ARTICLE

Allocation of Taxing Rights in the Digitalized Economy: Assessment of Potential Policy Solutions and Recommendation for a Simplified Residual Profit Split Method

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In 2019, the OECD released a public consultation document and its work program that address the tax challenges raised by the digitalization of the economy. These documents essentially discuss proposals that either address the allocation of taxing rights (Pillar I) or unresolved Base Erosion of Profit Shifting issues (Pillar II). Regarding Pillar I, three solutions were proposed: user participation, significant economic presence, as well as the marketing intangibles approach. The purpose of this contribution is to assess the Pillar I proposals considering their policy rationale and the broadly agreed tax policy principles by tax administrations. In light of the assessment, the author takes the view that the marketing intangible proposal, which seems to apply to consumer (or user) facing businesses, could be the most appropriate solution to address the issue of the allocation of taxing rights. However, that proposal incites several issues concerning its profit allocation mechanism. Thus, in order to achieve tax certainty, the contribution offers a potential solution for implementing the consumer (or user) facing proposal, that is, to resort to a simplified residual profit split method that is based on operating profit margins of a MNE Group . The article provides a high-level overview of the design of the mechanism and briefly addresses issues related to scope and nexus as well as rules that deal with elimination of double taxation.

1 The Purpose and Structure of this Contribution

1. In February 2019, the OECD released a public consultation document[1] (PCD) that addresses the tax challenges raised by the digitalization of the economy. The PCD essentially discusses proposals that either address the allocation of taxing rights (Pillar I) or unresolved Base Erosion of Profit Shifting (BEPS) issues (Pillar II). Thereafter, in May 2019, the OECD/G20 inclusive framework released its work programme to develop a consensus-based solution for both issues.[2] The purpose of this contribution is to assess the Pillar I proposals contained in the PCD and to propose the design of a potential profit allocation solution, especially considering the OECD's work program.

2. The contribution is structured as follows. In section 2, the author summarizes the current framework for taxing cross border business income. Section 3 addresses the issue of allocation of taxing rights. Section 4 depicts the assessment framework for the proposals. In section 5, the author assesses the three Pillar I proposals considering the assessment framework, that is, their policy rationale as well as broadly agreed tax policy principles by tax administrations. Thereafter, section 6 proposes a high-level design of a profit allocation solution in the form of a simplified residual profit split method . In section 7, the author briefly examines his opinion on fundamental reforms that are being discussed to solve the allocation of taxing rights issue. Finally, section 8 concludes.

2 The Current Framework for Taxing Cross Border Business Income: '*Supply*' or '*Supply-Demand*'?

3. Under the current international corporate tax framework, business income is generally '*sourced*' in the

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The author would like to thank Mr Nicolas Cepeda for his research assistance with respect to this contribution. The author would also like to thank Professor Robert Danon (Tax Policy Center, UNIL), Professor Luc De Broe (Professor, KU Leuven), Dr Richard Collier (Oxford Center for Business Taxation), Mr Stefaan De Baets (Of Counsel, PwC), and Conrad Turley (Partner, KPMG China) for commenting on the draft versions of this article. The contribution was finalized on 1 September 2019.
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1 OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Public Consultation Document*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2019).

2 OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2019).

INTERTAX, Volume 47, Issue 12
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State where an enterprise conducts business or economic activities with its production factors (such as employees).[3] Therefore, if an enterprise (Company R) produces in one State (Country R, the State in which it is a tax resident) and sells in another State (Country S) on a remote basis, then corporate tax on that business income is only payable in the former State (Country R).

4. The history of the framework can be traced back to the work undertaken by the League of Nations (LON). Specifically, the LON had appointed four economists to study the issue of double taxation who introduced their report in 1923.[4] With respect to business enterprises/commercial establishments, the economists came to the conclusion that such income should be taxed in the State where an enterprise has its '*origin*' factors.[5] Origin of income is typically the place where '*earnings are created*' by human agency.[6] These findings were reiterated in subsequent reports produced by the LON as well as draft conventions for prevention of double taxation.[7]

5. In 2005, the OECD once again discussed this framework in its report on Ecommerce.[8] Essentially, the OECD analysed the question as to whether the international corporate tax base should be allocated among States based on the '*supply*' approach or '*supply-demand*' approach.[9] Under the former approach, business income is allocated to the State where the enterprise has its '*production*' or '*origin*' factors. This would imply that demand factors provided by a market jurisdiction such as the presence of a consumer market or a consumer base that is able to pay for goods and services due to efficient functioning of that State are irrelevant for allocating the corporate tax base among States.[10] On the other hand, under the latter approach, the presence of demand factors plays an important role in the allocation of the corporate tax base as profits can only be earned from the interaction between supply and demand factors.[11] Several members of the Technical Advisory Group Members (TAG Committee) concluded that the former approach should be preferred. The report states, 'a *large majority … implicitly rejected the 'supply-demand' approach. For them, the mere fact that the realization of business transactions requires an interaction between the supply of goods or services by an enterprise and the demand*

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3 K. Vogel, *Worldwide vs. Source Taxation of Income: A Review and Re-evaluation of Arguments (Parts II)*, 16(10) Intertax 310, 320 (1988); K. Vogel, *Worldwide vs. Source Taxation of Income: A Review and Re-evaluation of Arguments (Part III)*, 16(11) Intertax 393, 398 (1988); A. Schäfer & C. Spengel, *ICT and International Taxation: Tax Attributes and Scope of Taxation*, Discussion Paper 02–81, Centre for European Economic Research 11, 11–12 (2002); E. C. C. M. Kemmeren, *Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach*, 60(11) Bull. Int'l Tax'n 430, 433–437 (2006); M. Devereux, *Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations*, 24(4) Oxford Rev. Econ. Pol'y 698, 712–715 (2008); L. U. Cavelti, C. Jaag & T. F. Rohner, *Why Corporate Taxation Should Mean Source Taxation: A Response to the OECD's Actions Against Base Erosion and Profit Shifting*, 9(3) World Tax J. 352, 352–354 (2017); 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, 22 (2018); J. Becker & J. Englisch, *Taxing Where Value Is Created: What's 'User Involvement' Got to Do with It?*, 47(2) Intertax 161, 163–164 (2019).

4 G. Bruins et al., *Report on Double Taxation: Submitted to the Financial Committee. Document E.F.S.73.F.19* (League of Nations 1923).

5 Bruins et al., *supra* n. 4, at 29–32 and 39–40.

6 *Ibid.*, at 22–25.

7 League of Nations, *Double Taxation and Tax Evasion Report and Resolutions Submitted by the Technical Experts to the Financial Committee, Document F.212* 31 (1925); League of Nations, *Draft of a Bilateral Convention for the Prevention of Double Taxation and Tax Evasion, Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, Document C.216.M.85.1927.II* 10–11 & 15 (1927); League of Nations, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, Document C.562.M.178.1928.II* 8–9 & 12–13 (1928); League of Nations, Fiscal Committee, *Report to the Council on the Work of the First Session of the Committee, Document C.516.M.175.1929* 4 (1929); League of Nations, Fiscal Committee, *Report to the Council on the Work of the Second Session of the Committee, Document C.340.M.140* 8 (1930); League of Nations, Fiscal Committee, *Report to the Council on the Fifth Session of the Committee, Purposes of Taxation, Document C.252.M.124* 5 (1935); League of Nations, Fiscal Committee, *London and Mexico Model Tax Conventions, Commentary and Text, Document C.88.M.88.1846.II.A* 13–21 & 60 (1946); O. E. E. C., *The Elimination of Double Taxation, The First Report of the Fiscal Committee* 6–7 (31 Jan. 1958). All these reports have been accessed on the following link, http://www.taxtreatieshistory.org/ (accessed 27 July 2019). For a detailed analysis of these reports, *see* R. Collier & J. Andrus, *Transfer Pricing and the Arm's Length Principle* Ch. 1 (Oxford University Press 2017).

8 OECD, *E-Commerce: Transfer Pricing and Business Profits Taxation*, No. 10, OECD Tax Policy Studies (OECD Publishing 2005).

9 *Ibid.*, para. 40.

10 Several academics/commentators seem to support the '*supply*' approach. For instance: Vogel argues exclusively for '*source*' taxation of business income. Source in this context means the place where the economic activities take place. *See* Vogel, *supra* n. 3. Other commentators include: Schäfer & Spengel, *supra* n. 3, at 11–12; Kemmeren, *supra* n. 3, at 435; Caveti, Jaag & Rohner, *supra* n. 3, at 352–354. Although it is not extremely clear, it seems that *Professor W. Schön* also supports this approach in one of his contributions, *see* Schön, *supra* n. 3, at 16–24. *Also see* Becker & Englisch, *supra* n. 3, at 163–164; Moreover, *see* US: Selected Tax Policy Implications of Global Electronic Commerce, Department of Treasury, 21–27 (1996); UK: HM Treasury, *Corporate Tax and the Digital Economy: Position Paper Update*, ss 2.26–2.32 (2018); Coalition of Netherlands based Technology Companies, at 8; Digital Economy Group, at 7.

