EDITORIAL

Achieving Certainty in an Uncertain Profit Allocation Environment

1 What does the profit allocation environment for taxing Multinational Enterprises (MNE) look like ?

Prior to the BEPS project, the application of the Arm's Length Principle (ALP) was already considered to be a discretionary exercise especially when searching for suitable and reliable comparables. Base Erosion and Profit Shifting (BEPS) Actions 8–10 and BEPS Action 7 have enhanced this discretion in the ALPs application by providing inconclusive guidance on existing concepts, introducing new concepts, or remaining silent regarding concepts that overlap in Article 9 and Article 7 contexts.

To illustrate, the updated OECD Transfer Pricing Guidelines (2017)[1] makes several key changes, which creates/increases the discretion in the application of the ALP. For instance, in the context of accurately delineating a transaction, these changes relate to the '*control over risk*' as well as the '*DEMPE*' requirement. In the circumstances when applying the Transactional Profit Split Method[2] (TPSM), the changes regard understanding the concepts of (1) '*unique and valuable contributions*', (2) '*highly integrated*' operations, and (3) '*shared assumption of economically significant risks*' or '*separate assumption of closely related risks*'. It is quite obvious that these concepts, along with their examples, open the door for differences in interpretation.

Similarly, for countries that follow the full[3] or partial ALP[4] approach to allocate profits to a Permanent Establishment (PE), tension arises between the nexus and profit allocation concepts when the PE does not perform any functions of its own. This is typically the case when a dependant agent PE (DAPE) of a non-resident principal gets triggered due to the activities of a related local entity. Arguably, as the DAPE does not conduct any activities (no functions, assets, and risks), it should not receive any remuneration. However, considering the guidance[5] issued on profit allocation to such PEs, which is inconclusive, PE jurisdictions will argue for additional profit attribution to DAPEs.

With specific reference to tax uncertainty surrounding these concepts/notions, several scholars/practitioners[6] have already raised the concern that tax disputes in the area of transfer-pricing will increase. These disputes in addition to comparability issues (for instance, as discussed by the General Court of the European Union in the recent Fiat and Starbucks State Aid cases) could relate to the scope of Article 9 such as (1) whether the wording of Article 9 permits the reclassification of transactions, for instance, of intra group debt into equity – an issue for which several countries have divergent opinions,[7] (2) the legal status of the OECD Transfer Pricing Guidelines post BEPS – for instance, whether the '*control over risk*' and/or '*DEMPE*' concept can be applied to pre-existing tax treaties, i.e. whether they are only inherently clarificatory or represent substantial modifications,[8] and/or (3) whether the concept of '*control over risk*' as applied in an Article 9 context is similar or

Notes

1 *See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (OECD Publishing 2017).

2 *See OECD, Revised Guidance on the Application of the Transactional Profit Split Method*, OECD/G20 Base Erosion and Profit Shifting Project (2018). *Also see* EU Commission – EU Joint Transfer Pricing Forum (EUJTPF), *The Application of the Profit Split Method within the EU*, Doc JTPF/002/2019 (2019).

3 *See* Art. 7 *OECD Model* Tax Convention (2017).

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

5 *See* OECD, *BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments* (OECD Publishing 2018).

6 J. Andrus & P. Oosterhuis, *Transfer Pricing After BEPS: Where Are We and Where Should We Be Going*, 95 Taxes Tax Mag. 89 (Mar. 2017). *Also see* V. Chand & B. Malek, *The Relevant Economic Activity Test and Its impact on International Corporate Tax Policy*, 3 BTR (2019) .

7 For instance, *see* OECD, *Discussion Draft, BEPS Actions 8–10: Financial Transactions, OECD/G20 Base Erosion and Profit Shifting Project* (OECD Publishing 2018). *Also see* V. Chand, *Transfer Pricing Aspects of Intra-Group Loans in Light of the Base Erosion and Profit Shifting Action Plan*, 44(12) Intertax 885 et seq. (2016).

