

# Pillar I: The Marketing and Distribution Safe Harbour (MDSH) as Applicable to Licensed Manufacturers and Centralized Business Models: Does It Fulfil Its Policy Objective?

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*The new Pillar I Amount A system aims to reallocate a portion of in-scope MNEs' residual profits to market countries. This said, there could be many instances when an MNE already reports residual profits in the market country under the current system, for example, when it operates with a substantial physical presence (which is entrepreneurial in nature) in the market country. In order to avoid the double taxation/double counting of what is known as 'residual profits', a Marketing and Distribution Safe Harbour (MDSH) mechanism was first developed in the 2020 Blueprint and redesigned in the 2022 Progress Report. The purpose of this article is to address the question as to whether the MDSH as designed in the Progress Report meets its objective, particularly after briefly describing it as drafted in both reports. The authors analyse whether it does so by testing it against two commonly found MNE business models, i.e., a licensed manufacturer (LM) in the market and a centralized business model with limited risk distributors (LRD) in the market. A technical analysis is undertaken which is then illustrated with numerical case studies. The analysis leads to the conclusion that the MDSH as designed in the Progress Report does not necessarily meet its policy objective of preventing double counting under both the LM and the centralized business models. Thus, one possible policy option is to redraft it and return to the test as originally conceived in the Blueprint. A second possibility is to further reflect on some of the MDSH components, in particular, the manner in which jurisdictional routine and residual profits are calculated with the overall aim of achieving simplicity as well as accuracy. With respect to determining jurisdictional routine profits, our main recommendation is to deem a certain percentage of jurisdictional elimination profits (EPs) to represent routine profits (e.g., 25%). Such a mechanism would be simpler than the existing mechanism to determine jurisdictional routine profits, which seems to be rather complicated. With respect to jurisdictional residual profits, our recommendation is to support the Y% with a facts and circumstances analysis to achieve accurate results (at least, in certain cases). For instance, the Y% will be deemed to be 100% in a country when the MNE group operates with a fully or partly decentralized business model such as a LM (or similar business models such as franchise models). It will be regarded as being 0% in a country when it operates with limited risk sales structures or/and structures that have access to the simplification offered by the Amount B project. In all other cases, the Y% could be considered to be, for example, 25% in a country (which would be a compromise). Moreover, our recommendation with respect to withholding taxes (WHT) (if they are taken into account) is to restrict its scope to selected payments (e.g., royalties or service fees) and to provide a downward adjustment in the residence jurisdiction of the recipient (as opposed to the payors). The effect would be that the EP of the recipient would be reduced, and these profits would then represent the base to provide relief from double taxation. More broadly, if the Amount A project does not achieve fruition, the authors believe that some lessons that can be learned from the Amount A reform, in general, and the MDSH for future alternate reforms. Thus, a few suggestions will be made to policymakers who are considering alternatives to the Amount A project.*

## I INTRODUCTION

### I.1 Background

Pillar I can be subdivided into three central units of which two relate to the allocation of profits, i.e., Amount A<sup>1</sup> and Amount B,<sup>2</sup> and the third to tax certainty.<sup>3</sup> On the one hand, Amount

A pursues the policy objective of reallocating part of the residual profits of the largest and most profitable MNE groups to market jurisdictions based on a formula. On the other hand, Amount B, in accordance with some of the key tenets of the arm's length principle (ALP), provides pricing solutions for in-country baseline marketing and distribution activities.

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<sup>2</sup> OECD, *Public Consultation Document – Pillar I – Amount B* (OECD Publishing Dec. 2022).

<sup>3</sup> OECD, *Progress Report on the Administration and Tax Certainty Aspects of Amount A of Pillar One* (OECD Publishing Oct. 2022).

Finally, the third unit of Pillar I refers to tax certainty through dispute prevention and resolution mechanisms for conflicts related to Amount A and beyond it.

To this date, Pillar I is still an ongoing project that, according to the agenda imposed by the OECD, should come into force in 2024 even if, realistically, it might never achieve fruition, at least in its present shape as argued by some and in light of some significant political headwinds coming from the United States (as well as India and Saudi Arabia).<sup>4</sup>

The cornerstone and most comprehensive work concerning Pillar I was brought in October 2020 by means of the Blueprint on Pillar I<sup>5</sup> that resulted from a global political agreement announced in October 2021. Aware of the work that remained to be accomplished and the room for improvement, the OECD dedicated 2021 and 2022 to releasing statements and public consultation documents on specific technical aspects of Pillar I.

In July 2022, the OECD Secretariat released another landmark document, i.e., the Progress Report, that contains the core elements of the rules that guide the functioning of Amount A.<sup>6</sup> Fundamentally, it is a collection of all of the conclusions drafted from the various public consultations along with the inclusion of new elements. The compilation itself is a consultation document intended to obtain further input from stakeholders on the technical design of Amount A including scope, nexus, and revenue sourcing rules; determination and allocation of taxable profit; and elimination of double taxation (EoDT). It must be stressed that the Progress Report has been released by the OECD Secretariat and does not represent the consensus views of the Inclusive Framework (IF) members, the Committee on Fiscal Affairs (CFA), or their subsidiary bodies,<sup>7</sup> unlike the Blueprint which reflected a future political agreement on some aspects of Amount A.

Regarding MNE profit reallocation, Amount A is based on a formula that determines the quantum of residual profits reallocated to market jurisdictions. Hence, within Pillar I, the Amount A calculation distanced itself from

the current transfer pricing rules and the ALP because it adopts a formulaic approach to reallocate profits to market jurisdictions under Amount A. For MNE groups falling into the scope of Amount A, '25% of residual profit defined as profit<sup>8</sup> in excess of 10% of revenue will be allocated to market jurisdictions with nexus using a revenue-based allocation key'.<sup>9</sup> All of the work undertaken and achieved by the OECD, including on profit allocation, is meant to be crystalized in the Model Rules that will serve as the basis for the provisions relating to Amount A to be included in the Multilateral Convention (MLC).

Amount A is envisioned as an additional system sitting on top of the current international tax rules to (re)allocate MNEs' profits; stated otherwise, it is not designed to replace the current corporate tax/transfer pricing rules and will only apply to MNE groups specifically falling into its scope. However, since it and the current transfer pricing rules will apply simultaneously to determine the allocation of profits of in-scope MNE groups, interactions between both systems are inevitable.<sup>10</sup> Therefore, Pillar I will interact with domestic corporate tax systems<sup>11</sup> and specifically with existing transfer pricing rules. One of the following consequences is that this interaction can result in double counting<sup>12</sup> which occurs when a market jurisdiction considers an MNE group's residual profits twice, i.e., once under Amount A and once under the current corporate tax/transfer pricing rules. Consequently, '[t]he relevant Amount A of in-scope MNE groups would then be allocated to eligible market jurisdictions as an overlay or partial override to the ALP-based profit allocation rules'.<sup>13</sup> In other words, such an interaction between both systems could 'result in a market jurisdiction being able to tax twice the residual profit of an MNE group'.<sup>14</sup> Therefore, double taxation could arise even though it is contrary to the very policy objectives of the OECD Pillar I.<sup>15</sup>

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<sup>4</sup> Graeme S. Cooper, *Building on the Rubble of Pillar One*, 75(11/12) Bull. Int'l Tax'n 533 (2021); Marco Adda, Francesco S. Scandone & Umberto Lorenzi, *The New Taxing Right Under Pillar One: Preliminary Thoughts on Potential Implications for MNEs*, 28 Int'l Transfer Pricing J. 9, 16 (2021). Also see <https://www.ibfd.org/news/us-india-and-saudi-arabia-are-blocking-oecd-led-pillar-one-french-finance-minister-says>. (accessed 22 Feb. 2023)

<sup>5</sup> OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS* (OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing 2020).

<sup>6</sup> OECD, *Progress Report on Amount A of Pillar One*, *supra* n. 1, para. 2 at 8.

<sup>7</sup> *Ibid.*, at 7.

<sup>8</sup> Profit Before Tax (PBT).

<sup>9</sup> OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing Oct. 2021), Art. 1 para. 2 al. a and b. For the algebraic formula, see OECD, *Progress Report on Amount A of Pillar One*, *supra* n. 1, Art. 6(2).

<sup>10</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, para. 528.

<sup>11</sup> Maarten Floris de Wilde, *Towards a '2020s Compromise' in International Business Taxation: Reflections on an Emerging New Tax Paradigm*, 76 Bull. Int'l Tax'n 207, 212 (2022), doi: 10.2139/ssrn.4031417.

<sup>12</sup> Harmen van Dam et al., *Taxing the Digitalized Economy: Key Takeaways from the OECD Public Consultation on the Pillar One and Pillar Two Blueprints*, 28 Int'l Transfer Pricing J. 164, 168 (2021); Cooper, *supra* n. 4, at 539.

<sup>13</sup> OECD, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy – January 2020* (OECD/G20 Inclusive Framework on BEPS, OECD Publishing 2020), para. 53.

<sup>14</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, para. 499.

<sup>15</sup> *Ibid.*, para. 528.

If the MNE group operates without a physical presence in the market country (for example, when an MNE in the social media industry functions without a physical presence in the market), the issue of double counting may not arise. Therefore, in this case, the market jurisdiction will only be competent to tax a share of the MNE's residual profits under Amount A which aligns with the objectives of Pillar I. However, when an MNE group operates with a physical presence in a market country through either a permanent establishment (PE) or a subsidiary, an interaction between Amount A and the current transfer pricing rules occurs and could lead to double counting<sup>16</sup> and ultimately to double taxation, as explained above.

As highlighted, double counting occurs when a market jurisdiction is competent to tax the residual profits<sup>17</sup> of an MNE group twice, i.e., once under the current transfer pricing rules and once under Amount A. Since the double counting issue is linked to residual profits, it is more likely to occur to a greater extent for MNE groups that are organized under a decentralized or partly decentralized business model operating through local entrepreneurs. Indeed, in these business models, local entrepreneurs generally book residual profits/losses in the market jurisdictions.<sup>18</sup> Conversely, regarding MNE groups organized under a centralized business model operating through low-risk entities in the market jurisdictions, the local entities operating in the market countries usually book routine profits to the extent they are present therein<sup>19</sup> whereas the groups' principal or headquarter registers residual profits.

To address the double counting issue, the OECD is willing to introduce a Marketing and Distribution Safe Harbour Rule (MDSH). However, before beginning the analysis of the rule, the authors will briefly explore the concept of residual profits in order to explain its relevance in the debate.

## 1.2 The Notion of Residual Profits

The question now arises of what constitutes 'residual profits'. The OECD defines the concept as follows:

At the level of a group or segment, the term "residual profit" for Amount A purposes refers to profit in excess

of an agreed profitability threshold [ ... ]. This differs from the transfer pricing concept of "residual profits", which are the profits (or losses) that remain after remunerating activities that can be reliably benchmarked using comparables.<sup>20</sup>

Therefore, two definitions must be differentiated, i.e., the one used in relation to Amount A and that one used for transfer pricing purposes.