11 Several academics/commentators seem to support the '*supply-demand*' approach. *See* R. Avi-Yonah, *International Taxation of Electronic Commerce*, 52(3) Tax L. Rev. 507, 538–542 (1997); A. Miller, *Taxing Cross-Border Services: Current Worldwide Practices and the Need for Change*, Doctoral Series vol. 37, 52–59 (IBFD 2014); P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy*, IBFD White Paper, 33–34 (2015); M. de Wilde, *Comparing Tax Policy Responses for the Digitalizing Economy: Fold Or All-In*, 46(6/7) Intertax 466, 471; M. Devereux & J. Vella, *Value Creation as a the Fundamental Principle of the International Corporate Tax system*, Eur. Tax Pol'y Forum, ss 2–4 (2018); W. Hellerstein, *A US Subnational Perspective on the 'Logic' of Taxing Income on a 'Market' Basis*, 72(4/5) Bull. Int'l Tax'n 293, s. 3 (2018); S. Gadžo, *Nexus Requirements for Taxation of Non-Residents' Business Income*, Doctoral Series vol. 42, 272–273 (IBFD 2018); E. Escribano, *Jurisdiction to Tax Corporate Income Pursuant to the Presumptive Benefit Principle*, Series On International Taxation Vol. 70, 42–47 (Wolters Kluwer 2019). Arguably, commentators who argue for withholding tax solutions could also be considered to be the supporters of such an approach. *See* A. Baez & Y. Brauner, *Taxing the Digital Economy Post BEPS … Seriously*, University of Florida Levin College of Law Research Paper No. 19-16 (2019).

in a market state has not historically been considered by countries to provide a sufficient link for considering that the profits of the enterprise arising from these transactions should, for purposes of income taxation, be sourced in the market state … The TAG's approach was therefore in line with the supply-based approach of considering that business profits should be viewed as originating from the location of the factors that allow the enterprise to realize business profits. It therefore rejected the suggestion that the mere fact that a country provides the market where an enterprise's goods and services are supplied should allow that country to consider that a share of the profits of the enterprise is derived therefrom' .[12] This said, the country that preferred the '*supply-demand*' approach was India'.[13]

6. It also appears as though the BEPS project has reinforced the application of the '*supply*' framework. To elaborate, one of the core objectives of the BEPS project was to ensure that profits are taxed where '*economic activities take place and value is created*'.[14] In this regard, several actions of the BEPS plan have reinforced the application of activity-based concepts. For example, Actions 8–10 now provide detailed guidance on the concept of control over risk,[15] Action 5 introduced the substantial activities test,[16] and BEPS Action 6[17] provides that treaty benefits will only be granted to taxpayer structures that are linked to core commercial activity.[18] Accordingly, if a corporate taxpayer's personnel, such as employees, performs relevant activities in Country R (assuming Country R is also the State of its tax residence) and sells in another State on a remote basis, business income is taxed only in the former State.[19] Arguably, this objective also supports the application of the '*supply*' approach as opposed to a '*supply-demand*' approach. In fact, several commentators are clear with the fact that the reference to the concept of '*value creation*' in the BEPS project implies taxation in the country where the '*supply*' or '*production*' factors are present. However, they question whether the concept can be broadened in order to include '*demand*' or '*market*' factors[20] (*nonetheless, see the discussion in section 3 that is made from the supplier's perspective*). As discussed by *Professor Kemmeren*, such an approach would comply with the '*benefits*' principle[21] (in particular, the direct benefits principle)[22] in the sense that the income is taxed by the State that provides/enables the taxpayer to produce goods or services with its physical or legal infrastructure. This being stated, it should not be overlooked that, in most scenarios, the latter State imposes indirect taxes such as Value Added Tax (VAT) on consumption by a consumer base in accordance with the destination principle.[23]

7. On the other hand, from a corporate tax perspective, when Company R from Country R conducts business in Country S through '*origin*', '*supply*', or '*value creation*' factors therein (such as its

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[12] OECD, *supra* n. 8, at paras 41–42.

[13] *See* IN: Ministry of Finance of India, *E-commerce and Taxation Report*, Circular No.1/2004, 146–147 (2 Jan. 2004). In our opinion, this is the core reason that India asserts '*more*' taxation of income that arises from its borders. For instance, several Indian tax treaties contain a provision that deals with fees for technical services or included services. Arguably, India has not yet implemented the supply – demand approach for the sale of goods.

[14] OECD, *BEPS Project Explanatory Statement – 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing Oct. 2015), para. 1. For a critical analysis of BEPS Transfer Pricing recommendations, *see* Collier & Andrus, *supra* n. 7, at Ch. 7.

[15] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Revised Guidelines on Action 8-10*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing Oct. 2015), paras 1.65–1.67.

[16] OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing Oct. 2015), Ch. 4.

[17] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing Oct. 2015).

[18] *OECD Model Tax Convention (2017): Commentary on Article 29*, para. 181.

[19] V. Chand & B. Malek, *The Relevant Economic Activity Test and Its Impact on International Corporate Tax Policy*, 3 BTR (2019); E. C. C. M. Kemmeren, *If We Need a Destination-Based Corporate Income Tax, Do We also Need a Production-Based Consumption Tax?*, in *International Taxation in a Changing Landscape – Liber Amicorum in Honour of Bertil Wiman*, Series on International Taxation vol. 71, 154–156 (J. Monsenego & J. Bjuvberg eds, Kluwer Law International 2019).

[20] For a discussion on the issue, *see* J. Hey, *'Taxation Where Value Is Created' and the OECD/G20 Base Erosion and Profit Shifting Initiative*, 72(4/5) Bull. Int'l Tax'n s. 2 (2018); S. Morse, *Value Creation: A Standard in Search of a Process*, 72(4/5) Bull. Int'l Tax'n 196, 196–198 (2018); Devereux & Vella, *supra* n. 11, at ss 2–3. The latter authors, who unnecessarily stretch this concept, also question whether the standard supports taxation in the ultimate shareholder State of the relevant entity.

[21] For a critical analysis on the '*Benefit Principle*', *see* W. Schön, *International Coordination for a Second-Best World (Part I)*, 1(1) World Tax J. 67, at 67–70 (2009). Moreover, *Professor Arnold* and *Professor Sasseville* argue that compliance and administrative concerns could be relevant to arrive at this conclusion. *See* B. J. Arnold & J. Sasseville, *Source Rules for Taxing Business Profits Under Tax Treaties*, in *The Taxation of Business Profits Under Tax Treaties* 109–130 (B. J. Arnold, J. Sasseville & E. M. Zolt eds, Canadian Tax Foundation 2003). *Also see* A. P. Dourado, *In Search of an International Tax System in a Post-BEPS Tax Competition Setting*, 47(1) Intertax 2 (2019).

[22] Kemmeren, *supra* n. 19, at 156.

[23] For a detailed discussion on the destination principle, *see* OECD, *International VAT/GST Guidelines*, paras 1.8–1.15 (OECD Publishing Apr. 2017); On the issue, *also see* Schön, *supra* n. 3, at 18; Becker & Englisch, *supra* n. 3, at 164.

employees), then the latter State is justified in taxing that business income. This is because the factors either '*benefit*' from that States (1) physical infrastructure (for example, roads, highways, police, defence, and so on); or (2) legal infrastructure (for example, presence of a legal framework for conducting business).[24] From a taxable nexus perspective, the value creation factors (such as employees) in Country S could either be a part of the same enterprise (such as a permanent establishment)[25] or a separate related entity. From a profit allocation perspective, transfer pricing rules, which are based on the arm's length principle, are typically employed to allocate profits to the separate related entity[26] or to the permanent establishment.[27] These rules allocate profits to the taxable nexus based on the functions, assets, and corresponding risks (FAR). However, with respect to the permanent establishments, the author would like to emphasize that, depending on the actual tax treaty and State practices, formulary approaches may also be used.[28] Nevertheless, in the majority of situations, the current nexus and profit allocation rules are linked to physical presence requirements (in particular, presence of personnel). This is where the debate/tension begins.

3 The allocation of taxing rights issue: the ongoing shift from tangible to intangible presence

8. With the rise of digitalization, there is the growing concern that companies of a Multinational Group (MNE), especially highly digitalized businesses (HDB), can centralize operations and sell their products/services on a remote basis (especially over the internet) and derive substantial business income from other countries (Market Country or Market State) without any physical presence of personnel or with minimal presence therein. Moreover, some businesses can use digital technologies to collect data from users of a platform or end consumers with the ultimate objective of enhancing and commercializing their own product/service offering. Arguably, operating without or with less physical presence and collecting data is also possible due to the fact that companies rely extensively on intangibles in the digital age.[29] Taking into consideration these features, from a tax policy standpoint, the question arises of how the Market Country can tax the business income of an enterprise operating in the digital space. This is because the manner in which business is conducted and where value creation takes place has evolved and is evolving from tangible to an intangible/non-tangible presence.[30]

9. While international policy making organizations such as the OECD, the EU Commission, and the UN have proposed ideas to resolve the issue, several States have begun introducing unilateral measures either targeting (1) HDBs[31]; or (2) all enterprises.[32] In order to limit the rise of unilateralism,[33] the PCD offered the following three solutions that are to be analysed on a '*without prejudice*' basis: the user participation, the significant economic presence (SEP), and the marketing intangibles approach. Prior to assessing those proposals, an initial question arises as to why the Market State should tax the business income of a non-resident if that income has been derived only on a remote basis. Otherwise stated, can the Market Country tax the business income of a foreign supplier in the absence of presence (with personnel) in that country?

10. From the perspective of applying the '"*benefit*" principle, it could be argued that a non-resident supplier that does not have any physical presence in

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[24] D. Pinto, *E-Commerce and Source-Based Income Taxation*, Doctoral Series Vol. 6, s. 2.2.1 (IBFD 2003).

[25] *See* Art. 5 *OECD* Model Tax Convention (2017).

[26] *See* Art. 9(1) OECD Model Tax Convention (2017).

[27] *See* Art. 7(2) *OECD Model* Tax Convention (2017). *Also see* OECD, Ctr. for Tax Policy & Admin., *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD Publishing 2010). This report provides detailed guidance the interpretation of Art. 7(2) of the OECD Model Tax Convention. *See* OECD Model Tax Convention (2017): Commentary on Art. 7, paras 8–9.

[28] *See* Art. 7(4) OECD Model Tax Convention (2008).

[29] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS,*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2018), para. 34.

[30] Ibid., para. 397

[31] Digital service taxes are currently being implemented/discussed in countries such as Austria, France, Italy, the UK, and Spain. For a critical analysis of these taxes, *see* A. Turina, *Which 'Source Taxation' for the Digital Economy?*, 46(6/7) Intertax 495–519 (2018).

[32] For example, diverted profit taxes introduced in the UK and Australia or the Significant Economic Presence test introduced in India.

[33] OECD, *supra* n. 2, at para. 11.

the Market Country does not benefit directly from that country's physical infrastructure. In fact, some members of the TAG committee were of this opinion when discussing the '*supply*' approach. The report states that a number of members contended that the Market Country is justified to tax only when '*… the enterprise carries on activities thereon*'.[34]

11. On the other hand, it could also be argued that, although the non-resident supplier does not have direct access to tangible infrastructure, it does have access to the legal infrastructure of the Market Country. *Professor Dale Pinto* emphasizes in his doctoral thesis that protection of intangible property (IP) is critical for enterprises operating in the digital era. Therefore, if the Market Country offers an appropriate IP protection legal framework and considering the fact that IP plays an important role in the digitalized economy, it could be argued that the non-resident enterprise (NRE) or the MNE to which the NRE belongs indeed receives a benefit. Therefore, the Market Country is justified in taxing as it provides a direct benefit, that is, a legal framework that enables efficient conducting of business.[35] Importantly, some members of the TAG committee concurred with this opinion when discussing the '*supply*' approach. The OECD TAG report states that, for some members, '*source taxation is justified in such a case because the business profits of the foreign enterprise derive partly from the enterprise's use of important locational advantages provided by that country's infrastructure which make the business operations profitable. These may include, but are not limited to … , a legal system that ensure the protection of property rights and a financial infrastructure.*'[36] Moreover, it could be argued that the NREs (especially digital businesses) benefit from the Market Country's telecommunication infrastructure as that infrastructure enables the NRE to sell over the internet or collect data from users of a platform or end consumers.

