. This implies that great care will need to be taken so that the predeterminations on which Amount B relies can be sufficiently robust. To this end, the authors are of the opinion that different margins need to be proposed for different businesses, as the margins applied for baseline distribution or marketing activities differ from one industry to the next. Moreover, different margins will need to be proposed for different regions or countries. Given the potential risk of fragmentation, in order to minimize the instances of international double (non-)taxation, the setting of the fixed return should not be left to individual jurisdictions but should be developed under the auspices of an ad hoc forum which should ensure reliance of the predeterminations with the broader ALP and monitor this on a regular basis.

In light of all the foregoing, the challenge that lies ahead is of remarkable proportions. As the title of this article has alluded to, granted all the political hurdles, the international tax regime may be about to move from the original "1920s compromise" to a new "2020s compromise". As illustrated, this would imply a move from BEPS 1.0 to BEPS 2.0 (base *expansion* and profit *sharing*). It could well be possible that, another century from now, the world may witness BEPS 3.0 (breaking existing profit-allocation systems) and will have moved towards taxing MNEs as single economic units only on the basis of predetermined formulas. Time will tell.