For the latter, it is "The group's remaining "residual profit" – meaning the excess of its aggregate profits over its total routine earnings".<sup>21</sup> The concept of routine profit must first be delineated<sup>22</sup> in order to define it properly because the isolation of residual profit implies the calculation of the group's routine profits. It is used under the current transfer pricing rules in the application of transfer pricing methods. For instance, profits can be allocated based on the residual profit split method that allocates residual profits between associated enterprises to reach an arm's length result.

In this context, the residual profit of the group is identified for Amount A purposes based on a profitability threshold of 10%. The profits in excess of this threshold are characterized as residual profits. As already mentioned, it must be noted that Amount A solely aims at reallocating a portion of a group's residual profits to market jurisdictions.

As a more general definition, SHAY stressed that 'the term residual profits refers to the portion of total profits that exceeds a threshold that, usually, is designed to isolate a minimum level of profit from taxation'.<sup>23</sup> This definition covers this concept for both Amount A and Transfer Pricing (TP) purposes. On the one hand, the threshold for the former is the profitability threshold while it is the routine profit for the latter. The profits in excess of the profitability threshold with regards to Amount A and those of an MNE group's routine profits will be deemed as residual profits. The concept hence entails a notion of excess of another element, e.g., profitability threshold or routine profits.

Therefore, the concept of residual profit is key in the debate on profit allocation in general and in determining the computation of the MDSH in particular. Depending on the mechanism, it will slightly vary, and the quantum will not be calculated similarly but, overall, the logic

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<sup>16</sup> Cooper, *supra* n. 4, at 539.

<sup>17</sup> In s. 1.2, the authors highlight that the term residual profits as used in Amount A does not correspond to the one used under the current transfer pricing rules.

<sup>18</sup> Richard S. Collier, Michael P. Devereux & John Vella, *Comparing Proposals to Tax Some Profit in the Market Country*, 13 *World Tax J.* 405, 416 (2021).

<sup>19</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, para. 504: 'In-scope MNE groups that for commercial reasons (given their particular business models) operate without an existing taxable presence in a market jurisdiction or only allocate a relatively limited return (e.g. on a cost-plus basis) to local marketing and distribution activities would not come under the safe harbour rule and thus would pay Amount A in the majority of market jurisdictions in which they operate'.

<sup>20</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, at 153–154, footnote n. 3.

<sup>21</sup> Sebastian Beer, Ruud de Mooij, Shafik Hebous, Michael Keen & Li Liu, *Exploring Residual Profit Allocation 5* (IMF Working Paper No. 20/49 2020).

<sup>22</sup> Shay argued that 'In transfer pricing, a routine return is the amount necessary to compensate an unrelated person for performing routine functions as a means to separate and identify "residual" returns from non-routine functions and valuable intangibles'. Stephen E. Shay, *The Deceptive Allure of Taxing 'Residual Profits'*, 75 *Bull. Int'l Tax'n* 527, 528 reference n. 6 (2021).

<sup>23</sup> *Ibid.*, at 527.

behind it remains.<sup>24</sup> For the present work, as it deals with Amount A, references to the term residual profit refers to the definition of residual profit as defined under Amount A.

### 1.3 The Issue and Limitations

Against this background, the focus will be on the MDSH mechanism and will ask the question of whether the MDSH fulfils its policy objective of avoiding double counting from the perspective of LMs and centralized business models<sup>25,26</sup>. In order to do so, the authors will first outline the MDSH mechanism under the Progress Report and the Blueprint (section 2). The application of the MDSH will then be illustrated through numerical examples. In particular, the application of this mechanism to LMs business models (section 3) and centralized business models (section 4) will be tested. Thereafter, several critical remarks will be made with respect to the MDSH formula and other matters linked to the MDSH mechanism (section 5). Finally, a few lessons from the Pillar I debate will be outlined and a few suggestions will be made for any future reform on the assumption that the Amount A project does not materialize (section 6).

Also, please note that as a scope limitation, the authors will not engage in a comprehensive debate on the conceptual framework for taxing cross border income, that is, whether Amount A is compatible with the ‘supply’, ‘demand’, ‘supply-demand’ or, more broadly, the ‘value creation’ framework. The question of analysing Amount A from the perspective of commonly accepted tax policy principles such as certainty and simplicity, efficiency (compliance costs standpoint), effectiveness, etc. will not be addressed as this was done in a previous publication.<sup>27</sup> This said, there will be comments on one tax policy

principle which is the anticipated or expected neutrality of the Pillar I reform.

An obvious disclaimer. The article is based on the authors’ understanding of the Progress Report (which is quite complicated to read and understand). In comparison to the ongoing work on Pillar 2, no commentary was released with respect to the Amount A Progress Report.

## 2 THE MARKETING AND DISTRIBUTION SAFE HARBOUR: MDSH

### 2.1 The MDSH in the Blueprint

The MDSH mechanism was first detailed in the Blueprint to address double counting issues with respect to Amount A while enforcing the vision that the latter should solely be allocated to market countries where MNEs’ residual profits are not already taxed under the existing transfer pricing rules. Conversely, Amount A should not be allocated to market countries competent to tax significant MNE groups’ residual profits under the current system because, otherwise, double taxation would arise and remain unresolved. As pinpointed in the Blueprint, the result is that the MDSH ‘is not an alternative way to allocate Amount A to a market jurisdiction, but rather a method to determine whether allocating Amount A to a market jurisdiction would give rise to double counting’.<sup>28</sup>

In the Blueprint, the OECD refers to such a tool as a safe harbour measure but nevertheless recognizes that it does not correspond to the traditional definition of a safe harbour.<sup>29</sup> This is because it would instead ‘cap’ the allocation of Amount A in cases where a market jurisdiction is already competent to tax residual profits derived from an MNE therein under the existing transfer pricing rules.<sup>30</sup> Hence, the safe harbour rule would limit the

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<sup>24</sup> The authors have highlighted the definition of residual profits as adopted in two profit allocation mechanisms, i.e., Amount A and the current transfer pricing rules. As another example, the Residual Profit Allocation by Income (RPAI), an alternative to the current profit allocation mechanism, allocates the entire residual profits to the destination jurisdiction while routine profits are allocated to the jurisdictions in which the MNE group performs functions and activities. See Michael P. Devereux, Alan J. Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön & John Vella, *Chapter 6: Residual Profit Allocation by Income in Taxing Profit in a Global Economy* (Oxford University Press 2019).

<sup>25</sup> The issue of double counting has been raised since the early beginnings of the Pillar I Project. See Vikram Chand, Alessandro Turina & Louis Ballivet, *Profit Allocation Within MNEs in Light of the Ongoing Digital Debate on Pillar 1 – A ‘2020 Compromise’?: From Using a Facts and Circumstances Analysis or Allocation Keys to Predetermined Allocation Approaches*, 12 *World Tax J.* 565, 619 (2020); Steffen Postler, *The OECD’s Work on Profit Allocation and Nexus Rules for a Digitalized Economy – A Potential Improvement of the International Taxation Framework?*, 74 *Bull. Int’l Tax’n* 76, 78 (2020); Pitambar Das & Amedeo Rizzo, *The OECD Unified Approach: Understanding the Real Deal for Market Countries*, 4 *Int’l Tax Stud.* 1, 8 (2021).

<sup>26</sup> Other interactions will occur between the current TP system and Amount A such as the elimination of double taxation. This will not be discussed in this article. On this issue, see Jinyan Li, *The Legal Challenges of Creating a Global Tax Regime With the OECD Pillar One Blueprint*, 75 *Bull. Int’l Tax’n* 84, 87 (2021). See also Heydon Wardell-Burrows, *Preliminary Observations on the Imposition of the Tax Liability and Elimination of Double Taxation Under the OECD Secretariat’s Progress Report on Amount A of Pillar One* (12 Jul. 2022), SSRN, <https://ssrn.com/abstract=4160616> where the author highlights another adverse consequence of the interaction between Amount A and the current TP rules regarding the elimination of double taxation. He makes the following observation: ‘If a jurisdiction is identified as a relieving jurisdiction and has not joined the MLC, it appears that there will be double taxation imposed at the rate of the (non-)relieving jurisdiction’.

<sup>27</sup> Vikram Chand, *Allocation of Taxing Rights in the Digitalized Economy: Assessment of Potential Policy Solutions and Recommendations for a Simplified Residual Profit Split Method*, 47 *Intertax* 1023, 1028 (2019), doi: 10.54648/TAXI2019106. And all the references therein.

<sup>28</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, para. 644.

<sup>29</sup> In the Glossary of Terms available on the OECD website, a safe harbour is defined as: ‘Where tax authorities give general guidelines on the interpretation of tax laws, these may state that transactions falling within a certain range will be accepted by the tax authorities without further questions’. See, <https://www.oecd.org/ctp/glossaryoftaxterms.htm#S>. (accessed 30 Nov. 2022)

<sup>30</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, para. 501.

quantum of Amount A allocated to a market jurisdiction to address the double counting issue.

For the safe harbour to apply, the MNE group must have a physical presence in the country,<sup>31</sup> otherwise, no double counting issue would arise, and it must carry on marketing and distribution activities connected to locally sourced in-scope revenue.<sup>32</sup> The MNE group's profits allocated to the market jurisdiction under existing profit allocation rules for the performance of these marketing and distribution activities are referred to as the existing marketing and distribution profits.<sup>33</sup> The MNE group would have to compare those profits to the safe harbour return.<sup>34</sup> The latter is composed of two elements: first, the quantum of Amount A and, second, a fixed return on top of Amount A that would represent the remuneration for in-country routine marketing and distribution activities. The fixed return 'would act as a test to identify situations when allocating Amount A to a market jurisdiction would give rise to double counting'.<sup>35</sup> In summary, the MDSH mechanism would take into consideration the actual taxes paid under the current transfer pricing rules and those payable under Amount A as expressed in the Blueprint. The MDSH:

would consider the income taxes payable in the market jurisdiction under existing taxing rights and Amount A together, and adjust the quantum of Amount A taxable in a market jurisdiction, on the basis of limiting it where the residual profit of the MNE group is already taxed in that jurisdiction as a result of the application of the existing profit allocation rules.<sup>36</sup>

Hence, four features are essential in order to understand how the MDSH detailed in the Blueprint would work in practice: the *safe harbour return* which would be the sum of the *Amount A quantum* as calculated under the Amount A

formula; the *fixed return for in-country routine marketing and distribution activities*; and, finally, the *existing marketing and distribution profit* to which the safe harbour return would be compared. It must be noted that the OECD did not quantify the fixed return for routine marketing and distribution activities in the Blueprint or in any discussion drafts that followed and has not been fully clear regarding its goal.<sup>37</sup>

With these elements, the MNE group should have the details necessary to determine whether the MDSH applies and how Amount A would be adjusted, if necessary. Indeed, three outcomes are possible. First, if the existing marketing and distribution profits are lower than the fixed return, the safe harbour does not apply. Second, suppose the existing marketing and distribution profit exceeds the safe harbour return. In that case, the market jurisdiction will not be allocated any Amount A because it is deemed that the jurisdiction already sufficiently taxed the residual profits of the group under the current transfer pricing rules. Finally, the third situation implies a partial reduction of Amount A where the existing marketing and distribution profit exceeds the fixed return but does not reach the safe harbour return. In this case, Amount A will be reduced to the difference between the safe harbour return and the profit already allocated to the local presence. Therefore, the MDSH mechanism would apply in part or in full under the two last scenarios to adjust Amount A and prevent double counting.