12. Considering the above discussion, the author takes the position that the '*supply*' framework or '*value creation*' standard should, as a start, be seen from a supplier's perspective. This would imply that the framework/standard clearly permits taxation in the supply State in the traditional sense (the State where the firm performs its activities with its personnel). This also implies that the framework/standard permits taxation in the Market Country to the extent that the non-resident supplier has created value in that State. In this context, the framework/standard act as '*source*' rules. Under this line of thinking, it should be noted that the presence of personnel in the Market Country is not a precondition for exercising taxing rights by that State.[37] The '*source*' of income could be an intangible factor that has been developed by the firm, for instance, market related intangibles linked to that State such as customer intangibles or user networks (*as discussed in section 5.3*).

13. This said, the Market Country should exercise its tax jurisdiction only when the NRE supplier '*actively*' intervenes and benefits from that country's infrastructure in order to create value for itself. From a pragmatic perspective, nexus related thresholds would need to be developed to indicate such active or regular participation by the foreign supplier in the economic life of the Market Country. If the non-resident supplier crosses those thresholds, then profits will need to be computed and allocated to the Market Country.

4 Assessment framework

14. Also, before beginning the analysis, it should be noted that any solution for the digitalized economy should be built on a sound policy rationale and well-established tax policy principles (such as those agreed in the context of the '*Ottawa*'

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[34] OECD, *supra* n. 8, at para. 45.

[35] For a detailed analysis, *see* Pinto, *supra* n. 24, at s. 2.2.1. The author also argues that neutrality considerations, principles of equity as well as the concept of entitlement also indicate that the Market Country is justified in taxing the business income. *Also see* D. Pinto, *Exclusive Residence or Source Based Taxation – Is a New and Simpler World Tax Order Possible?*, 61(7) Bull. Int'l Tax'n 277, 288–289 (2007).

[36] OECD, *supra* n. 8, at para. 44.

[37] *Professor Schön* reaches a similar conclusion but on the grounds of '*efficiency*' as opposed to '*fairness*' considerations represented by the benefit principle or value creation standard. *See* 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, 3–12 (2019). This is also the area where we differ with notable commentators that equate the supply approach or value creation standard with physical presence requirements. Interestingly, *Professor Schwarz* comments '*If value creation is just the originating cause of income or profit, then the only real analytical task today remains the continuing examination of modern income and profit generation to identify its originating cause and the location of that cause*'. *See* J. Schwarz, *Value Creation: Old Wine in New Bottles or New Wine in Old Bottles?* (21 May 2018), http://kluwertaxblog.com/2018/05/21/value-creation-old-wine-new-bottles-new-wine-old-bottles/ (accessed 21 May 2019).

Framework[38]). For instance, any solution should (1) be neutral[39] in the sense that it should apply to all businesses (traditional or digital) unless certain reasonable exceptions can be made; (2) be flexible[40] meaning that it should take into consideration new business models that could be precipitated by digitalization; (3) pursue the path of certainty and simplicity,[41] especially with respect to profit allocation; (4) be efficient in that the compliance costs should be low for both tax administrations and taxpayers[42]; and (5) be effective in the sense that taxes can be easily collected by the tax administration and fair so that opportunities for tax avoidance are minimized.[43] This last criterion (5), which is particularly important in relation to determining the location of sales, will not be examined in this contribution as all proposals are still at a conceptual stage.

5 Assessing potential policy solutions

5.1 *The User Participation Proposal*

5.1.1 *Overview*

15. The proposal is premised on the policy rationale that '*users*' create value in the value creation process of selected digital businesses such as online advertisers or online market places.[44] For example, consider the situation of Company F and assume that it is a tax resident in Country R for its European operations, and the users that maintain their profiles on the online platform live in the UK. Essentially, users contribute their personal data to Company F and use that company's online platform in return. Thereafter, the employees in Country R process that raw data and sell targeted advertising services to clients all over the world. The clients then pay advertisement fees to Company F. Another example deals with Company A that runs a multi-sided business model for renting properties. Assume, once again, that it is a tax resident in Country R for its European operations, and the accommodation seekers and providers who are unrelated to each other are present in the UK. Essentially, for every booking that is made on Company A's online platform, the company charges intermediation fees for its services. Under the current framework, the profit derived from advertising or intermediation services is taxable only in Country R as all of the production activity takes place in that country.[45] This proposal thus contends that '*users*' to the platform are '*origin*', '*supply*', or '*value creation factors*'. In other words, their contribution leads to network effects and externalities and enhances the brand image and value of the platform depending on the business. Consequently, it seeks to allocate a part of the profits to the UK[46] with predetermined formulas.

5.1.2 *Assessment of the Policy Rationale*

16. This policy rationale appears to be highly debatable.[47] The EU Commission, the HMRC, and the UN Committee of Experts argue that '*users*' can be regarded as value creation factors. This is because their contribution is essential for a digital business (such as an online advertiser) to survive, operate, and commercialize.[48] However, several commentators are critical of this view. For example, *Professor Michael Devereux and Professor John Vella* argue that the data generated from user participation is a regular

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[38] OECD, *Electronic Commerce: Taxation Framework Conditions*, Report by the Committee on Fiscal Affairs (OECD Publishing 1998), para. 9 (Box 2); OECD, *supra* n. 8, at paras 60–99; OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD Publishing Oct. 2015), paras 10–13.

[39] OECD, *Electronic Commerce, supra* n. 38, at para. 9 (i); OECD, *supra* n. 8, at para. 60; OECD, *Addressing the Tax Challenges*, *supra* n. 38, at para. 10.

[40] OECD, *Electronic Commerce, supra* n. 38, at para. 9 (v); OECD, *supra* n. 8, at paras 87–98; OECD, *Addressing the Tax Challenges*, *supra* n. 38, at para. 10.

[41] OECD, *Electronic Commerce, supra* n. 38, at para. 9 (iii), OECD, *supra* n. 8, at paras 66–71; OECD, *Addressing the Tax Challenges*, *supra* n. 38, at para. 10.

[42] OECD, *Electronic Commerce, supra* n. 38, at para. 9 (ii); OECD, *supra* n. 8, at paras 61–65; OECD, *Addressing the Tax Challenges*, *supra* n. 38, at para. 10.

[43] OECD, *Electronic Commerce, supra* n. 38, at para. 9 (iv); OECD, *supra* n. 8, at paras 74–82; OECD, *Addressing the Tax Challenges*, *supra* n. 38, at para. 10.

[44] OECD, *supra* n. 1, at paras 18–19; OECD, *supra* n. 29, at paras 37–38; UK: HM Treasury, *supra* n. 10, at 7–10.

[45] OECD, *supra* n. 1, at para. 20.

[46] *Ibid.*, para. 21.

[47] *See* NZ: New Zealand Government, Options for Taxing the Digital Economy – a Government Discussion Document, para. 4.19 (June 2019).

[48] 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, 2018/0073(CNS), (21 Mar. 2018), 8–9; HM Treasury, *supra* n. 10, at paras 2.4–2.5; UN Committee of Experts on International Cooperation in Tax Matters, *Tax Issues Related to the Digitalization of the Economy: Report* (Apr. 2019), para. 15. Others supporting this position include: Y. Brauner & P. Pistone, *Some Comments on the Attribution of Profits to the Digital Permanent Establishment*, 72(4a) Bull. Int'l Tax'n 3 (2018).

business input in the production process.[49] Also, *Professor Johannes Becker and Professor Joachim Englisch*, in light of several examples that deal with the traditional economy, have demonstrated that user contributions that assist in enhancing network effects or assist in data collection/data production cannot be considered as '*value creation*' factors.[50] Similarly, *Professor Itai Grinberg* has convincingly demonstrated with several examples (in particular, by referring to the medical business and credit card business) that, if '*users*' are to be regarded as value creation factors, then the impact of that conclusion should not be restricted to a subset of digital businesses and should apply more broadly.[51] The author agree with these views, particularly with the fact that raw data is a regular business input. The author also concurs with *Professor Schoen's* opinion that a large user base only indicates that an NRE supplier actively intervenes through its own efforts in the Market Country[52] to develop a user base (the profits linked to this base are not taxed under the current framework). Therefore, the entire proposal seems to be built on a weak policy rationale.

5.1.3 *Assessment in Light of Policy Principles*

17. From the perspective of the application of tax policy principles, this proposal clearly amounts to ring fencing as it only applies to a subset of HDBs such as social media platforms, search engines, and intermediation platforms.[53] For similar reasons, it is also not flexible given the fact that this proposal will not encompass future business models (such as 3D printing) wherein digitalization may play a key role.[54] With respect to allocation of profits, the proposal seems to reject the use of transfer pricing rules due to their inherent subjectivity.[55] As an alternative, it suggests allocating a part of the MNE Groups non-routine or residual profits back to the '*user*' country by using predetermined formulas.[56] It is stated that the formulas would approximate the value generated by users.[57] Such a result, while being simple, could indeed eventuate arbitrary profit allocation outcomes.[58] If nexus rules are developed based on user thresholds and if that threshold is somehow low (for example, one hundred thousand users as put forward for the EU Commission[59]) then, arguably, this proposal would come with excessive compliance and enforcement costs for both taxpayers and tax administrations. An analysis of the public comments also indicates that this proposal is the least preferred by all commentators.[60] Therefore, in the author's opinion, this proposal has the least number of chances of being adopted as a global long-term solution. This said, several countries are currently contemplating or are ready to adopt digital service taxes that are built on the user participation concept as a short-term measure. This is conceptually incorrect.