8 For instance, *see* R. Collier & J. Andrus, *Transfer Pricing and the Arm's Length Principle* (Oxford University Press 2017).

INTERTAX, Volume 47, Issue 12
© 2019 Kluwer Law International BV, The Netherlands

different to the concept of '*significant people functions*' regarding risk assumption under Article 7.[9]

In addition to tax uncertainty and tax disputes, it is anticipated that there will be significant costs of compliance. For the large taxpayer, in addition to the costs to search for reliable comparables, costs will increase for preparing transfer-pricing documentation, notably Country by Country Reporting (CBCR).[10] For a tax administration, costs will inflate for training/deploying resources to audit taxpayer's activities. Moreover, they will be required to invest in digital technology. For instance, a tax administration will be obligated to invest in data analytics technology and new digital architecture not only to assess CBCRs but also to comply with the confidentiality standards as well as other aspects of the '*appropriate use*' condition.[11]

2 How is the digital debate impacting the profit allocation environment?

It is well recognized that the most important part of the solution to a problem that needs to be solved concerning Pillar I of the current digital economy debate pertains to the design of new profit (loss) allocation rules[12] (even though the design new scope, new nexus rules and new rules for eliminating double taxation are equally significant). Three methods are being contemplated to allocate more profits to the customer/user jurisdictions: the Fractional Apportionment Method (FA), the Modified Residual Profit Split Method (MRPS), or a Distributions based (DB) approach.[13] All of these methods, in the way they have been presented, accord with the multinational enterprise (MNE) Group approach towards determination of profit that must be reallocated to market/user countries. In this context, they move away from the separate entity principle that is linked to the ALP.

At one end of the spectrum, the digital debate has reignited the question as to whether countries should adopt the group/global formulary apportionment mechanism (similar to the EU Common Consolidated Corporate Tax Base (CCCTB)). The FA method completely shifts in context from the ALP and allocates profits among various countries based on predetermined formulas linked to people, tangible assets, or sales. An additional criterion, i.e., the '*user*' criterion, is being contemplated to address highly digitalized businesses (HDBs), for instance, online advertisers. The proponents of this approach also contend that profits should be allocated to the new nexus even if the MNE as a whole is experiencing losses at the group level. Thus, it also reflects features of a minimum deemed profit allocation regime.

At the other end of the spectrum, the MRPS could be considered to be a hybrid profit allocation method. Although it accords with an MNE Group approach, the ALP is still retained for determining the profit that is allocable to market related intangibles. The method, which follows a '*top-down*' methodology, consists of four steps. The ALP could be used to calculate routine returns (step 2) or to calculate residual returns that are allocable to marketing intangibles (step 3). However, the analysis could be rather subjective and complicated. Thus, the use of simplified conventions in the form of predetermined formulas (or safe harbours) is being contemplated in its various steps.

The DB approach follows a '*bottom-up*' methodology. To understand this approach, a difference must be made between two situations. The first is when a non-resident enterprise (NRE) of an MNE operates with a local taxable presence in the Market Country, i.e. through a separate entity or a PE that could be characterized as a distributor. In this situation, the proposal contemplates that a baseline profit (or a routine return) could be allocated to the local taxable presence for its marketing or distribution activities. This baseline return could be computed based on a predetermined formula (for example, 3% on sales made in that country). Thereafter, the baseline profit could be increased based on an MNE group's overall profitability whereby a portion of the residual return could also be reallocated. The proponents of this approach also contend that such an approach would reduce transfer pricing disputes associated with marketing/distribution structures. The second occurs when an NRE operates in the market country on a remote basis. In this case, the proposal also contemplates allocating a baseline and residual return to the market jurisdiction but no guidance is provided for the manner in which it could be done. As the proposal is still at a conceptual phase, the question arises as to whether the baseline returns under both approaches operate as a safe harbour that is backed by the ALP or is a final return allocation. If it is the latter, then the proposal, similar to the FA method, acts as a minimum deemed profit allocation regime and would depart from the ALP.