Another option to effectively address double counting issues has been discussed in the Blueprint, i.e., the domestic business exemption test.<sup>38</sup> The OECD envisaged the possibility of introducing two types of domestic business exemptions, a simpler one and a more complex one. The simplest form would involve excluding large domestically oriented businesses with a minimum level of foreign

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<sup>31</sup> Adda, Scandone & Lorenzi, *supra* n. 4, at 16: the authors argue that 'this safe harbour mechanism applies only when the group in question has a taxable presence in a given market. The authors believe that this is discriminatory to groups using third-party distributors. In cases in which it is impossible to determine third-party distributor returns on sales on deals with the group, an alternative safe harbour mechanism should be set up (e.g., by increasing the turnover threshold in the presence of third-party distributors or by excluding markets with third-party distributors)'.

<sup>32</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, para. 502. See also Nadia Altenburg & Katharina Schluicke, *The New World of Pillar One – Practical Thoughts on the New Scope*, 29 Int'l Transfer Pricing J. 24, 26 (2022).

<sup>33</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, para. 502.

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*, para. 542.

<sup>36</sup> *Ibid.*, para. 501.

<sup>37</sup> Adda, Scandone & Lorenzi, *supra* n. 4, at 16. The authors argue concerning the fixed return that 'First, it should ideally be aligned with Amount B (otherwise we do not understand the purpose of having two different sets of "basic" returns under Pillar One). Second, the "extra return" granted under the ALP could derive simply from a different benchmark or a different position in the range'.

<sup>38</sup> In the Comments on the OECD Public Consultation Document – Reports on the Pillar One and Pillar Two Blueprints, some commentators were in favour of further exploring the possibility of adopting a domestic business exemption as a supplementary mechanism to address double counting. See e.g., Deloitte; DET3; The German Federal Chamber of Tax Advisers. However, in many instances, commentators pinpointed the additional complexity of introducing such mechanism. Indeed, some commentators argued that, since MNE groups perform business mostly as integrated businesses on a global basis, the domestic business exemption is not essential and would bring complexity. See e.g., The BEPS Monitoring Group; *economiesuisse* and *SwissHoldings*; *Maisto and Associates*. More recently, in its Comments on the OECD Progress Report on Amount A of Pillar One, KPMG argued in favour of a separate domestic or autonomous business exemption: 'Simply excluding profits accounted for in the MDSH (or even a multiple of these profits) is not an alternative to a domestic or autonomous business exemption, because it does not adjust the profits reallocated to other jurisdictions as the proposed exemption would'. It must be noted that KPMG is the only commentator that referred to the domestic business exemption in the comments on the Progress Report.

income from the scope of Amount A.<sup>39</sup> The more complex type would result in the exclusion from Amount A of the profits derived from the sale of goods or services that are developed, manufactured, and sold in a single jurisdiction.<sup>40</sup>

Under this domestic business exemption test, the taxpayer would have to identify and isolate standalone domestic businesses to exclude their profits from Amount A. Since these are more likely to derive residual profits, double counting could arise, and the domestic business exemption test would prevent this.

Careful reconsideration and significant enhancement of the domestic business exemption test would still be required for it to be a potential option to alleviate double counting since, as acknowledged by the OECD, such an exemption would result in significant additional complexity to determining the Amount A tax base.<sup>41</sup> In addition, the OECD also recognized that the test could only be developed in conjunction with another mechanism to tackle double counting because it would only reduce its occurrence.<sup>42</sup>

## 2.2 The MDSH in the Progress Report

The OECD reaffirms in the Progress Report that the MDSH is designed to adjust the allocation of Amount A to market jurisdictions that already have existing taxing rights over an MNE group's residual profits.<sup>43</sup> Accordingly, its Article 6 states that, under specific conditions, the MDSH adjustment shall apply to reduce the amount of profits reallocated to a market jurisdiction and consequently provides the rules applicable to calculate this MDSH adjustment. Its calculation can be divided into four steps with step three containing many subtests.

First, the quantum of Amount A allocated to each jurisdiction must be calculated in accordance with Article 6 (1) and (2) of the OECD Progress Report. The calculation of the MDSH adjustment will enable determining whether Amount A in a jurisdiction must be adjusted in order to avoid double counting.

Second, once Amount A has been determined on a jurisdictional basis, the EP of the group entities must also be calculated on a jurisdictional basis. The rules to calculate these seem to be inspired from Chapter 3 of the OECD Global Anti-Base Erosion (GloBE) Model Rules.<sup>44</sup> Under Amount A, the EP of a covered group in a jurisdiction for a period is defined as the sum of the EP of the group entities located in the same market jurisdiction.<sup>45</sup> Essentially, the EP of a group entity corresponds to the entity's financial accounting profit for which several adjustments are performed,<sup>46</sup> and this is subject to a reduction for available loss carry-forwards.<sup>47</sup>

The calculation of the EP of a covered group in a jurisdiction is essential since the Progress Report provides that the MDSH adjustment shall be applied solely when it is equal to or greater than a certain amount in EUR for the determined period.<sup>48</sup> This test is referred to as the *de minimis* absolute threshold test and must still be detailed.<sup>49</sup> For example, if the EP of the covered group in a country is less than EUR one million, then the MDSH adjustment would not apply. Conversely, if it is more than EUR one million, then the MDSH adjustment could apply. The *de minimis* rule is a simplification measure aiming at carving out countries where the MNE Group has low EPs.

Third, when the *de minimis* absolute threshold test is satisfied, the formula to calculate the MDSH adjustment under Article 6(5) must be applied. The MDSH adjustment equals:

$$M = \text{MIN} ((EP - PEP) \times \{Y\%, Q\})$$

Where –

- M is the Marketing and Distribution Profits Safe Harbour Adjustment that shall be deducted from the amount of profit allocated to [Jurisdiction name] for a Period under paragraph 2.
- EP is the Elimination Profit of the Covered Group in [Jurisdiction name] for a Period.
- PEP is the Portion of Elimination Profit of the Covered Group in [Jurisdiction name] for a Period which would result in [a Return on Depreciation and Payroll (RDP) of the Covered Group in [Jurisdiction name] equal to the higher of the

## Notes

<sup>39</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, para. 547.

<sup>40</sup> *Ibid.*, para. 549.

<sup>41</sup> *Ibid.*, para. 527.

<sup>42</sup> *Ibid.*, para. 553.

<sup>43</sup> OECD, *Progress Report on Amount A of Pillar One*, *supra* n. 1, at 8 para. 2.

<sup>44</sup> OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (OECD Publishing 2021); OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)* (OECD Publishing 2022).

<sup>45</sup> OECD, *Progress Report on Amount A of Pillar One*, *supra* n. 1, Title 7, para. 30.

<sup>46</sup> For instance, tax expense is excluded from the entity financial accounting profit while accrued pension expense is included: *Ibid.*, Sch. I, s. 2, para. 1(a) and (h).

<sup>47</sup> *Ibid.*, Sch. I, s. 7.

<sup>48</sup> *Ibid.*, Art. 6(4).

<sup>49</sup> It must be stressed that the OECD specifies in a footnote that 'Further work is ongoing to consider the introduction and design of a *de minimis* profits threshold as well as possible application of other scoping conditions'. *Ibid.*, Art. 6, footnote n. 2.

Elimination Threshold RDP of the Covered Group or 40%].

- Y is the offset percentage, meaning the portion of a Jurisdiction's residual profits (i.e., EP-PEP) that is eligible for offset under the MDSH mechanism.
- Q is the amount of profit of the Covered Group allocated to [Jurisdiction name] for a Period under paragraph 2.
- MIN(,) means that M, the amount of the adjustment, is the lower of  $(EP - PEP) \times Y\%$  or Q.<sup>50</sup>

Under this step, the components of the formula must be identified or calculated.

First (subtest), the EP per jurisdiction as calculated in step two is used as a starting point to determine the MDSH adjustment.

The second (subtest) deals with determination of the PEP of a covered group in a jurisdiction for a period. PEP is the amount/percentage (although it is not clear) 'which would result in a RDP of the Covered Group' in a country that is equal to the higher of two other percentages that is (1) the Elimination Threshold RDP of a covered group or (2) 40%.

The Elimination Threshold RDP of a covered group 'is determined by multiplying the Covered Group's Revenues by 10 per cent and dividing the product by the sum of the Covered Group's Depreciation and Payroll'.<sup>51</sup> The formula is hence  $(\text{consolidated revenues} \times 10\%) / (\text{consolidated depreciation costs} + \text{consolidated payroll costs})$ . If the Elimination Threshold RDP of a covered group is higher than 40%, it will be retained as the PEP of the covered group in the jurisdiction. On the contrary, if it is lower than 40%, the latter percentage will be deemed as the PEP of the covered group.

Two issues arise here. First, the reference to 'a Return on Depreciation and Payroll of the Covered Group' in the country is not entirely clear. It may be said that another alternate reading of the formula is that the PEP is equal to the *jurisdictional depreciation and payroll x the higher of the two percentages* outlined above. If this is the case, Schedule J (Elimination of double taxation - Return on Depreciation and Payroll) becomes relevant here. However, this alternate reading is not considered hereafter as it is not clear. Also, the alternative reading could further reduce routine returns, increase residual returns, and thereby reduce Amount A allocations. Second, the OECD did not justify why a fixed percentage of 40% has been adopted. Thus, for the purpose of this article and the sake of simplicity, it will be assumed that the PEP needs to be expressed in a percentage and it represents the higher of 40% or the Elimination Threshold RDP of a covered group.

The third (subtest), the Y%, which is the offset percentage, is yet to be determined. It seems that it was

designed to address the concerns of certain countries that not all residual profits located in a market jurisdiction are relevant for double counting purposes. That is why the Y% was designed to determine the portion of a jurisdiction's residual profits (i.e., EP-PEP) that is eligible for offset under the MDSH mechanism. It must be stressed that the justification for the Y% is not obvious nor discernible in the OECD documents. It is, in fact, difficult to understand the reasons why Amount A should only be offset against a portion of the residual profit of a covered group under the MDSH mechanism. Accordingly, it is believed that the Y% is a political component of the MDSH adjustment formula that is not connected to any economic nor legal principles. It can be perceived as an approximate justice method aiming at identifying the amount of residual profit that will be eligible for offset under the MDSH.

Fourth (subtest), it must be determined which quantum, Amount A (Q) or  $(EP - PEP) \times [Y\%]$  is lower. Indeed, the MDSH adjustment will correspond to the lower amount between  $(EP-PEP) \times Y\%$  and the amount of profit of the covered group allocated under Amount A to a jurisdiction for a period calculated under Article 6(2).