5.2 *SEP Proposal*

5.2.1 *Overview*

18. The SEP proposal is premised on the assumption that digitalization has enabled, to an unprecedented

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[49] M. Devereux & J. Vella, *Taxing the Digitalised Economy: Targeted or System-Wide Reform?*, 4 BTR 387, 396–400 (2018). Other commentators also agree with this view. *See* de Wilde, *supra* n. 11, at 470–471; W. Neuvel, S. Jong & Á. De Uceda, *Profit Attribution Challenges in a Digital Economy – A Transfer Pricing Analysis of the EU virtual Permanent Establishment Concept*, 25(5) Int'l Transfer Pricing J. 335, 335–342 (2018). *See* OECD, *supra* n. 29, at para. 39; OECD, *supra* n. 1, at para. 61.

[50] For a discussion on the issue, *see* Becker & Englisch, *supra* n. 3, at 166–170.

[51] I. Grinberg, *International Taxation in the Era of Digital Disruption: Analyzing the Current Debate* 20–22 (28 Oct. 2018). I. Grinberg, *User Participation in Value Creation*, 4 BTR 413–417 (2018).

[52] In the context of discussing the '*digital investment*' proposal, *Professor Schön* also reaches a similar conclusion. *See* Schön, *supra* n. 3, at 26 and Schön, *supra* n. 37, at 18–19. *Also see* Becker & Englisch, *supra* n. 3, at 166–170.

[53] OECD, *supra* n. 1, at para. 28; New Zealand Government, *supra* n. 47, at para. 4.22.

[54] New Zealand Government, *supra* n. 47, at para. 4.33.

[55] *Ibid.*, para. 23.

[56] *Ibid.*, para. 24.

[57] *Ibid.*, para. 27.

[58] *Ibid.*, para. 4.24.

[59] European Commission, *Proposal for a COUNCIL DIRECTIVE Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence*, COM(2018) 147 final, 8–9 (21 Mar. 2018).

[60] Only a few commentators support this proposal. For instance, *see* the public comments of: (1) Businesses: AstraZeneca, at 1. (2) Business associations: World Association of Newspapers and News Publishers (WAN-IFRA), at 3. (3) Academics: Hernandez (University CLAPES). *See* OECD, *Public Comments on Consultation Document* (2019), http://www.oecd.org/tax/beps/public-consultation-tax-challenges-of-digitalisation-13-14-march-2019.htm (accessed 27 July 2019).

extent, an enterprise to actively intervene in the economic life of another country without having significant physical presence therein.[61]

19. With respect to the nexus, the proposal applies to a NRE that exceeds a revenue threshold combined with one or more of the following factors: user based factors (such as the size of the user base or volume of data collected[62]), digital factors (such as maintaining a website in the local language and payment options in the local currency[63]), 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 marketing and sales promotion activities.

20. With respect to resolving the profit attribution issue regarding sales that are done on a remote basis, one approach that the proposal contemplates is to adopt a fractional apportionment method.[64] A reference could be made to a recent draft report of the Indian Tax Administration to understand the application of this approach, although their approach was mainly discussed in the context of attributing profits to Permanent Establishment Permanent Establishment (PE) that arise under current treaty rules (fixed place or agency PE rules). First, the profit derived from the Market Country needs to be determined. The proposal contemplates that this could be calculated by applying the global profit rate of the MNE Group to the revenues that are generated in a particular jurisdiction. For example, assume that Company R from Country R, which is in the cloud computing business, sells remotely in India and derives gross revenue of USD 100. Also assume that the MNE Group to which Company R belongs makes a consolidated operating profit margin based on its consolidated financial accounts of 30% (consolidated operating profit/consolidated sales). Thus, in the first step, the profits derived from India would amount to USD 30 (30% of USD 100).[65] Second, the profits will be apportioned based on predetermined formulas (allocation keys). For example, the draft report contemplates giving equal weight to employees, assets, and sales.[66] This would imply that 67% of the profit will be allocated to Country R (due to the presence of employees and assets), and 33% will be allocated to India (based on sales). Thus, approximately one third of USD 30, i.e. USD 10, will be the profit of the SEP on which corporate taxes will have to be paid in India.

21. Interestingly, with respect to the first step, the Indian Tax Administration is of the opinion 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 the MNE Group's consolidated operating profit margin is negative (–5%). Even in such situations, the proposal states that the taxable base in India should, at a minimum, be equal to 2% of Indian revenues. Thus, profits derived from India will amount to USD 2, and one third of those profits, (USD) 0.66, will then be allocated to the SEP in India on which corporate taxes will have to be paid.

22. Moreover, in the draft report, India also contends that '*users*' can be regarded as value creation factors (a proposition that the author rejected in the previous section). Thus, in the context of certain digitalized businesses in which user participation plays a significant role or a less relevant role, the Indian proposal also considers allocating a certain weight to users based in India. Essentially, it is contemplated that sales will be allocated a weight of 30%, users 10–20% (depending on whether they are passive or active users), and the balance will be allocated to assets and employees.[67] Consequently, the profits of Company R (as discussed above) could be enhanced further.

23. An alternate approach entails resorting to a deemed profit methodology.[68] This method initially considers the SEP to be equivalent to a physical presence from which the NRE is operating a business. Thereafter, the method determines deemed net

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[61] OECD, *supra* n. 1, at para. 50; UN, *supra* n. 48, at para. 12.

[62] OECD, *Addressing the Tax Challenges*, *supra* n. 38, at para. 280.

[63] *Ibid.*, para. 279.

[64] OECD, *supra* n. 1, at para. 52; OECD, *Addressing the Tax Challenges*, *supra* n. 38, at para. 287; UN, *supra* n. 48, at para. 15; *Also see* OECD, *supra* n. 2, at paras 30–31.

[65] IN: Government of India, Central Board of Direct taxes, Income department, *Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment* (CBDT 2019), at para. 159.

[66] *Ibid.*, paras 152–158.

[67] *Ibid.*, paras 176–178. *Also see* European Commission, *Proposal for a Council Directive on a Common Corporate Tax Base*, COM(2016) 685 final, 2016/0337 (CNS) (25 Oct. 2016).

[68] OECD, *supra* n. 1, at para. 54; OECD, *Addressing the Tax Challenges*, *supra* n. 38, at para. 289.

income of the SEP by applying a ratio of presumed expenses to the NRE's revenue that is derived from transactions concluded with customers in the market jurisdiction. The ratio could be determined based on a number of factors such as by making references to industry profit margins of domestic taxpayers. For example, an online advertiser (NRE) could be classified under the advertisement industry, and its SEP could be allocated profits based on profit margins that are derived by comparable advertisement businesses in the market State.[69]

24. The SEP proposal proposes using gross based withholding taxes as a collection or enforcement mechanism. As the withholding tax will be applied in a non-final manner, the NRE could file a tax return to claim a refund for any excess taxes that have been paid.[70]

5.2.2 *Assessment of the Policy Rationale*

25. On the one hand, the proposal is premised on the policy rationale that the State in which the non-resident is actively present through digital means is justified to exercise tax jurisdiction. This proposition seems to be a reasonable suggestion from the perspective of the application of the '*benefit*' principle. Moreover, this approach would be compliant with the opinion of one group of the TAG Committee that expressed the view that, under the '*supply*' approach, the Market Country is justified to exercise its taxing rights even when there is no physical presence.[71]

26. On the other hand, if the policy rationale of this proposal is based on the fact that the '*supply-demand*' approach[72] should be the conceptual base for sharing the corporate tax base, then this would symbolize a shift in the current framework, at least the framework applied by OECD Member States.[73] In fact, as discussed previously, India[74] argues for this position. In its recent draft report on profit attribution, the Indian Tax Administration referred to the following passage of the 1923 report of the LON to support their position: '*The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, up to the point where wealth reaches fruition, may be shared in by different territorial authorities*'. The draft report states, '*This famous example only elaborates a simple principle that is always recognized by all businessmen, that it is the market and the demand for consumption that dictates production and not vice versa. In other words, profits are created by sales and not by inventories. Since it goes without saying, production is an equally essential element to business and no profits can be generated without production, it becomes clear that both production and sales are essential for the generation of profits. It also means that neither can be ignored for the purpose of determining the profits that would be taxable in a jurisdiction*'.[75]

27. At the outset, it should be noted that the example used by the four economists was only to emphasize the issue of equitably apportioning the taxable base among countries. The principles to actually do so were developed in the subsequent part of their report. To reiterate, the four economists came to the conclusion that business income should be taxed in the '*origin*' State. Thus, the context in which the example is used by the Indian Tax Administration is incorrect. Arguably, such an approach is also not in accordance with the '*value creation*' standard. To elaborate, this proposal does not begin by assessing the non-resident suppliers' efforts to create value in the Market Country but rather starts with the assumption that the presence of a market must be rewarded or that it also drives production. Moreover, the proponents of this proposal also appear to neglect the fact that VAT is collected on consumption by a consumer base.[76] Therefore, the SEP proposal seems to be built based on a debatable policy rationale (at least, in the author's opinion).

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[69] OECD, *Addressing the Tax Challenges*, *supra* n. 38, at para. 290.

[70] OECD, *supra* n. 1, at para. 55.

[71] OECD, *supra* n. 8, at para. 44.

[72] UN, *supra* n. 48, at para. 15.

[73] *Ibid.*, para. 17.

[74] CBDT, *supra* n. 65, at Ch. 4.

[75] *Ibid.*, para. 51.

[76] UN, *supra* n. 48, at para. 51; New Zealand Government, *supra* n. 47, at. paras 4.51–4.52. *Also see* Schön, *supra* n. 37, at 15–16. In the context of discussing this proposal, the author also raises the question as to why the mere presence of demand factors, which is already tackled by VAT, should justify taxation in the Market State.

5.2.3 *Assessment in Light of Policy Principles*

28. From the perspective of the application of tax policy principles, it is rather ambiguous as to whether the proposal applies to *'digital businesses'* or *'all businesses'*.[77] A recent UN document indicates that the proposal could apply only to the former category of businesses, in particular, HDBs.[78] Thus, it may amount to ring fencing and could be non-neutral.[79] Similarly, non-neutral outcomes will exist if collection mechanisms (such as withholding taxes) are applied only for payments made to HDBs as opposed to traditional cross border trade.