The Pillar II proposal is executed when the effective tax rate of the controlled intermediary (separate entity or establishment) decreases below a certain pre-agreed tax

Notes

[9] *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.

[10] *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 2015).

[11] OECD/G20, *BEPS Action 13 on Country-by-Country Reporting – Guidance on the Appropriate Use of Information Contained in Country-by-Country Reports* (OECD Publishing 2017).

[12] *See* M. Olbert & C. Spengel, *International Taxation in the Digital Economy: Challenge Accepted?*, 9 World Tax J. 1, 3 (2017). *Also see* I. Grinberg, *International Taxation in the Era of Digital Disruption: Analyzing the Current Debate* (28 Oct. 2018).

[13] 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).

rate. The income inclusion rule applies even if the entity/ establishment perform actual economic activities. The base eroding payments rule applies even if payments such as interest, royalties, fees for technical services, and so on are at arm's length. In this context, the proposal goes beyond the ALP framework. Moreover, several compatibility issues could arise between these rules with either Tax Treaty or European Union Law.

3 How do we achieve tax certainty in the profit allocation debate?

At the outset, the author believes that there is a minimal possibility of adopting a group-wide formulary apportionment system as contemplated by the EU CCCTB or the Indian Tax Administration with respect to digitalized businesses.[14] Accordingly, the author would wager between two approaches – the MRPS or the DB approach.[15] However, if the ALP is built into these approaches, especially the MRPS, then the analysis becomes rather discretionary and open for differences in interpretation. Then the question that arises is how to achieve certainty when devising a profit allocation mechanism for Pillar I of the digital debate and, more broadly, in the general operation of the ALP. The answer is to adopt simplified conventions based on predetermined formulas or safe harbours on a multilateral basis.

In fact, a unified approach[16] could be developed which combines a formulary approach and the ALP. The former approach will apply at the MNE Group level whereas the latter approach will continue to apply at the separate entity level. For example, a simplified version of the MRPS that is based on deemed operating profit margins could apply to all MNEs that are within the scope of the new taxing right. This approach will reallocate a part of the MNEs residual or excess profits to the customer/users jurisdictions. Ideally, it would be desirable to have this approach as a safe harbour (as used in a Transfer Pricing context) but this could lead to significant compliance costs for both the taxpayer and the tax administration if the case ends up in disputes. Thus, the computation mechanism will need to be based on predetermined formulas or simplified conventions to keep the excess profit re-allocation excercise simple (although several complications could arise if a MNE Business line approach is adopted). In this sense, such an approach will clearly go beyond the ALP.

On the other hand, a simplified version of the DB approach could apply to local distributors of a MNE that are engaged in distribution or marketing activities. That approach could establish that a local distributor is given a minimum return on sales depending on the industry in which it operates (3% or 6% on sales), as a safe harbour and not a minimum profit allocation regime. However, if the facts and circumstances indicate that the local distributor should be entitled to a higher or lower return then that different return should be allocated.

From an implementation standpoint, the CBCR standard will need to be modified to collect MNE Group level information to implement a Pillar I profit allocation solution, in particular, the simplified MRPS. It also appears that the time has come to devise a new Multilateral Tax Convention to implement a Pillar I solution.

Prof. Dr. Vikram Chand
Tax Policy Center, University of Lausanne

Notes

14 IN: Government of India, Central Board of Direct taxes, Income department, *Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment* (CBDT 2019).

15 *See* I. Grinberg, *Stabilizing 'Pillar One': Corporate Profit Reallocation in an Uncertain Environment* (2019).

16 *See* OECD, *Secretariat Proposal for a 'Unified Approach' under Pillar One, Public Consultation Document, OECD/G20 Base Erosion and Profit Shifting Project* (OECD Publishing 2019).