Finally, under Step four, once the MDSH adjustment has been determined, the relevant portion of the adjusted profit before tax of a covered group that is taxable under Amount A in a jurisdiction is identified. It equals the result of the profit allocation formula in Article 6(2) reduced by the MDSH adjustment calculated under Article 6(5) or zero, whichever is higher.<sup>52</sup>

As can be seen, the formula contains several concepts entirely new for Pillar I since they were not developed in the Blueprint. For instance, these concepts are the EP of the covered group per country, the Elimination Threshold RDP of a covered group, and the offset percentage. However, they are recurrent in the Progress Report and also relevant for other articles, including those concerning the EoDT.

In this context, the authors will now test the application of this mechanism to some common MNE business models and determine whether it achieves its policy goal of avoiding double counting.

### 3 LMs BUSINESS MODEL

#### 3.1 The Case Study: Key Facts

To illustrate the application of the MDSH mechanism, assume that a profitable MNE group is organized under a LM business model (*see* diagram 1). The parent entity is located in Country Z and owns the group's Intellectual

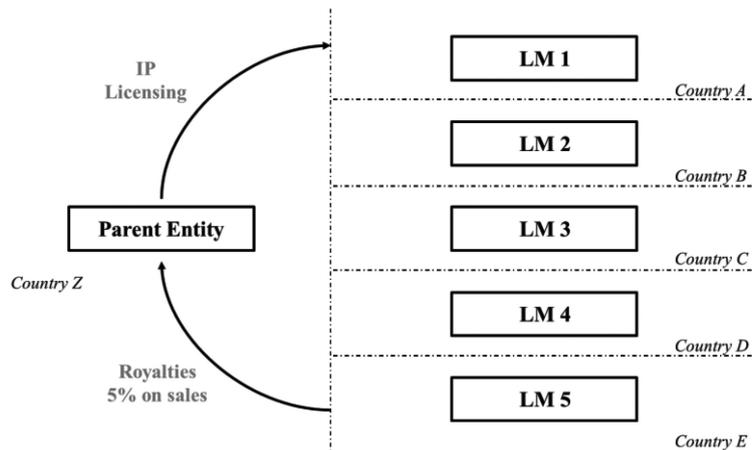
#### Notes

<sup>50</sup> *Ibid.*, Art. 5.

<sup>51</sup> *Ibid.*, Title 7, para. 31.

<sup>52</sup> *Ibid.*, Art. 6(1).

Diagram 1 LMs Business Model



Property (IP). It owns subsidiaries in Countries A, B, C, D, and E that are characterized as local LMs. Accordingly, they produce goods under a licensing agreement with the parent entity and sell them in their respective markets to the final customers. It is assumed that they perform local buying, manufacturing, and selling activities in the local market including marketing and distribution activities. Moreover, they undertake limited innovation related activities for brands owned by the parent entity (such as customization to the local market). The latter performs the bulk of the innovation, research and development (R&D) and brand equity management activities and licenses the group IP (patents and trademarks) to the local manufacturers in exchange for royalty payments. The latter amount up to 5% of the manufacturers' local third-party sales and such royalties are deemed at arm's length. Consequently, the LMs book the royalty payments as an expense in their financial statements while the parent lists them as income. For simplicity, also assume that the parent does not charge management services fees (high or low value added services) which is indeed common in such models. It must be noted that, given the nature of a LMs business model, the relevant residual profits are booked both in the market jurisdictions, i.e., Countries A, B, C, D, and E, and in the parent jurisdiction, i.e., Country Z.

To understand the application of the MDSH mechanism, key MNE level information and second key jurisdiction level information must be gathered.

The key MNE level information is displayed in Table 1.

Table 1 Key MNE Level Information

Key MNE Level Information	All Amounts in Million	Calculation
MNE Group consolidated third party sales	30,000	
MNE Group consolidated profits	7,500	
MNE Group standardized Profit Before Tax margin <sup>53</sup>	25%	
MNE Group residual profit margin	15%	$(25\% - 10\%)^{54}$
MNE Group Amount A percentage	3,75%	$(25\% \text{ of } 15\%)^{55}$
MNE Group Amount A	1,125	$(30,000 \times 3,75\%)^{56}$ or; $(7,500 - 30,000 \times 10\%) \times 25\%^{57}$
MNE Group payroll expenses	7,500	
MNE Group depreciation expenses	7,500	
MNE Group consolidated payroll and depreciation expenses	15,000	
MNE Group Elimination Threshold RDP	20%	$(30,000 \times 10\%) / (7,500 + 7,500)^{58}$

Key jurisdictional level information is detailed in Table 2.

## Notes

<sup>53</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, paras 507–518.

<sup>54</sup> *Ibid.*

<sup>55</sup> *Ibid.*

<sup>56</sup> *Ibid.*

<sup>57</sup> OECD, *Progress Report on Amount A of Pillar One*, *supra* n. 1, Art. 6(2).

<sup>58</sup> *Ibid.*

Table 2 Key Jurisdictional Level Financial Information<sup>59</sup>

All Amounts in Millions	Parent Entity	LM 1	LM 2	LM 3	LM 4	LM 5	MNE Total Consolidated
Third Party Local Income	15,000	6,000	4,500	3,000	900	600	30,000
Related Party Income – Royalties based on local sales	750	0	0	0	0	0	
Related Party Expenses – Royalties to Parent Entity	0	300	225	150	45	30	
Third Party Operating expenses	11,500	3,200	3,150	2,100	630	420	21,000
Profit Before Interest and Taxation	4,250	2,500	1,125	750	225	150	9,000
Interest	800	100	300	200	50	50	1,500
PBT	3,450	2,400	825	550	175	100	7,500
Elimination Profit (EP) = PBT	3,450	2,400	825	550	175	100	7,500
PBT Margin (PBT/Sales) <sup>60</sup>	23%	40%	18%	18%	19%	17%	25%

### 3.2 Analysis Under the Progress Report

Under the Progress Report, various steps must be followed to calculate the MDSH adjustment, as previously mentioned. First, the MNE Group Amount A must be calculated and allocated on a jurisdictional basis. Second, the EP of the covered group in a jurisdiction must be determined to apply the *de minimis* absolute threshold test. Since this has not yet been detailed by the OECD, it will be disregarded for the case study. Third, each element of the formula must be determined and applied. The formula is  $M = \text{MIN}((EP - PEP) \times [Y\%], Q)$ . As mentioned, since the Y% has not yet been defined by the OECD, the authors selected two different amounts for it, i.e., 20% (Table 3) and 50% (Table 4). Using a different Y% allows drafting conclusions on whether the MDSH mechanism, as designed under the Progress Report, fulfils its objective of eliminating double counting.<sup>61</sup> Fourth, the relevant portion of the adjusted profit before tax of a covered group that is taxable in a jurisdiction is determined.

Tables 3 and 4 present how the MDSH adjustment is calculated based on the formula contained in Article 6(5) of the Progress Report. In these tables, the four-step

process is represented. First, Amount A is allocated on a jurisdictional basis; second, the EP of the covered group in each country is displayed; third, the MDSH formula is applied; and, fourth, the adjusted Amount A is calculated at the jurisdictional and consolidated levels.

The above numerical example allows drafting the following conclusion: The lower the Y%, the less adjustment to Amount A (i.e., more Amount A is allocated to the markets). Indeed, when Y% equals 20%, the allocated Amount A at the group level is reduced from EUR 1,125 million to EUR 288 million. Contrastingly, when the Y% equals 50%, the allocated Amount A at the group level is reduced to zero. This means that the higher the Y%, the more adjustment to Amount A (i.e., less/no Amount A is allocated to the markets).

Therefore, the lower the Y%, the more unresolved double counting issues. Indeed, when the Y% is capped at 20%, the results show that Amount A is still partially allocated to the parent entity, LM2, LM3, LM4, and LM5 jurisdictions except to the jurisdiction where LM1 is located. However, except for the latter country, the other market jurisdictions already tax the residual profits of the MNE group, and double counting consequently remains in

#### Notes

<sup>59</sup> For sake of simplicity, the authors deem that PBT = elimination profit. Additionally, also for sake of simplicity, it is considered that there is only one group entity located in a single market jurisdictions. However, the authors acknowledge that, in reality, several group entities can be present in a single jurisdiction. The authors hence simplified the application of the jurisdictional approach by establishing only one associated enterprise per jurisdiction. These statements apply for all of the examples developed in this contribution.

<sup>60</sup> Usually, for transfer pricing purposes, the profit margin is calculated at the EBIT level.

<sup>61</sup> The intention of explaining the basics of how the MDSH mechanism works and how the Y% influences the conclusions of the case studies justifies the choice of capping the Y% at 20% and 50%. The authors acknowledge that the cap at 20% seems extreme and unrealistic since it would limit the group's residual profit that is eligible for offset to 20% under the MDSH adjustment. Such a solution is quite unlikely, nevertheless, the authors wanted to show that the application of the MDSH mechanism can result in strange and illogical results in certain cases, leading to the conclusion that every element of the MDSH adjustment formula is crucial to ensure that the mechanism fulfils its policy objective of avoiding double counting.

Table 3 MDSH Adjustment – Calculation With Y% Capped at 20%

All Amounts in Millions	Parent Entity	LM 1	LM 2	LM 3	LM 4	LM5	MNE Total Consolidated
<i>Step 1:</i>							
Amount A = Q <sup>62</sup>	562.5	225	168.75	112.5	33.75	22.5	1,125
<i>Step 2:</i>							
PBT = EP	3,450	2,400	825	550	175	100	7,500
<i>Step 3:</i>							
Elimination Threshold RDP							20%
MAX Elimination Threshold RDP or 40%							40%
PEP	1,380	960	330	220	70	40	
Residual profit: EP – PEP	2,070	1,440	495	330	105	60	
Y%	20%	20%	20%	20%	20%	20%	
(EP – PEP) x Y%	414	288	99	66	21	12	
MIN (EP – PEP) x Y% or Q	(EP-PEP) x Y%	Q	(EP-PEP) x Y%	(EP-PEP) x Y%	(EP-PEP) x Y%	(EP-PEP) x Y%	
<i>Step 4:</i>							
Adjusted Amount A	148.5	0	69.75	46.5	12.75	10.5	288

these jurisdictions. Stated differently, the lack of full elimination of double counting entails that there is no longer just a reallocation of residual profit under Amount A but an allocation of extra profit to the market states.

Conversely, the higher the Y%, the less unresolved double counting. Indeed, when Y% is capped at 50%, Amount A in all jurisdictions is reduced to zero and the residual profits are therefore solely taxed under the current corporate income tax system. As a result, it may be argued that the Y% should be eliminated (or capped at 100%) because, if the MDSH genuinely fulfilled its policy objective to eliminate double counting, no Amount A should be allocated to the jurisdictions where residual profits are booked which, in this case, are all of the displayed countries (*see* next section).

### 3.3 Comparison With the Blueprint

Four amounts must be determined for applying the MDSH mechanism as provided in the Blueprint.

First, the quantum of Amount A allocated to each market jurisdiction must be calculated. Second, the fixed return for routine marketing and distribution activities is established which is assumed to be 2% on sales. The addition of both quanta will calculate the safe harbour return. Amount A allocated at the MNE group level expressed in a percentage equals 3,75%. Added to the fixed return, it corresponds to the safe harbour return, i.e., 5,75%. Third, the amount of existing marketing and distribution profit must be determined. The

#### Notes

<sup>62</sup> Amount A is calculated based on the formula contained in Art. 6(2) of the Progress Report:

$$Q = (P - R \times 10\%) \times 25\% \times L / R$$

Where –

– Q is the amount of profit of the Covered Group allocated to [Jurisdiction name] for a Period.