29. Assuming that the proposal applies only to HDBs, if the nexus definition of the SEP is drafted in specific terms, that is, by referring to various thresholds (revenue, users or otherwise) as opposed to a general concept, it could also be inflexible. Arguably, the profit attribution mechanism would be simple to implement if the new rules are based on predetermined formulas or deemed profit mechanisms. However, such rules may be inflexible to the extent that they do not take into account the actual facts and circumstances of the particular business. Thus, the proposals' profit allocation mechanisms could lead to arbitrary outcomes that may not accord with transfer pricing rules. Moreover, if the rules seek to levy taxes on the revenues derived by loss making companies (as contemplated by India), then they would breach *'principles of economic capacity and net basis taxation'*.[80]

30. With respect to implementation, if the SEP nexus is implemented by amending the PE definition, an issue arises as to how the SEP proposal interacts with the fixed place or agency PE concept and their related attribution rules. If the new rules apply only to HDBs, then it would be required to establish *'rules of order'* to resolve the issue of which provision applies first. The coexistence of all of these rules could also imply that MNEs may plan and fragment their activities to take advantage of different PE rules. A similar issue arises with respect to coordination with existing profit attribution rules. Under the current framework, some States apply the separate entity principle to allocate profits to a PE (for instance, Germany and Japan have adopted the Authorized OECD approach). However, a number of other States apply formulary approaches (for instance, as argued by India). If the new SEP rules are based on formulas, then it is difficult to foresee that States that follow the arm's length principle will agree to such predetermined formulas, especially the weights that must be allocated to employees, assets, or sales. Moreover, several issues arise with respect to the interaction of the SEP PE with other treaty distributive rules that contain the PE provision. To summarize, the SEP concept raises several challenges from a tax policy perspective. This said, several commentators to the PCD, particularly non-governmental organizations and trade unions, support this proposal.[81]

5.3 *Marketing Intangibles Proposal*

5.3.1 *Overview*

31. The marketing intangibles proposal is premised on the policy rationale that a traditional or digital NRE can be actively present in the Market Country on a remote basis (digitally) or through a local presence (limited presence) to develop existing or new marketing intangibles such as brands, trade names, customer data, customer lists, and customer relationships.[82] For example, Company R (traditional or digital) in Country R (the country in which it produces its goods or services) could either be present in Country S on a remote basis or have a local presence (branch or company). In the former scenario, Company R could, through sales and

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[77] OECD, *supra* n. 1, at para. 51.

[78] UN, *supra* n. 48, at 11 & 14.

[79] New Zealand Government, *supra* n. 47, at para. 4.50.

[80] *See* OECD, *Corporate Loss Utilisation Through Aggressive Tax Planning* 26 (OECD Publishing Aug. 2011).

[81] *See* OECD, *supra* n. 60, comments by: Canadians for Tax Fairness, at 3; Chambre des Salaries Luxembourg; Eurodad, at 3; German Development Institute, at 1; ICRICT, at 5; Initiative for Human Rights Principles and Guidelines in Fiscal Policy in Latin America, at 4; International Bureau of Fiscal Documentation (IBFD), at 8; Oxfam, at 7; Public Services International (PSI), at 1; Tax Justice Network (TJN), at 8; Tax Justice Network Africa, at 3; Tax Justice Network Israel, at 2; Trade Union Advising Committee (TUAC), at 3; BEPS Monitoring Group (BMG), at 12; Intergovernmental Group of 24, at 3. *Also see* the comments by: (1) Businesses: BlaBlaCar, at 1; Santander, at 3; Kaka (Senior Advocate, India), at 6; Dhruva Advisors, at 3; Carrefour, at 2–3; Sanghvi & Associates, at 5; Rajmilovich & Forcada, at 2; Monica Victor, at 2; Lunardi & Partners, at 3; La Française des Jeux, at 2; Suranjali Tandon, at 3; Knav, at 2; BonelliErede, at 5. (2) Business associations: Bombay Chartered Accountants' Society (BCAS), at 7. (3) Academics: Academic Political Scientists on International Taxation, at 4; Eva Escribano (UC3M), at 1; Institute for Austrian and International Tax Law (UW), at 8; Shay (Harvard University); Sanghavi et al. (Maastricht University), at 1.

[82] OECD, *supra* n. 1, at para. 30; *Also see* M. Olbert & C. Spengel, *International Taxation in the Digital Economy: Challenge Accepted?*, 9(1) World Tax J. 3, at 35–37 (2017). These authors also argue that user base or customer data can be regarded as intangibles. On the concept and importance of marketing intangibles, *see* D. Canapa, *Trademarks and Brands in Merger Control: An Analysis of the European and Swiss Legal Orders*, International Competition Law Series Vol. 67, 48–49 (Wolters Kluwer 2016).

marketing activities, sell its products/services in Country S over the internet (or otherwise) and derive substantial revenues from therein. Under the current framework, the business income is taxed only in Country R. In the latter scenario, Company R could sell its products/services either, for example, (1) through a related local limited sales or marketing services provider which would report an arm's length service fee in Country S[83]; (2) through a limited risk distributor (LRD) which would report an arm's length routine operating profit margin in Country S; or (3) through a full-fledged distributor (FFD) which will report an arm's length entrepreneurial operating profit margin in Country S. Nevertheless, under all of these models, business income flows out to Company R. Arguably, under some of these scenarios (especially, the first two situations) the income (profit) linked to marketing intangibles also moves out of Country S.[84] Other situations in which the marketing intangibles related profit moves out of Country S relates to cases wherein Company R licenses trademarks to a local taxpayer on which royalties are required to be paid (for example, on a standalone basis to FFDs or through franchising arrangements with related or unrelated parties).

32. This proposal essentially argues that, if an NRE supplier actively intervenes in the Market Country and develops marketing intangibles therein, then the latter State should have a right to tax the profits (at least a part of it) linked to the marketing intangibles. This is because an intrinsic function link exists between the marketing intangibles and the market jurisdiction.[85] Accordingly, new nexus and profit allocation rules will have to be developed to ensure Market Country taxation. It should be noted that the proposal clearly provides that profit allocable to trade intangibles should be carved out.[86]

33. In order to determine the profit allocable to marketing intangibles that would be reallocated to the Market Country, one approach that is contemplated is to rely on a facts and circumstances analysis, that is, the current transfer pricing approach. Under this approach, the contribution of marketing intangibles to the overall profits needs to be determined. Thereafter, a portion of the profit linked to marketing intangibles will be reallocated to the Market Country in the form of a marketing intangibles adjustment.[87] An alternate approach would be to rely on a residual profit split analysis[88] or a modified residual profit split method. Under this approach, first, the total profits of the MNE Group will need to be determined. Second, routine profits that are allocable to all of the entities in the MNE Group must be calculated. This could be ascertained by either resorting to a transfer pricing analysis or using a mechanical approach (simplified conventions). Third, the routine profits will then be deducted from the overall profits in order to arrive at the residual profit. Fourth, the residual profit will then be split between profit allocable to trade intangibles and profit allocable to marketing intangibles. In order to evaluate the contribution of marketing intangibles to the residual profit, several approaches could be used such as income / cost-based methods or predetermined formulas (simplified conventions). Fifth, the profit allocable to marketing intangibles would then be reallocated to the Market Country based on sales (or depending on the business model, users of a platform).

5.3.2 *Assessment of the Policy Rationale*

34. Arguably, the policy rationale of this proposal complies with the benefit principle. As argued previously, if the Market Country offers an appropriate IP protection legal framework and considering the fact that IP plays a significant role for HDBs and traditional enterprises in the digitalized economy, in the authors' opinion, it could be argued that the Market Country is justified to tax.

35. From a '*sourcing*' perspective, a few commentators such as *Professor Lawrence Lokken*[89] and *Professor Mitchell A Kane*[90] have argued that the use of IP could be sourced to the Country wherein laws

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[83] *See* L. Spinosa & 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?*, 2018 46(6/7) Intertax 476, at 485.

[84] OECD, *supra* n. 1, at paras 40–42.

[85] *Ibid.*, paras 31–32.

[86] *Ibid.*, para. 34.

[87] *Ibid.*, paras 45–46. This approach seems to have been dropped in the OECD, *supra* n. 2.

[88] OECD, *supra* n. 1, at para. 47; OECD, *supra* n. 2, at para. 28.

[89] L. Lokken, *The Sources of Income from International Uses and Dispositions of Intellectual Property*, 36 Tax L. Rev. 233, 242 (1981).

[90] M. A. Kane, *A Defense of Source Rules in International Taxation*, 32 Yale J. Regulation 311, 341–342 (2015).

provide legal protection for that property.[91] Other commentators such as *Paul Oosterhuis and Amanda Parsons* build on this line of thinking and state that, under existing principles, '*a strong argument can be made that the jurisdiction where the base of customers or a network exists is a natural source for goodwill and customer-based intangibles*'. On the other hand, the commentators also indicate, '*It is not as obvious that going-concern value or supplier-based intangibles should be sourced to the jurisdiction of the ultimate customer. Supplier-based intangibles constitute the value stemming from the future purchase of goods or services from existing suppliers. Therefore, it arguably would be more appropriate to source these intangibles to the place of production. Going-concern value includes the value attributable to the ability of a trade or business to continue functioning and generating income without interruption; workforce in place is often a key element of going-concern value. The appropriate source would likely vary based on the nature of the particular business but often would not be tied to the location of the ultimate customer. Thus, a destination-based allocation of these types of intangible income may not be appropriate*'.[92] Thus, when a non-resident supplier actively intervenes in the Market Country and develops marketing intangibles (a large customer base or user network), then that State is allowed to exercise its taxing right over the profits (or at least a portion of the profits) linked to those intangibles.