– P is the Adjusted Profit Before Tax of the Covered Group for a Period pursuant to Article 5.

– R is the Revenues of the Covered Group for a Period.

– 10% is the profitability threshold.

– 25% is the reallocation percentage.

– L is the amount of Revenues of the Covered Group for a Period that arise in [Jurisdiction name] pursuant to Article 4 in respect of which the nexus test is met for that Period pursuant to Article 3’.

For instance, for Amount A calculation for Country Z where the HQ is located:  $Q = (7,500 - 30,000 \times 10\%) \times 25\% \times 15,000 / 30,000 = 562.5$ .

Marketing and Distribution Safe Harbour (MDSH)

Table 4 MDSH Adjustment – Calculation With Y% Capped at 50%

<i>All Amounts in Millions</i>	<i>Parent Entity</i>	<i>LM 1</i>	<i>LM 2</i>	<i>LM 3</i>	<i>LM 4</i>	<i>LM5</i>	<i>MNE Total Consolidated</i>
<i>Step 1:</i>							
<i>Amount A = Q</i>	562.5	225	168.75	112.5	33.75	22.5	1,125
<i>Step 2:</i>							
<i>PBT = EP</i>	3,450	2,400	825	550	175	100	7,500
<i>Step 3:</i>							
<i>Elimination Threshold RDP</i>							20%
<i>MAX Elimination Threshold RDP or 40%</i>							40%
<i>PEP</i>	1,380	960	330	220	70	40	
<i>EP – PEP</i>	2,070	1,440	495	330	105	60	
<i>Y%</i>	50%	50%	50%	50%	50%	50%	
<i>(EP – PEP) x Y%</i>	1,035	720	247.5	165	52.5	30	
<i>MIN (EP – PEP) x Y% or Q</i>	Q	Q	Q	Q	Q	Q	
<i>Step 4:</i>							
<i>Adjusted Amount A</i>	0	0	0	0	0	0	0

Table 5 Adjusted Amount A

	<i>HQ</i>	<i>LM 1</i>	<i>LM 2</i>	<i>LM 3</i>	<i>LM 4</i>	<i>LM 5</i>	<i>MNE Total Consolidated</i>
<i>Amount A</i>	562.5	225	168.75	112.5	33.75	22.5	1,125
<i>PBT</i>	3,450	2,400	825	550	175	100	7,500
<i>PBT Margin</i>	23%	40%	18%	18%	19%	17%	25%
<i>Fixed Return</i>	2%	2%	2%	2%	2%	2%	
<i>Safe Harbour Return</i>	5.75%	5.75%	5.75%	5.75%	5.75%	5.75%	
<i>PBT Margin compared to Safe Harbour Return</i>	PBT Margin > Safe Harbour Return						
<i>Adjusted Amount A</i>	0	0	0	0	0	0	0

final step of the process is to compare the safe harbour return to the existing marketing and distribution profit to determine whether the MDSH applies and whether Amount A needs to be adjusted. It must be stressed that there is no mention in the Blueprint of the EP nor of the elimination threshold RDP as stated in the Progress Report.

Table 5 displays the key data at the jurisdictional level that are necessary to calculate the adjusted Amount A according to the MDSH under the Blueprint. First, the table shows the Amount A that is allocated, the PBT margin of the associated enterprises, the fixed return, and the safe harbour return. Then, the PBT margin, which corresponds to the existing marketing and distribution profit, is compared to the safe harbour return to establish whether Amount A needs to be adjusted in a jurisdiction.

The safe harbour return must be compared to the PBT margin of the group entities to determine whether the MNE group already allocates a return in excess of the safe harbour return and hence if the MDSH applies. Both the parent entity and the LMs have a PBT margin superior to the safe harbour return of 5,75%. Therefore, the group already allocates a return in excess of that to the parent entity and the LMs, and the MDSH consequently apply. Thus, Amount A is adjusted in the market jurisdictions where double counting arises, and the MNE group under review has an adjusted consolidated Amount A of zero. This outcome is logical because the MNE group is organized under a LMs business model and, therefore, residual profits are booked in all of the market jurisdictions.

Under the Blueprint, the MDSH fulfils its objective of preventing double counting in this particular example. Indeed, in this case, the MNE residual profits will only be taxed under the current corporate tax system/transfer pricing rules as the application of the MDSH adjusted Amount A to zero in the market jurisdictions. Double counting has effectively been prevented.

Regarding the comparison with the Progress Report, apart from acknowledging that the safe harbour must address double counting issues, the MDSH mechanism introduced in it departs from that developed in the Blueprint. Indeed, a jurisdictional approach that contrasts the more entity-centred approach in the Blueprint is adopted in it. Therefore, the MDSH mechanism in the Progress Report does not refer to the safe harbour return composed of the Amount A quantum and a fixed return nor to the existing marketing and distribution profit. Instead, a pure formulaic approach is adopted in it with the introduction of the formula:  $M = \text{MIN}((EP - PEP) \times [Y\%], Q)$ .

Furthermore, while the total amount of an MNE group's residual profits were eligible for the MDSH mechanism under the Blueprint, the Progress Report limits it by introducing an offset percentage, i.e., the Y%.

Finally, under the Blueprint, a facts and circumstances analysis was introduced while the Progress Report included a pure formulaic and quantitative approach.

### 3.4 Summary

In summary, the main question to be addressed is whether the MDSH as designed under the Blueprint and the Progress Report fulfils its main objective of eliminating double counting in the business model at stake. Based on the above example, it can be ascertained that the MDSH mechanism under the *Blueprint* effectively eliminates double counting issues for profitable LMs business models which are those in which double counting is more likely to occur and be extensive.

Regarding the application of the MDSH mechanism as designed under the *Progress Report* to a LMs business model, depending on the quantum of the Y%, if it is less than 100%, double counting could remain. Indeed, as shown in the practical examples, the lower the Y%, the less adjustment to Amount A in jurisdictions where residual profits are booked and already taxed under the current transfer pricing rules. Therefore, as long as the Y% is maintained and assuming it is lower than 100%, the MDSH mechanism under the Progress Report does not effectively eliminate double counting for LMs business models in comparison with the Blueprint.

## 4 CENTRALIZED BUSINESS MODEL

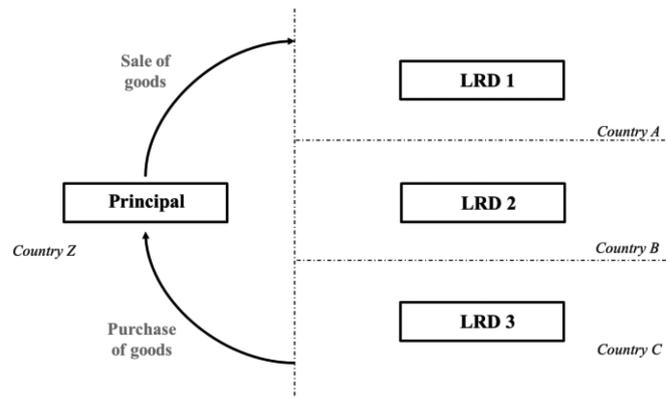
### 4.1 The Case Study: Key Facts

As a second practical example, assume an MNE group is organized under a centralized business model (diagram 2). The parent entity is located in Country Z and owns subsidiaries in Countries A, B, and C that are characterized as limited risk distributors (LRD). The local entities purchase the finished goods from the principal, i.e., the parent entity, and sell them in their respective markets with low risks. Therefore, in their financial statements, the local LRDs book an intragroup expense under purchase of goods and, accordingly, the principal registers an income for the intragroup sale of goods to its local LRDs.

The LRD located in Country A derives a 3% return on sales (ROS), the one in Country B gains a 4% ROS (approximately), and the one in Country C receives a 3% ROS. These profit margins are considered to be at arm's length, and it is also assumed that these margins represent PBT margins.

Accordingly, the local entities derive routine profits due to their low functional profile while the parent entity books the group's residual profits in Country Z. It is assumed that the LRDs are in scope of Amount B, and these profit margins are also compatible with the

Diagram 2 Centralized Business Model



ongoing debate on Amount B that is meant to be a simplification and streamlining measure in the application of the ALP to in-country baseline marketing and distribution activities.

As the calculation of the MDSH requires MNE group level information, the key MNE level information is similar to that presented in the LMs business model case study and depicted in Table 6.

Table 6 Key MNE Level Information

Key MNE Level Information	All Amounts in Million
MNE Group consolidated third party sales	30,000
MNE Group consolidated profits	7,500
MNE Group standardized PBT margin	25%
MNE Group residual profit margin	15%
MNE Group Amount A percentage	3.75%
MNE Group Amount A	1,125
MNE Group payroll expenses	7,500
MNE Group depreciation expenses	7,500
MNE Group consolidated payroll and depreciation expenses	15,000
MNE Group Elimination Threshold RDP	20%

Moreover, key jurisdictional level information is outlined in Table 7.

## 4.2 Analysis Under the Progress Report

Under the Progress Report, four steps must be followed to calculate the MDSH adjustment as formerly highlighted. First, the MNE group's Amount A must be calculated and allocated on a jurisdictional basis. Second, the EP of the covered group in a jurisdiction must be determined in order to apply the *de minimis* absolute threshold test. Since the test has not yet been detailed by the OECD, it will be disregarded for the case study and deemed as satisfied. Third, each element of the formula must be determined, and the it must be applied. Finally, the relevant portion of the adjusted profit before tax of a covered group that is taxable in a jurisdiction is determined.

To illustrate this four-step process developed in the Progress Report, data has been aggregated into several tables. First, the MDSH adjustment is calculated based on the formula  $M = \text{MIN}((EP - PEP) \times [Y\%], Q)$  of the Progress Report. As mentioned, since the Y% has not yet been defined by the OECD, the authors selected two different amounts for it, i.e., 20% (Table 8) and 50% (Table 9).<sup>63</sup>

Tables 8 and 9 show the formula used to determine the MDSH adjustment according to Article 6(5) of the Progress Report. These tables show the four-step process: first, the jurisdiction-based allocation of Amount A; second, the EP of the covered group in each country; third, the application of the MDSH formula; and fourth, the jurisdiction- and consolidation-level calculation of the adjusted Amount A.

It should be emphasized that the Y% is capped at 20% for Table 8 and 50% for Table 9. As a consequence, the MDSH adjustment and the adjusted Amount A will be impacted.

## Notes

<sup>63</sup> See justification above in footnote n. 62.