36. In the author's opinion, it seems that several NREs (HDBs or traditional) can actively intervene over the internet or other communication means or with local presence and develop intangibles such as customer data, customer lists, and customer relationships. At the same time, HDBs or traditional enterprises can actively intervene over the internet or other communication means or with local presence and develop their trademarks or tradenames. Under the current framework, the Market Country does not tax the '*value*' linked to such intangibles ('*escaped value*').[93] Thus, the objective of the proposal is to ensure that the Market Country taxes the escaped value with respect to an intangible asset that is '*sourced*' in that country. This said, the '*source*' of the intangible asset, intuitively, seems stronger for businesses that sell consumer goods or consumer services (either in a Business to Business or Business to Consumer or in a franchising context) and businesses that develop user networks as opposed to businesses that sell raw material, capital goods or commmodities to other businesses. Also, this approach would be compliant with the opinion of one group of the TAG Committee that expressed the opinion that, under the '*supply*' approach, the Market Country is justified to exercise its taxing rights even when the foreign supplier has no physical presence.[94] This approach also seems to be consistent with the value creation concept as the Market Country will be allocated taxing rights over the untaxed value of the foreign supplier linked to that State.[95]

5.3.3 *Assessment in Light of Policy Principles*

37. The way this proposal has been presented may not create issues related to ring fencing as it applies to HDBs (for example, those discussed in *sections 5.1 and 5.2*) and traditional businesses. It thus seems to be more neutral than the other proposals. This said, at this stage, the scope of application of this proposal is uncertain. Arguably, as the proposal will be introduced as a general concept as opposed to specific rules being developed for HDBs, it could be flexible for accommodating new business models that are consumer (or user) facing. Although several businesses and business associations support this proposal as it accords with the value creation concept,[96] the biggest challenge associated with the model is in relation to

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[91] *Professor Richard Vann* had already raised the question that '*is it not strange to maintain that no income from an intangible is sourced in a country when the owner of the intangible is prepared to spend large amounts of money in the country to establish or defend its monopoly rights there? Or, to put it another way and possibly more narrowly, the economic construct that underlies the transfer-pricing regime is based on the marginal cost view of pricing, and that view is not relevant to economic rents. So whenever a person derives an economic rent from a jurisdiction, that jurisdiction has a claim to tax, and intangibles give rise to rents. It is not necessary here to establish definitively what the right analysis is,* ***just that there is a source taxing claim for business income that does not depend on a place of activity in the country asserting the tax claim***'. *See* R. Vann, *Reflections on Business Profits and the Arm's-Length Principle*, in *The Taxation of Business Profits Under Tax Treaties* 145–146 (B. J. Arnold, J. Sasseville & E. M. Zolt eds, Canadian Tax Foundation 2003).

[92] P. Oosterhuis & A. Parsons, *Destination Based Income Taxation: Neither Principled Nor Practical?*, 71 Tax L. Rev. 515, 522–524 (2018).

[93] Typically, in situations of remote sales. In his thesis, Dr Oddleif Torvik, also argues that, depending on the business model, under the current framework, income from marketing intangibles is not taxed in the Market Country. *See* O. Torvik, *Transfer Pricing and Intangibles: US and OECD Arm's Length Distribution of Operating Profits from IP Value Chains*, IBFD Doctoral Series Vol. 45, 770–772 (2019); *Also see* J. Bankman, M. A. Kane & A. Sykes, C*ollecting the Rent: The Global Battle to Capture MNE Profits*, Stanford Law and Economics Olin Working Paper No. 527, 14–18 (25 Oct. 2018); OECD, *supra* n. 2, at para. 23.

[94] OECD, *supra* n. 8, at para. 44.

[95] OECD, *supra* n. 44, at para. 33.

[96] *See* OECD, *supra* n. 60, For instance, the proposal is supported by the following commentators (1) Businesses: Booking.com, at 4; Carrefour, *supra* n. 81, at 2–3; Johnson&Johnson, at 2; Procter & Gamble, at 4; Spotify, at 2; Uber, at 6. By (2) Business associations: 100 group, at 4; Accountancy Europe, at 3; Anitec-Assinform, at 2;

the profit allocation mechanism that will be used to calculate the '*marketing intangible*' profit. The residual profit split analysis, up to the extent that it uses an arm's length or facts and circumstances approach, would clearly involve a high degree of subjectivity and complexity. Undoubtedly, this could also lead to tax uncertainty and a plethora of tax disputes. Also, it would be fair to state that, due to its subjectivity, the proposal would trigger substantial costs of compliance for both taxpayers and tax administrations.

5.4 *Interim Conclusion*

38. All of the proposals raise significant challenges, and none of them are absolutely perfect. This said, in the author's view, a core issue that must be resolved by policy makers is whether cross border business income should be taxed based on the '*supply*' approach or the '*supply-demand*' approach?

39. The author's opinion is that the former approach should prevail for corporate income tax purposes. This is primarily due to the reason that the principle of value creation applies to corporate income tax whereas the principle of destination applies to VAT.[97] In other words, VAT already takes into consideration the presence of '*consumption*' or '*demand*' side factors.[98] This approach would make sense from the perspective of resorting to the general equilibrium theory in international trade.[99] If this equilibrium is not maintained, then the production country could also assert that a part of the VAT taxable base should be allocated to it. This is because consumption can only occur when there is production, and the production country has offered an appropriate framework to ensure the creation of goods/services for consumption. As stated by *Professor Kemmeren*, ' … *If a customer's market for goods or services would be relevant for the allocation of the production of income (wealth), then the producers market should also be relevant for the allocation of the consumption of wealth. This implies that we should assume that part of the consumption takes place in the state of the producer of the goods or services. Only then, the reasoning would be consistent, since we have to take into account the tax system as a whole and not taxes in isolation*'.[100]

40. If the '*supply*' approach is the starting point for dividing the international corporate tax base, then the user participation and the SEP proposals are developed on unsound/debatable policy rationales as they conflict with the author's understanding of the '*supply*' approach/'*value creation*' standard (**which may or may not be the common understanding of the approach or standard**). To elaborate, the author takes the position that users cannot be considered as '*supply*' or '*value creation*' factors. Hence, the user participation proposal is conceptually flawed. Similarly, the SEP proposal is built on a debatable policy rationale as it incorporates the assumption that the presence of a market needs to be rewarded.

41. This said, the '*supply*' approach/'*value creation*' standard should not be interpreted in a manner that focuses on or requires physical activities in a State. As discussed previously, the '*supply*' approach/'*value creation*' standard allows the Market Country to tax a foreign supplier's intangible presence (or a part of the profits that are linked to the value created by the supplier) even if that NRE does not employ personnel in that State. Arguably, the marketing intangible proposal accords with that approach/standard as those intangibles can be '*sourced*' to the Market Country, especially, in a consumer facing or user network oriented business. However, that proposal raises several issues with respect to achieving certainty in relation to profit allocation. Thus, in order to achieve certainty, the author's agree with *Collier and Andrus* who argue that countries, in general, should '*return to the issue of transfer pricing safe harbours*'.[101] Accordingly, the author foresees the application of a simplified residual profit split

Notes

Coalition of Netherlands based Technology Companies, *supra* n. 10, at 3; Computer & Communications industry association (CCIA Europe), at 2; Confederation of British industries (CBI), at 15; Criteo, at 1; Digital Economy Group, *supra* n. 10, at 7; Digital Europe, at 7; European Ecommerce and Omni-Channel Trade Association (EMOTA), at 3; International Chamber of Commerce (ICC), at 3; Keidanren, at 2; Silicon Valley Tax Directors Group (svtdg), at 2; Skadden, at 2; United States Council for International Business (USCIB), at 3. By (3) academics: Becker Englisch (Muenster university); Danon & Chand (University of Lausanne), at 12–14; Hernandez (University Clapes), at 1; Jimenez (University of Cadiz), at 6.

[97] Although it is not extremely clear, it seems that, for a single source case, i.e. when all production and sales activities take place in one country, the Musgrave's argue '*taxation by source is preferable*'. Also, for multiple source cases, the Musgraves argue that the taxable base should be allocated to the country where the '*capital operates*'. *See* R. Musgrave & P. Musgrave, *Inter-nation Equity* in *Modern Fiscal Issues: Essays in Honor of Carl S. Shoup* 78–85 (R. Bird & J. Head eds, University of Toronto Press 1972).

[98] For a detailed discussion on why the supply approach should be preferred, *see* Kemmeren, *supra* n. 19, at 154–156.

[99] Becker & Englisch, *supra* n. 3, at 164.

[100] *See* Kemmeren, *supra* n. 19, at 155.

[101] Collier & Andrus, *supra* n. 7, at 269–270. *Also see* J. Andrus & P. Oosterhuis, *Transfer Pricing After BEPS: Where Are We and Where Should We Be Going*, 95 Taxes Tax Mag. 89, 104 (Mar. 2017).

allocation mechanism or, as otherwise stated, a safe harbour (or rebuttable presumption)[102] that will use mechanical approximations or fixed contribution percentages[103] to approximate the allocation of profits linked to marketing intangibles. In the next section, the author further develops the solution.

6 Recommendation: the design of a solution

6.1 *Introductory Comments*

42. **The idea of this section is only to provide a high-level overview of the design of a potential solution, especially regarding profit allocation. It is not the purpose of this section to examine the solution** in depth. It has been partially inspired by the public comments that were submitted by Skadden, Johnson & Johnson, the Digital Economy Group, the Coalition of Netherlands Based Technology companies, the consultation draft issued by the New Zealand government, and the OECDs work programme. Needless to say, a new taxing right or profit allocation rule will need be introduced at the domestic law and tax treaty level (also an amendment may be required to the Transfer Pricing guidelines), depending on the exact solution.

6.2 *Nexus and Scope*

43. Prior to discussing the profit allocation mechanism, in the author's view, the new taxing right should be conceptualized as a new concept of taxable income that is '*sourced*' in the Market jurisdiction[104] with the source being the '*marketing intangible*' (consumer or user base that has been created by the suppliers efforts) located in the market jurisdiction. Ideally, the nexus rule should be designed based on global consolidated turnover[105] and local market turnover[106] thresholds. The former threshold will indicate that the MNE has substantial operations across the globe whereas the latter threshold will demonstrate that the MNE (or an entity in an MNE) has a substantial economic link or connection with the market jurisdiction. In other words, the local market revenue threshold indicates that the MNEs enter into a jurisdiction to develop marketing intangibles. In the author's opinion, the amounts employed in these thresholds should be high in order to ensure that the administrative burden of such source taxation is low. It is also preferable not to use qualitative factors (as contemplated in the Indian SEP proposal) as they could lead to uncertain outcomes. The nexus rule will also need a '*degree of permanence*' to be built into it in order to ensure that isolated/one-off transactions are not caught by this provision. This permanence could be indicated by resorting to other objective thresholds such as, depending on the business, number of users linked to a particular country or the number of contracts concluded with respect to sales made in a country. Furthermore, carve outs could be contemplated for some businesses which are not consumer or user facing such as businesses in the extractive industry (mining or oil and gas), businesses that sell raw materials or commodities or capital goods to other businesses (which are processed or used in processing by the purchasing business), businesses that are subject to regulation and which already operate with substantial business presence in the Market Country (for example, certain business lines of banks and insurance companies) as well as businesses that are subject to special rules under the current framework (such as shipping and airlines). Ideally, this rule must be implemented through a new distributive rule in order to ensure that potential conflicts and overlaps with Article 5,

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[102] For a discussion on safe harbours or presumptions, *see* OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (OECD Publishing 2017), paras 4.95–4.133; V. Thuronyi, *Tax Law Design and Drafting: Chapter 12, Presumptive Taxation* vol 1, 3–6 (IMF 1996); A. Turina, *Back to Grass Roots: The Arm's Length Standard, Comparability and Transparency: Some Perspectives from the Emerging World*, 10(2) World Tax J. 295–348 (2018); S. Picciotto, *Problems of Transfer Pricing and Possibilities for Simplification*, ICTD Working Paper 86, 29 (Box 4) (Nov. 2018).