## Intertax

Table 7 Key Jurisdictional Level Information

	<i>Principal</i>	<i>LRD 1</i>	<i>LRD 2</i>	<i>LRD 3</i>	<i>MNE Total Consolidated</i>
<i>Third Party Local Income</i>	20,000	2,000	3,000	5,000	30,000
<i>Related Party Income – Sale of finished goods</i>	5,000				
<i>Related Party Expenses – Purchase of goods</i>		500	2,000	2,500	
<i>Operating expenses</i>	16,320	1,440	890	2,350	21,000
<i>Profit Before Interest and Taxation</i>	8,680	60	110	150	9,000
<i>Interest</i>	1,500	0	0	0	1,500
<i>PBT</i>	7,180	60	110	150	7,500
<i>Elimination Profit (EP) = PBT</i>	7,180	60	110	150	7,500
<i>PBT Margin</i>	35.9%	3%	4% approx.	3%	25%

Table 8 MDSH Adjustment – Calculation With the Y% Capped at 20%

	<i>Principal</i>	<i>LRD 1</i>	<i>LRD 2</i>	<i>LRD 3</i>	<i>MNE Total Consolidated</i>
<i>Step 1:</i>					
<i>Amount A = Q</i>	750	75	112.5	187.5	1,125
<i>Step 2:</i>					
<i>PBT = EP</i>	7,180	60	110	150	7,500
<i>Step 3:</i>					
<i>Elimination Threshold RDP</i>					20%
<i>MAX Elimination Threshold RDP or 40%</i>					40%
<i>PEP</i>	2,872	24	44	60	
<i>Residual profit: EP – PEP</i>	4,308	36	66	90	
<i>Y%</i>	20%	20%	20%	20%	
<i>(EP – PEP) x Y%</i>	862	7	13	18	
<i>MIN (EP – PEP) x Y% or Q</i>	Q	$(EP - PEP) \times Y\%$	$(EP - PEP) \times Y\%$	$(EP - PEP) \times Y\%$	
<i>Step 4:</i>					
<i>Adjusted Amount A</i>	0	68	99	170	337

The main conclusion to be drafted based on the application of the MDSH to a centralized business model is that, logically, as for the LMs business model, the lower the Y%, the less the adjustment to Amount A (i.e., more

Amount A is allocated to the markets). Indeed, when the Y% equals 20%, the allocated Amount A at the group level is reduced from EUR 1,125 million to EUR 335 million. Contrastingly, when the Y% equals 50%, the

Table 9 MDSH Adjustment – Calculation With the Y% Capped at 50%

	<i>Principal</i>	<i>LRD 1</i>	<i>LRD 2</i>	<i>LRD 3</i>	<i>MNE Total Consolidated</i>
<i>Step 1:</i>					
<i>Amount A = Q</i>	750	75	112.5	187.5	1,125
<i>Step 2:</i>					
<i>PBT = EP</i>	7,180	60	110	150	7,500
<i>Step 3:</i>					
<i>Elimination Threshold RDP</i>					20%
<i>MAX Elimination Threshold RDP or 40%</i>					40%
<i>PEP</i>	2,872	24	44	60	
<i>Residual profit: EP – PEP</i>	4,308	36	66	90	
<i>Y%</i>	50%	50%	50%	50%	
<i>(EP – PEP) x Y%</i>	2,154	18	33	45	
<i>MIN (EP – PEP) x Y% or Q</i>	<i>Q</i>	<i>(EP – PEP) x Y%</i>	<i>(EP – PEP) x Y%</i>	<i>(EP – PEP) x Y%</i>	
<i>Step 4:</i>					
<i>Adjusted Amount A</i>	0	57	80	143	279

allocated Amount A at the group level is reduced from EUR 1,125 million to EUR 276 million. This means that, the higher the Y%, the more adjustment to Amount A (i.e., less/no Amount A is allocated to the markets).

The MDSH effectively eliminates the double counting occurring for the principal. The Amount A allocated to it is reduced to zero in both scenarios, and, the residual profits derived by the principal are consequently only taxed under the current transfer pricing rules.

However, it must be stressed that applying the MDSH mechanism results in adverse consequences for the market countries where the LRDs are located. Indeed, Amount A is adjusted more in these market countries when the Y% is lower or higher, although no adjustment to Amount A should occur. The low-risk distributors solely derive routine profits, therefore, in the jurisdictions where they are located, no double counting occurs. So then, from a policy perspective, a question arises as to why Amount A is adjusted in these jurisdictions.

### 4.3 Comparison With the Blueprint

According to the Blueprint, double counting can partially be solved through the mechanism of EoDT 'because where an entity is allocated significant residual profit in a market jurisdiction under existing profit allocation rules, this entity may be identified as a "paying entity" within the group for the purpose of eliminating double taxation'.<sup>64</sup>

The paying entity would bear a portion of the Amount A tax liability resulting in a netting-off effect.<sup>65</sup> This is effective especially if the MNE group is organized under a centralized business model because, indeed, the principal or parent entity books the residual profits of the group while the local group entities list routine profits.

In this case, double counting will occur solely in the parent entity's jurisdiction because its residual profits will be taxed once under the current transfer pricing rules and once under Amount A. However, the parent entity will

## Notes

<sup>64</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, para. 499.

<sup>65</sup> *Ibid.*, para. 528. For numerical examples of the netting-off effect for a centralized and a decentralized business model, see *ibid.*, Box C.2 and Box C.3.

Table 10 Netting-Off Effect

	<i>Principal</i>	<i>LRD 1</i>	<i>LRD 2</i>	<i>LRD 3</i>	<i>MNE Total Consolidated</i>
<i>PBT</i>	7,180	60	110	150	7,500
<i>PBT Margin</i>	35.9%	3%	4%	3%	25%
<i>Amount A</i>	750	75	112.5	187.5	1,125
<i>ALP Based Allocation</i>	7,180	60	110	150	7,500
<i>Total Taxable Profits</i> <sup>68</sup>	7,930	135	223	338	8,625
<i>Potential double counting</i>	750	0	0	0	750
<i>Netting-off of profits under the mechanism to eliminate double taxation</i>	-1,125				
<i>Total Taxable Profits</i>	6,805	135	233	338	7,500

also likely be identified as a paying entity that must provide relief for double taxation for the MNE group. In summary:

Identifying this entity as a “paying entity” for Amount A purposes will, in turn, result in a “netting-off” effect: the residual profit allocated under existing rules to the market jurisdiction will, in effect, be reduced by the method used to relieve double taxation from Amount A (including Amount A allocated to other market jurisdictions).<sup>66</sup>

Some members of the IF emphasized that the elimination of the double taxation mechanism might be inadequate to address double counting when MNE groups are organized under a decentralized business model deriving profits from numerous entities located in multiple jurisdictions. According to them, ‘It may be difficult to calibrate this system to ensure that a full-risk distributor (already allocated residual profit) is identified as the paying entity for the Amount A allocated to the jurisdiction in which it is resident’.<sup>67</sup> That is why the Blueprint recommends applying the MDSH mechanism to decentralized and partly-decentralized business models and the EoDT mechanism for centralized business models operating through low-risk entities in market countries to address double counting.

It is assumed that, under the EoDT mechanism, the principal has been identified as the paying entity of the MNE group based on Chapter 7 of the Blueprint on EoDT. Accordingly, the paying entity must relieve double

taxation from Amount A, including that allocated to other market jurisdictions, because it has been identified as the sole relieving entity in the MNE group.

As shown in Table 10, double counting solely arises in the principal’s jurisdiction and not in the other market jurisdictions where the LRDs are located because the principal books the residual profits of the group. Accordingly, given that the LRDs only register routine profits, double counting does not arise. The principal’s jurisdiction will therefore be the only one to be impacted by the netting-off of profits under the mechanism to eliminate double taxation. As a consequence, the principal’s total taxable profits, i.e., ALP-based allocation and Amount A, will be reduced while the LRDs’ total taxable profits will be maintained.

In summary, under the mechanism to eliminate double taxation, the principal is identified as the paying entity and, hence, Country Z is required to provide double tax relief for the EUR 1,125 million in profits reallocated under Amount A. The mechanism to eliminate double taxation entirely nets-off double counting in Country Z (i.e., EUR 750 million) by effectively reducing the profit for which income tax will be paid in Country Z.

This outcome is logical as double counting solely occurs in Country Z where the principal is located since the latter books the residual profits of the group. Given that the local LRDs solely register routine profits, double counting does not occur in their jurisdictions. Therefore, Amount A should not be adjusted in the LRDs’ market

## Notes

<sup>66</sup> *Ibid.*, para. 531.

<sup>67</sup> *Ibid.*, para. 528.

<sup>68</sup> The total taxable profits exceed the taxable profits of the MNE group given that the double taxation arising from Amount A has not yet been eliminated.

countries, and double taxation is relieved by the paying entity, i.e., the principal, which results in a netting-off effect that prevents double counting.

In this case, the application of the MDSH as designed in the Blueprint is not necessary for centralized business models. The elimination of the double taxation mechanism is sufficient for obtaining the result of a netting-off effect that will avoid double counting.

#### 4.4 Summary

To summarize, regarding centralized business models, double counting is less likely to occur since the local entities in the market jurisdictions book routine profits and not residual profits. Since only the parent entity or principal records the residual profits of the group, double counting solely occurs in the latter's jurisdiction. The result is that the MDSH mechanism should only apply to the entity registering the residual profits that is subject to potential double counting.

Under the Blueprint, the MDSH is not applied to centralized business models; rather, it is demonstrated that the mechanism to eliminate double taxation is sufficient as it results in a netting-off effect that eliminates double counting for the parent entity. Logically, the quantum of Amount A is not adjusted for the market countries where routine profits are booked, as no double counting arises.

On the contrary, under the Progress Report, the application of the MDSH mechanism to a centralized business model, although it eliminates double counting where it occurs, creates adverse consequences. Even though the application of the MDSH effectively results in the elimination of double counting for the principal entity, i.e., the entity booking the residual profits, it also reduces the quantum of Amount A allocated to the other market jurisdictions where low-risk entities are located. However, Amount A should not be adjusted in these jurisdictions as double counting does not occur there. The total reallocated adjusted Amount A is thus unnecessarily reduced.

## 5 SELECTED ISSUES ON THE MDSH UNDER THE PROGRESS REPORT

### 5.1 The Formula and Selected Issues/ Suggestions

#### 5.1.1 Concisely, Why Is the Formula Needed?

Simply stated, after analysing the cases studies, it is obvious to the authors that, in the process of applying the MDSH, comparing the Amount A allocable to a market that represents deemed residual profits calculated at the MNE group level with the residual profits of the MNE group at the in-country level (jurisdictional residual

profits) is necessary. Essentially, if the latter exceeds the former then there should not be any Amount A (deemed residual profits) allocated to the markets.

To determine the in-country residual profits (or a jurisdiction's residual profits), the in-country EP (the total profits) must be determined and subsequently split into routine and residual profits.

In this paper we have assumed that the jurisdictional routine profits are linked to the jurisdictional RDP metric and are deemed to be the higher of 40% or the Elimination Threshold RDP of the Covered Group. However, as stated before, this is not clear.

The jurisdictional routine profits are reduced from the total profits (EP-PEP) in order to arrive at the deemed jurisdictional residual profits. These residual profits are further reduced by a Y% (offset amount) to determine the *final jurisdictional residual profits*. These in-country jurisdictional residual profits are then compared to the allocable Amount A for the jurisdiction in order to understand whether an MDSH adjustment is required.

In general, Amount A is not allocated to the market country if the *final jurisdictional residual profits* are higher than the allocable Amount A. This is because the market country is booking residual profits under the existing system. On the contrary, Amount A is allocated to the market country if the *final jurisdictional residual profits* are lower than the allocable Amount A. This is because the market country is considered not to be booking residual profits under the existing system.

#### 5.1.2 Issues in the Formula With Some Suggestions

First, for the EP, it should be noted that its calculation is a prerequisite for not only the MDSH but also for the rules that deal with the EoDT provisions. The Amount A system leverages on the GloBE rules, and the mechanism to calculate the EP per jurisdiction is similar to the calculation of adjusted GloBE income in each jurisdiction. Logically, using GloBE information would reduce the administrative burden on the MNE group. However, the GloBE rules are already complex, and several of their parameters with respect to the denominator are undecided.

For instance, as just as one illustration, the separate entity financial statements are the starting point for the calculation of the adjusted GloBE income for an entity. However, it could well be possible that intra group prices recorded in these statements differ from those that are entered into a tax return as a result of transfer pricing rules. In this regard, Article 3.2.3 and its related commentary require adherence to the ALP requirement (in certain cases). This means that, in some situations, transfer pricing figures (reported for taxable income purposes) would flow into the calculations of adjusted GloBE income per jurisdiction as opposed to the information reported in the financial statements. Moreover, when

dealing with PEs and having to compute their adjusted GloBE income, in many cases, Article 3.4 provides that the items of income/expenses need to be attributed to a PE based on the relevant OECD Model. It typically uses a transfer pricing approach to allocate profits to a PE. This once again means that, in some cases, transfer pricing figures (reported for taxable income purposes) would flow into the calculations of a PE's GloBE income as opposed to the information reported in the financial statements (to the extent that they exist).

In this regard, Schedule I (Elimination Tax Base), section 2(3) and section 3 of the Progress Report contain rules that are similar to Article 3.2.3 and Article 3.4 of the GloBE rules, respectively. This once again means that, in some cases, transfer pricing figures (reported for taxable income purposes) would flow into EP calculations.

Thus, on the one hand, the Pillars go beyond the ALP. However, on the other hand, transfer pricing rules (in one way or another) become an integral part of the Pillars. This is because in-country financial statements will always have to adhere to the ALP or be adjusted for ALP outcomes to determine GloBE income/loss or EP/loss. Thus, as a suggestion, it becomes important for policy makers to clarify the interaction between the ALP and the Pillars.

Second, the PEP represents routine profits in a country. The formula deployed to calculate these routine profits is rather confusing. First, there is a reference to 'Return on Depreciation and Payroll of the Covered Group' in a country. Assume that the group's elimination threshold RDP is 20%. Thus, the higher deemed percentage of 40% will be considered in this formula. It is not clear whether 40% of the EP amount needs to be reduced from the jurisdiction's EP (assumed in this article), if 40% of the in-country depreciation and payroll needs to be reduced from the jurisdiction's EP, or if another amount needs to be reduced. Clarity on this matter is welcome.

Furthermore, a large MNE argued that the RDP seems antiquated and does not account for all expenses in a market jurisdiction<sup>69</sup> and, if maintained, it should not rely so heavily on tangible assets, i.e., depreciation and payroll, but rather take into account intangibles. However, it must be stressed that tangible assets offer the significant advantage of being immobile, to a great extent. On the contrary, given that intangible assets are mobile, they are more prone to manipulation and relocation. Moreover, another commentator stated:

By limiting the calculation of residual profit to RDP, the MDSH formula ignores the reality of how many MNEs do business. Depreciation and payroll expense are antiquated in that, in today's world, intangible assets are key elements in an MNE's value chain. At the very least the MDSH formula should incorporate amortization of intangibles in the formula in addition to depreciation of tangible assets and payroll expense.<sup>70</sup>

The question may also be raised as to why there is a reference to the elimination threshold RDP. This amount/percentage is calculated at the MNE group level. So why should this be relevant for jurisdictional level computations? Stated differently, does the elimination threshold RDP accurately reflect routine jurisdictional returns? Indeed, several commentators pointed out that the reference to 10% of revenue in the formula to calculate such a figure exceeds routine returns.<sup>71</sup> However, another commentator stressed that the elimination threshold RDP is at least connected to a concept of routine profits to a certain extent.<sup>72</sup>

Third, as commentators accentuated, the arbitrary 40% used to calculate the PEP is problematic. The OECD must clarify the reasoning behind this choice and the policy objective. Logically, if the PEP is retained at 40% (because it is greater than the group elimination threshold RDP), then the in-country residual profit of the MNE group, i.e., EP-PEP, amounts to 60% of the country's EP (this is the authors' understanding of the formula's current functioning which they appreciate is not its universal understanding). Accordingly, it means that the PEP of 40% represents the group's in-country routine profits, although 40% clearly exceeds normal routine returns. It may indeed be argued that such an arbitrary percentage of 40% does not properly reflect the MNE group's in-country routine returns and should accordingly be abandoned. Moreover, the possibility of selecting the higher amount between 40% and the group's elimination threshold RDP should not be offered.<sup>73</sup>

After reflecting on the above second and third points and on the assumption that the ALP cannot be deployed here to calculate jurisdictional routine returns, the authors believe that a simpler approximate justice formula would be more appropriate for calculating jurisdictional routine profits rather than the one proposed in the Progress Report (which is rather complicated). A simple formula is just to deem a certain percentage of jurisdictional EPs (e.g., 25%) as representing routine profits similar to what

## Notes

<sup>69</sup> Microsoft Comment on Progress Report, at 4.

<sup>70</sup> BRT Comment on Progress Report, at 8.

<sup>71</sup> Silicon Valley Tax Directors Group (SVTDG) Comment on Progress Report, at 14; DEG Comment on the Progress Report, at 18.

<sup>72</sup> PwC Comment on Progress Report, at 6.

<sup>73</sup> In the Comment on the Progress Report, the Digital Economy Group (DEG) argued that 'the definition of PEP which is the higher of those two measures exacerbates the deviation from normal routine returns'; at 18. See also KPMG Comment on Progress Report, at 22.

was done with respect to Amount A. The same percentage could be applied across all industries. Alternatively, an MNE specific formula could be designed to determine jurisdictional routine profits (e.g., cap routine profits to represent a certain percentage of sales).

Fourth, it is obvious to us that higher the Y% the larger are the jurisdictions residual profits. In such situations, it could well be possible that no Amount A is allocated assuming that they are lower than the jurisdictions residual profits. On the contrary, lower the Y% the lower are the jurisdictions residual profits. In such situations, it could well be possible that Amount A is allocated assuming that they are higher than the jurisdictions residual profits. This said, the practical examples demonstrated that, depending on the amount of the Y%, the MDSH mechanism only partially fulfils its policy objective to eliminate double counting.

For LM's business models, applying a Y% lower than 100% will inevitably result in some unresolved double counting and reduce the impact of the MDSH. Some commentators<sup>74</sup> expressed in their comments on the Progress Report that the Y% should be no less than 100% and that the most appropriate option would be to simply delete it. Commentators have examined the policy objective of having a Y% lower than 100% and whether such an objective is aligned with that of the MDSH to resolve double counting issues. Subsequently, they argued that it is not evident why the MDSH mechanism must take into account only a portion of the market jurisdiction's residual benefits.<sup>75</sup>

On the contrary, regarding centralized business models, eliminating the Y% can have unfavourable consequences. Indeed, the authors mentioned that the lower the Y%, the less adjustment to Amount A and, contrastingly, the higher the Y%, the more adjustment to Amount A. This statement applies not only to LM's business models but also to centralized business models. Stated otherwise, when the Y% is lower, the Amount A allocation increases; accordingly, when the Y% is higher, Amount A allocation decreases. It indicates that, as shown in the practical example of the application of the MDSH to a centralized business model, the quantum of Amount A in the jurisdictions where low-risk entities deriving routine profits are located is adjusted although no double counting occurs. Hence, if the Y% is eliminated or equal to 100%, it will result in significant adjustments to Amount A in these countries. The MDSH will therefore fulfil its objective to eliminate double counting for the entity booking the residual profits, but it will actually lead to an unnecessary adjustment of Amount A in the other market jurisdictions. As a result, the quantum of Amount A at the group level will be impacted, and Pillar

I will fail its policy objective to adequately reallocate profits to the market jurisdictions.

If returning to the example of the centralized business model for which the MDSH adjustment is applied and deem that the Y% equals 100%, the following results will be obtained and confirm the statement that the total quantum of Amount A will be unnecessarily reduced. Amount A should indeed be reduced to zero in the principal's jurisdiction in order to prevent double counting, however, it should not be adjusted in the other market jurisdictions given that no double counting arises in the LRDs' jurisdictions since they do not derive residual profits. Hence, the total adjusted Amount A should be the sum of the other market jurisdictions' full Amount A, i.e., EUR 375 million, and not EUR 183 million. Table 11 shows the results of the MDSH adjustment and adjusted Amount A when the Y% is capped at 100%.

However, for pure centralized business models, it can be questioned whether the problem genuinely lies in the Y% or rather in the way residual profit, i.e., EP-PEP, is calculated. Indeed, capping the Y% at 100% in the centralized business model case study leads to the (erroneous) conclusion that residual profits are not only derived by the principal entity but also by the LRDs in the market jurisdictions. Indeed, in Table 11, it is observed that EP-PEP is a positive amount in all three market jurisdictions where the LRDs are located, respectively, EUR 36, 66 and 90 million. Nevertheless, the assumption of the case study was that the LRDs are low-risk entities and consequently do not derive any residual profits. Thus, it appears that the calculation to identify these is not appropriate to reflect where such profits are truly generated. Inevitably, it leads to a misapplication of the MDSH that countervails its original purpose. Thus, as already mentioned, not only is the Y% a problematic element of the MDSH adjustment formula, but the PEP figure and how residual and routine profits are determined are also issues.

One possibility to tackle this issue is to add another test in the process of determining jurisdictional routine profits. For instance, it could be agreed that PEP could be the higher of either the jurisdictional RDP percentage or a ROS (e.g., 4% on sales). If this is the case, then there would not be any jurisdictional residual profits.

Alternatively, on the assumption that the Y% is still retained, the authors' proposal would be to back it with a facts and circumstances analysis and deem it to be 100% in the case of decentralized business models (such as licensed manufacturing business models) and 0% when the MNE group is operating with a low risk sales entity or an entity that can claim the simplification offered by the Amount B project.

## Notes

<sup>74</sup> See for instance, Microsoft, KPMG, DigitalEurope, Unilever Comments on Progress Report.

<sup>75</sup> Unilever Comment on Progress Report, at 4.