[103] OECD, *supra* n. 1, at paras 47 & 48.

[104] OECD, *supra* n. 2, at para. 39.

[105] Similar thresholds are found in draft proposals with respect to digital service taxes. *See* European Commission, *supra* n. 48; HM Treasury, *supra* n. 10. *Also see* comments by Coalition of Netherlands based Technology Companies, *supra* n. 10, at 14–15; Digital Economy Group, *supra* n. 10, at 8.

[106] Commentators supporting the development of nexus rules based on turnover include: B. Arnold, *Threshold Requirements for Taxing Business Profits under Tax Treaties*, 57(10) Bull. Int'l Tax'n 476–492 (2003); Schön, *supra* n. 21, at 67; A. J. Cockfield, *Balancing National Interests in the Taxation of Electronic Commerce Business Profits*, 74 Tulane L. Rev. 133, 198–206 (1999). Other academics who support such thresholds (also the '*supply-demand*' approach) include R. Avi-Yonah & O. Halabi, *A Model Treaty for the Age of BEPS*, Law & Economics Working Papers, Paper 103, 15 (2014); R. Avi-Yonah, *Designing a 21st century Taxing Threshold: Some International Implications of South Dakota vs. Wayfair*, Public law and Legal Theory research paper no. 611 (2018); Gadžo, *supra* n. 11, at 318–332. *Also see* OECD, *supra* n. 2, at para. 40.

Article 7, and Article 9 are minimized.[107] The following profit allocation mechanism could be built into that rule.

6.3 *Profit (Loss) Allocation: Modified but Simplified Profit Split Method*

44. If the objective of a potential solution is to achieve tax certainty, especially from a developing country's standpoint, then a solution to implement the marketing intangibles proposal would be to resort to a safe harbour[108] that is built on return on sales[109] or operating profit margins[110] (operating profits/operating revenue). The author uses this indicator as it is usually used in a transfer pricing context. Although, not used in this section, a net profit margin (earnings before taxation/operating revenue) could also be used as it represents the true profitability of the business. The solution presented here will be built on a consolidated basis as opposed to a separate entity basis as all three proposals presented in the PCD follow the '*global approach to determination of profit*'.[111] It is also preferable to develop this safe harbour solution at the consolidated level as opposed to a business line segmentation approach or a regional approach as the latter approaches raise significant data availability and administration issues.[112] The safe harbour will need to be implemented in the context of a simplified residual profit split analysis[113] using a *top-down* approach.[114] **Please note that the numbers used in the following paragraphs are for illustrative purposes only. A proper economic/statistical analysis will be required to justify any numbers.**

45. As indicated in the PCD and the recent work programme, various steps are required to implement a residual profit split analysis.[115] First, the total profits of the MNE Group need to be determined. For the purpose of the solution presented here, this is required to understand the overall operating profit margin of the Group. The information could be determined, for instance, by examining the MNE's consolidated financial statements.[116]

46. Second, routine profits or a routine operating profit margin must be determined. For instance, a predetermined margin could be developed which would provide that the routine operating profit margin is established at a certain percentage as opposed to using a facts and circumstances transfer pricing analysis. For the purpose of this solution, assume that this margin is fixed at 5%.[117] The percentage is inspired from a recent document released by the Australian Tax Administration in the content of inbound distribution arrangements in Australia[118] and the OECD work on Low Value Added Services.[119] This would imply that, if the MNE Group's overall operating profit margin is less than 5%, then it would fall outside the scope of this proposal.[120]

47. Third, residual profit or a residual operating profit margin needs to be determined. This could be achieved by deducting the routine operating profit margin from the overall operating profit margin. For example, if the MNE Group has an overall operating profit margin of 45%, then 5% will be allocated to routine operating profit margins whereas 40% will be allocated to a residual operating profit margin.

Notes

107 OECD, *supra* n. 44, at para. 82.

108 *Ibid.*, para. 75.

109 *See* Johnson&Johnson, *supra* n. 96, at 2.

110 *See* Skadden, *supra* n. 96, at 6. In other words, Earnings Before Interest and Taxation (EBIT) relative to sales.

111 OECD, *supra* n. 44, at para. 56.

112 OECD, *supra* n. 2, at para. 36.

113 *See* Skadden, *supra* n. 96, at 6; Johnson&Johnson, *supra* n. 96, at 2.

114 To understand this approach, *see* M. Devereux, A. Auerbach, M. Keen, P. Oosterhuis, W. Schön & J. Vella, *Residual Profit Allocation by Income*, Saïd Business School Working Paper 19/01, 35 (2019).

115 OECD, *supra* n. 1, at paras 47 & 74; OECD, *supra* n. 2, at para. 29. It should be noted that the Programme of Work only discusses four steps.

116 *See* Skadden, *supra* n. 96, at 6 & 8–10. For large MNEs, such information can also be gathered from Country by Country reports. *See* OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing Oct. 2015).

117 For example, some authors (such as *Professor Avi Yonah*) have suggested a 7.5% mark-up for routine profits. *See* Andrus & Oosterhuis, *supra* n. 101, at 101.

118 Although issued in a different context, the Australian guidance states that distributors that earn an operating profit margin of at least 5.3% can be categorized as '*low risk*' from a transfer-pricing audit standpoint. *See* AU: ATO, *Practical Compliance Guideline, Transfer Pricing Issues Related to Inbound Distribution Arrangements* 11 (PCG 2019/1).

119 OECD, *supra* n. 102, at Ch. 7.

120 *See* Skadden, *supra* n. 96, at 7; OECD, *supra* n. 2, at para. 29. The author is completely aware of the fact that low risk distribution margins could be lower.

48. Fourth, the residual operating profit margin will then be divided between trade intangibles and marketing intangibles. The portion allocable to marketing intangibles will be subject to the new taxing right. Once again, a safe harbour in the form of a predetermined formula could be developed which would approximate the contribution of marketing intangibles to the residual operating profit margin.[121] One approach would involve comparing the consolidated research and development costs of the MNE to the consolidated marketing and sales expenses.[122] For example, if the MNE's research and development costs amount to USD 8 and sales and marketing expenses amount to USD 2, then the split will be in the form of an 80–20 split. However, such an approach, even though it is easily implemented, will depend on the facts and circumstances of each MNE. Another approach could be to fix the formula at a 50–50 division between trade and marketing intangibles. This percentage could be inspired from Section 936(h) of the US Internal Revenue Code that provided for such a split related to a regime that concerned the operations by US companies in US possessions.[123] However, such an excessive percentage for marketing intangibles could be unreasonable especially if such intangibles have been developed by activities of personnel outside the borders of the Market jurisdiction. While several approaches could be considered, for the purpose of this contribution, the author will begin with the arbitrary split,[124] that is, a 75–25% split. Essentially, a 25% weight will be allocated to marketing intangibles as the average life of investments in marketing intangibles (at least in some businesses) is usually shorter than the average life of investments in trade intangibles (research and development costs). For example, if the MNE Group has a residual operating profit margin of 40%, then 10% of that margin (25%) will be allocated to marketing intangibles related profit that is linked to Market countries.

49. Fifth, the profit allocable to marketing intangibles would then be reallocated to the Market Countries. The reallocation can occur based on the sales that are made in those countries. The location of sales could be determined by resorting to proxies used in a VAT context. Also, depending on the business model, reallocation can also be made to user countries (especially for advertisers) to the extent that they are different from countries in which sales are made.[125]

50. **Illustration**: Co G, a tax resident of Country G (EU State), is the parent entity of an MNE Group that is active in several countries. Co G has developed its products in Country G and sells in that market and in other markets. In Country X, the products are sold on a remote basis. In Country Y, the products are sold through a related distributor, Co Y, that reports an arm's length operating margin of 6%.

51. **Financial information**: The overall consolidated operating revenue of the Group is USD 1,000, and the overall operating profit is USD 450. The sales to end customers in Country X and Country Y amount to USD 200 and USD 300, respectively.

52. **Solution**: Under the proposed solution, the overall operating profit margin of the Group is 45%. The deemed routine operating profit margin is 5%. Accordingly, the deemed residual operating profit margin is 40%. One fourth of that margin is deemed attributable to marketing intangibles that are linked to the Market Countries. This would lead to the conclusion that the profit attributable to marketing intangibles linked to the Market Countries is 10% of the overall revenues, which amounts to USD 100 (USD 1,000*10%). Country X will be allocated USD 20 (100*200/1000 = 20) and Country Y will be allocated USD 30 (100*300/1000 = 30) of that profit. Local corporate income tax must be paid on the reallocated profits. As indicated in the program of work, taxes could either be collected based on self-declaration or withholding mechanisms. This would be the case in Country X.[126] It can also be foreseen that, in Country Y, Co Y could be jointly liable with Co G to discharge the tax liability[127] (further consideration should be given as to whether the reallocated profits should be reduced by the profit already being reported by Co Y, if the amount exceeds a pre agreed percentage as

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[121] *Also see* Grinberg, *supra* n. 51, at 30–36.

[122] New Zealand Government, *supra* n. 47, at. 36.

[123] *See* Skadden, *supra* n. 96, at 4–5; OECD, *supra* n. 2, at para. 29.

[124] Grinberg, International Taxation *supra* n. 51, at 43–44; Coalition of Netherlands based Technology Companies, *supra* n. 10, at 15.

[125] OECD, *supra* n. 1, at para. 78.

[126] OECD, *supra* n. 2, at para. 46.

[127] *See* Skadden, *supra* n. 96, at 7; Coalition of Netherlands based Technology Companies, *supra* n. 10, at 19; Digital Economy Group, *supra* n. 10, at 12.

discussed in the simplified distribution based approach further below).

53. **Losses**: The proposal would also permit the carry forward of losses. For example, if the MNE Group has a negative overall operating profit margin that would lead to marketing intangible related loss, then that loss will be carried forward for set off against marketing intangibles related profits for future years. Thereafter, the profit (after taking into consideration the losses) will be reallocated to the market jurisdiction.[128]Also, special rules will need to be developed to capture pre-existing losses.

54. If the taxpayers do not agree with the results produced by the safe harbour, then they can certainly rebut its application and offer their facts and circumstances analysis keeping in mind that their analysis could be subjective which could then lead to disputes. The analysis could be based on a product or service line/business line/regional approach. Moreover, instead of using fixed formulas, taxpayers can resort to a transfer pricing analysis or/and a capitalized expenditure analysis or a return on capital employed analysis[129] in order to arrive at profits that are allocable to marketing intangibles. It should be noted that if this approach is not used as a safe harbour (as understood in a transfer pricing context) then it will clearly go beyond the arm's length principle. If implemented, this would then represent an add on to the existing system. Nevertheless, if a formulary solution is developed as an add on to the exisiting system on a MNE Business Line basis then this safe harbour could be used within that approach as MNE business line information could be difficult to gather.

55. The above solution represents a simple method for implementing the marketing intangibles proposal. That method only deals with allocating residual or excess profits. Another approach that merits consideration (in addition to the above proposal) is the distribution margin approach.[130] The approach (or its simplified version) merits consideration up to the extent it incorporates safe harbours to enhance tax certainty as opposed to allocating non rebuttable deemed profit margins. For instance, when a MNE operates with a distributor (LRD) in a jurisdiction, a safe harbour could be developed which guarantees a minimum return (example, a certain percentage on sales depending on the industry in which the taxpayer operates). The advantage of this approach is that it offers upfront tax certainty to the distributor as in recent years such entities have been subject to litigation (for example, Advertising, Marketing and Promotion (AMP) expenses in India) . A detailed discussion of that approach is not made in this contribution.

6.4 *Relief from Double Taxation*

56. Ideally, the credit method should be used by the residence State to provide relief from double taxation.[131] For example, If Country G (in the aforementioned example) follows the credit method, then the taxes paid in Country X and Country Y can be credited against the corporate income tax for which Company G is exposed. Of course, several issues arise when multiple entities within an MNE group own or use marketing intangibles. For example, consider the situation of Company R in State R that has developed marketing intangibles. Company R sells its products in the State R market. Further, for its overseas operations, Company R establishes a centralized business model (Company P) in State P. Company P employs the intangibles for its operations and derives business income on a remote basis from several countries (including State S) and pays an arm's length amount of royalties to Company R. If a tax liability arises in State S for the MNE Group, then the question arises as to who is the taxpayer to whom the tax liability could be attributed, i.e. is it Company R (who is the owner of the intangible) or Company P (the taxpayer that has used the intangible)?[132] In this case, both entities could be considered as the relevant taxpayers for the purpose of this solution. Moreover, it could also be foreseen that both States should provide the relief, that is, to the owner of the intangible as well as the user of the intangible within the Group. This would imply that both State R (Company R) and State P (Company P)

Notes

[128] Coalition of Netherlands based Technology Companies, *supra* n. 10, at 14–15; Digital Economy Group, *supra* n. 10, at 10–11. *Also see* OECD, *supra* n. 2, at para. 38.

[129] Oosterhuis & Parsons, *supra* n. 92, at 532–533.

[130] *See* Johnson&Johnson, *supra* n. 96, at 2–3; OECD, *supra* n. 2, at paras 32–35.

[131] OECD, *supra* n. 1, at para. 80; New Zealand Government, *supra* n. 47, at para. 4.37. Even exemption countries should switch to the credit method. For instance, Art. 23(A)(2) of the OECD Model Tax Convention (2017) mandates exemption countries to follow the credit method for dividend and interest income. Alternatively, corresponding adjustments could be considered.

[132] OECD, *supra* n. 1, at para. 83; OECD, *supra* n. 2, at para. 41. *Also see* Coalition of Netherlands based Technology Companies, *supra* n. 10, at 18.

could provide the relief. The relief could be divided in a predetermined proportion. For instance, if Company P has a profit margin of 15% (pre royalty) and pays 5% royalties to Company R (an arm's length royalty) then the releif could be split two thirds and one third.

6.5 *Dispute Prevention and Resolution*

57. If the simplified profit split mechanism will be developed based on predetermined formulas, the determination of the profit to be allocated to the market jurisdiction should not be an overly complicated exercise. However, issues could arise if a MNE Business Line approach is used. Moreover, disputes could arise on the identification of the taxable person and the corresponding relief from double taxation that the relevant State of residence must provide to its resident person. In these circumstances, it would be appropriate to develop rules such as multilateral competent authority arrangements that primarily focus on dispute prevention mechanisms (focussing more on obtaining consensus for predetermined formulas, providing guidance on MNE Business Lines as well as rules regarding identification of the taxable person). Also, it will be desirable that more countries (including developing countries) adopt mandatory arbitration[133] as a dispute resolution mechanism if a facts and circumstances analysis is built into the proposal (either in the simplified method or as a back up to the simplified distribution method).

7 Fundamental reforms focussing on '*demand*' side solutions

58. Some commentators and a recent IMF Paper[134] have argued for more '*demand*' side solutions. The solutions can be grouped into two broad categories. The first category, the residual profit allocation mechanism (RPA), allocates routine returns to '*source*' countries in accordance with the arm's length principle whereas residual returns are allocated to the market jurisdictions.[135] The second category, destination based cash flow taxes (DBCFT), ensures that the seller does not pay domestic corporate taxes in its country on exports. The tax, depending on the manner in which it is adopted, allocates returns (from exports) to the market jurisdictions as it is based on a destination framework.[136]

59. At the core, the supporters of these proposals contend that '*production*', '*origin*', '*supply*', or '*value creation*' factors (such as employees in combination with intangibles) are mobile. Accordingly, MNEs can move these factors from high tax to low tax jurisdictions and engage in profit shifting. Also, countries may compete with each other in order to attract such factors within their territory by offering tax incentives in the form of reducing corporate tax rates. Therefore, the current framework encourages profit shifting (now genuine) and tax competition. On the other hand, the proponents of the '*demand*' side solutions argue that their proposals either restrict (under RPA) or do not lead to (under DBCFT) profit shifting/tax competition as they are linked to consumers in a market. As customers are relatively immobile, an MNE does not have an incentive to move, for instance, its '*production*' factors to a low tax country. At the same time, countries will not engage in tax competition to attract '*production*' factors.

60. While these proposals may have their merits from the perspective of profit shifting and tax competition considerations[137] (efficiency aspects), a general question arises as to why the Market Country should obtain substantial taxing rights over income that is substantially '*sourced*' in another country. Does this proposal not directly conflict with the '*benefits*' principle? In the authors' opinion, this should definitely be the case, especially for the DBCFT (and, to a lesser extent, for the RPA system). Also, if the proponents of these proposals argue for a full/part destination framework for corporate income tax then why should VAT not be based on the residence or origin principle to maintain an equilibrium for State finances?[138] Also, if corporate tax and VAT are paid in the destination country, the proponents of these proposals do not seem to realize that the '*loser*' countries (smaller

Notes

[133] OECD, *supra* n. 1, at para. 84; OECD, *supra* n. 2, at paras 43–44.

[134] IMF, *Corporate Taxation in the Global Economy*, Policy Paper No. 19/007 (IMF Mar. 2019).

[135] *Ibid.*, paras 86–99; Devereux et al., *supra* n. 114; Collier & Andrus, *supra* n. 7, at 286–289.

[136] A. Auerbach, M. Devereux, M. Keen & J. Vella, *Destination-Based Cash Flow Taxation*, Saïd Business School Working Paper 2017/09 (2017); IMF, *supra* n. 134, at paras 61–73; Collier & Andrus, *supra* n. 7, at 290–293.

[137] For a critical analysis of a destination based corporate income tax *see* Kemmeren, *supra* n. 19, at 155–162. The author demonstrates that a DBCFT system could also encourage double non taxation outcomes if the system is not universally adopted.

[138] Kemmeren, *supra* n. 19, at 149.

markets) will increase tax rates for individuals (income tax or wealth taxes) to fund public coffers. Thus, these '*demand*' side proposals pose severe threats on public finance considerations. The attractiveness of such proposals will also decrease if countries adopt the Pillar II proposals, that is, the income inclusion as well as the base eroding payment rules.[139]

8 Conclusion

61. This contribution supports the '*supply*' framework as opposed to the '*supply-demand*' or a '*demand*' framework for international corporate taxation. This said, the '*supply*' framework also permits a Market Country to exercise its jurisdiction to tax over a non-residents supplier's business profits if that taxpayer has a sufficient connection in that State. Otherwise stated, the framework allows a Market Country to tax the value created by the non-resident supplier in that State till the extent the income can be '*sourced*' therein. After assessing the three proposals and considering their rationale and broad tax policy principles, the Marketing intangibles proposal appears to be the only proposal that comports with the '*supply*'/'*value creation*' framework. Thus, from a nexus perspective, a positive '*source*' rule,[140] i.e. a new marketing intangible related '*source*' rule would need to be developed. However, the most significant challenge with the proposal is in relation to its profit allocation mechanism. Thus, this contribution proposes the design of a simplified residual profit split method. Further research is essential to answer the technical questions that arise in the context of the simplified method (especially relief from double taxation and collection mechanisms) as well as to justify the formulaic numbers that will be used in its various steps. In addition to a simplified profit split method, consideration should be given to a simplified distribution based approach (a safe harbour that will be backed by a transfer pricing facts and circumstances analysis). Also, from an implementation standpoint, consideration should be given towards developing a true Multilateral Tax Convention as opposed to the existing Multilateral Instrument, which modifies bilateral tax treaties.

Notes

[139] OECD, *supra* n. 1, at paras 88–102; OECD, *supra* n. 2, at paras 50–77.

[140] Professor Wilkie aruges that the BEPS recommendations have created negative source rules. *See* S. Wilkie, *New Rules of Engagement? Corporate Personality and the Allocation of 'International Income' and Taxing Rights*, in *Tax Treaties After the BEPS Project: A Tribute to Jacques Sasseville* 365–371 (B. J. Arnold ed., Canadian Tax Foundation 2018). For a critical analysis of the 'source concept', *see* H. J. Ault & D. F. Bradford, *Taxing International Income: An Analysis of the U.S System and Its Economic Premises*, NBER Working Paper Series no. 3056, 26–29 (Aug. 1989).