Table 11 MDSH Adjustment Calculation With Y% Capped at 100%

	<i>Principal</i>	<i>LRD 1</i>	<i>LRD 2</i>	<i>LRD 3</i>	<i>MNE Total Consolidated</i>
<i>PBT = EP</i>	7,180	60	110	150	7,500
<i>Amount A = Q</i>	750	75	112.5	187.5	1,125
<i>Elimination Threshold RDP</i>					20%
<i>MAX Elimination Threshold RDP or 40%</i>					40%
<i>PEP</i>	2,872	24	44	60	
<i>Residual profit: EP – PEP</i>	4,308	36	66	90	
<i>Y%</i>	100%	100%	100%	100%	
<i>(EP – PEP) x Y%</i>	4,308	36	66	90	
<i>MIN (EP – PEP) x Y% or Q</i>	<i>Q</i>	<i>(EP – PEP) x Y%</i>	<i>(EP – PEP) x Y%</i>	<i>(EP – PEP) x Y%</i>	
<i>Adjusted Amount A</i>	0	39	47	98	183

Of course, complications could arise when an MNE group sells in the market through a dual structure, that is, through LMs and LRDs. In such cases, there would need to be a compromise and possibly cap the Y%, for example, at 25%. In this sense, the benefit of the previous paragraph cannot be extended to such situations.

## 5.2 The Broader Issue of Withholding Taxes (WHT)

Perhaps one of the most controversial topics at the moment, especially with respect to decentralized business models, is whether the MDSH should take into account WHT on deductible payments, e.g., royalties. The OECD mentioned that the Progress Report does not address such a question,<sup>76</sup> nonetheless, the debate is highly essential for the business community which strongly supports that WHT should be considered in the MDSH.

Several commentators<sup>77</sup> firmly advanced that, because the WHT (e.g., on royalties or service fees or business income) also taxes residual profits on a gross basis, disregarding them under the MDSH leads to distortions and does not address the issue of double counting. Indeed,

they advocate that market jurisdictions would therefore be able to tax the residual profits of a covered group twice, i.e., through the WHT and Amount A,<sup>78</sup> hence potentially leading to double taxation. To avoid such a result, it has been recommended 'that any withholding tax paid by an Amount A taxpayer on payments deductible in the market jurisdiction should decrease the Amount A allocation to that taxing jurisdiction by the amount necessary to avoid double taxation of the taxpayer's residual profit'.<sup>79</sup> Considering the WHT when applying the MDSH would avoid over-allocating residual profits to market countries and conversely under-allocating them to other countries.

On the contrary, the G24 and many developing countries, such as the fifty-four jurisdictions represented by the South Centre, favour the exclusion of the WHT under the MDSH. The G24 expressed:

Withholding taxes are levied in respect of a limited set of payments only and there cannot be any presumption that they are related to residual profit only. On the other hand, withholding taxes are mostly linked to operational activities leading to routine profits and, therefore, outside the scope of Amount A. G-24 is of the considered view that any consideration of

### Notes

<sup>76</sup> OECD, *Progress Report on Amount A of Pillar One*, *supra* n. 1, para. 5.

<sup>77</sup> See for instance, BDI, KPMG, Microsoft, Unilever comments.

<sup>78</sup> KPMG Comment on Progress Report, at 22.

<sup>79</sup> USCIB Comment on Progress Report, at 10.

withholding taxes in Amount A will lead to erosion of existing taxing rights and will make Pillar One unattractive and meaningless for the developing countries.<sup>80</sup>

Furthermore, the South Centre recalled that ‘Double counting assumes two separate taxes are being levied on the same income; it is thus irrational to compare Amount A, which is a tax, with a withholding tax, which is a collection mechanism’.<sup>81</sup>

For the purpose of this article, the authors do not take a position on this issue as arguments can be made for and against. This said, we would still offer a couple of recommendations if WHT are taken into account. First, the scope of payments covered by this rule should be as narrow as possible (for example, it should only be applied to payments made towards royalties or service fees). Second, the amount subject to gross WHT should be reduced from the EP of the recipient of the income rather than from the EP of the payor. This amount would then be relevant for the EoDT provisions from a recipient’s perspective.

### 5.3 Overall Assessment from a Market Country’s Standpoint

In light of the above discussion, it could be argued that market countries may not receive their fair share of promised revenues under Pillar 1 Amount A. This is due to the following four reasons:

- First, depending on the Y%, Amount A allocations could be reduced/eliminated when an MNE is operating with a centralized business model. This is clearly not appropriate and, thus, the Y% shall be deemed to be 0% in these cases. Alternatively, an additional test could be built which would consider the routine profits to be a certain percentage on sales (e.g., 4%).
- Second, if WHT are taken into account especially for decentralized business models, then Amount A allocations would be further reduced. This is why we proposed that amounts exposed to gross WHT should be reduced from the income recipients EP base as opposed to the payors.
- Third, it could well be possible that, as a result of Amount B, many MNEs may restructure their operations from full-fledged distributors to LRD

with the effect that less/lower profits would then be kept in the markets.

- Fourth, the Pillar I framework requires many countries to abandon their Digital Service Taxes (DSTs). Abandoning these may not be appealing if the revenues collected from them are more/much higher than the Amount A allocations.

However, on the other hand, estimates released by the OECD in January 2023 indicate that a higher amount of Amount A could be allocated to market countries compared to the previously indicated amounts. It is estimated now that USD 200 billion will be reallocated to market countries, and this will result in annual global tax revenues of between USD 13–36 billion.<sup>82</sup>

Thus, it becomes difficult to posit on whether market countries would indeed benefit substantially from this reform.

## 6 KEY LESSONS FROM PILLAR I AND THE MDSH FOR ANY SOLUTION

As indicated at the beginning of this contribution, it could well be possible that the Pillar 1 Amount A project may not achieve fruition. Even if Amount A is introduced, many questions still need to be addressed: How many countries will sign the MLC? If key countries do not sign it, will it jeopardize the project? How many countries will eventually ratify it? How long will it take before it enters into force? It could well be possible that other solutions are developed to address the Pillar I issues because countries may not find it appealing to join the MLC.

One realistic possibility is that countries will continue enacting DSTs with a limited or a broad scope.<sup>83</sup> The former would apply to selected digital businesses where user participation plays a key role (e.g., online advertising and online intermediation). The latter would apply, in addition to the scope of the former, to other digital businesses (e.g., cloud computing, online streaming, etc.). At the same time, Amount B would apply to all businesses that essentially sell goods through routine distributors.

Another practical possibility is that countries would enact limited digital PE concepts (applicable only to digital businesses)<sup>84</sup> or broad based significant economic presence (SEP)<sup>85</sup> concepts that would apply to all businesses that sell goods and services in the market countries.

## Notes

<sup>80</sup> G24 Comment on Progress Report, para. 7.1.

<sup>81</sup> South Centre Comment on Progress Report, III, ii.

<sup>82</sup> See <https://www.oecd.org/tax/beps/revenue-impact-of-international-tax-reform-better-than-expected.htm>. (accessed 18 Jan. 2022)

<sup>83</sup> Pasquale Pistone, João Félix Pinto Nogueira & Alessandro Turina, *Digital Services Tax: Assessing the Policy Reasons for Its Introduction in the European Union*, 4 Int’l Tax Stud. 1 (2021).

<sup>84</sup> Peter Hongler & Pasquale Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* (WU International Taxation Research Paper Series No. 2015-15 2015).

<sup>85</sup> Pasquale Pistone, João Félix Pinto Nogueira & Betty Andrade Rodríguez, *The 2019 OECD Proposals for Addressing the Tax Challenges of the Digitalization of the Economy: An Assessment*, 2 Int’l Tax Stud. 1 (2019), s. 4.

A less pragmatic option is to apply WHT on gross payments such as those on payments made for selected digital services. This solution was proposed by the UN<sup>86</sup> and will most likely not be accepted as a global solution.

Finally, the unrealistic approaches would be destination based cash flow taxes<sup>87</sup> or a full-fledged formulary apportionment idea based solely on tangible factors.<sup>88</sup>

It must be pointed out that, more recently, the EU is contemplating adopting a formula for allocating taxable profits that would incorporate intangible assets to adapt to the realities of modern economies through its Business in Europe: Framework for Income Taxation (BEFIT) Project.<sup>89</sup> This could be appealing for some countries.

The pros and cons of all of these options have been discussed extensively in academic literature, and it is not the purpose of this article to repeat them. The authors opine that, irrespective of the chosen outlet for a solution, some policy choices need to be made. Of course, there are many policy choices, but the authors will focus on three essential choices to keep the discussion within reasonable proportions.

First, two theoretical approaches have been historically extensively developed to allocate MNE group profits among jurisdictions, i.e., the separate entity approach and the group approach (or unitary taxation). The current applicable approach, i.e., the separate entity approach, entails that each member of an MNE group must be treated as a separate and independent entity from the rest of the MNE group for transfer pricing purposes. On the contrary, the second potential approach, i.e., the group approach, implies that the MNE group forms one taxpayer, and profits must be allocated accordingly. Thus, the starting point is to make a decision of the approach to be adopted towards a potential solution. Mixing both approaches is not appropriate as it would just enhance the complexity of the system.

To be specific, under the current separate entity system, transfer pricing rules through the ALP are applied. On the contrary, Amount A would be based on a group approach departing from the separate entity approach. Indeed, residual profits would be reallocated to market jurisdictions. Essentially, Amount A considers the whole group's residual profits first and does not focus on those of each particular group member for reallocation purposes. Therefore, Amount A and the current transfer pricing

rules diverge; nonetheless, since Pillar I Amount A has been envisioned as an add-on system to the current transfer pricing rules, both systems will still apply simultaneously.<sup>90</sup> Because two systems cannot fully be isolated if they have a common scope, i.e., the largest and most profitable MNE groups, they will inevitably interact. Unfortunately, the interactions between Pillar I and the current transfer pricing rules result in adverse consequences that must be addressed.

Second, there must be adherence to the principle of neutrality. Pillar I Amount A has been evolving significantly since its early stage. Under the Blueprint, its scope was reduced to automated digital services (ADS) and consumer facing businesses (CFB) that had to meet certain thresholds. Nonetheless, in its present shape, only the thresholds remain, but Pillar I is applicable to all industries (except extractives and regulated financial services).

As drafted in the Blueprint, the Pillar I project was criticized because it was ring-fencing the digital economy and was hence not neutral. Neutrality is a crucial principle in international taxation. Based on the Ottawa Taxation Framework Conditions, the OECD defines it as follows:

Taxation should seek to be neutral and equitable between forms of business activities. [ ... ] In this sense, neutrality also entails that the tax system raises revenue while minimising discrimination in favour of, or against, any particular economic choice. This implies that the same principles of taxation should apply to all forms of business, while addressing specific features that may otherwise undermine an equal and neutral application of those principles.<sup>91</sup>

Therefore, when the scope of Pillar I was limited to the ADS and CFS, the principle of neutrality was breached, and the OECD made a sound decision by broadening the scope of the reform to all types of businesses and not only digital businesses. This said, some MNEs were carved out (such as the extractives sector or financial services sector), and the policy rationale for doing so is indeed debatable.

Moreover, it is questionable whether establishing thresholds also breaches the principle of neutrality. Indeed, an MNE group falls into the scope of Pillar I whenever it meets the revenue and profitability tests. The former implies that, to be in scope, the revenues of an

## Notes

<sup>86</sup> UN, *Model Tax Convention Art. 12 B – Income From Automated Digital Services* (2021). See also Andres Báez Moreno & Yariv Brauner, *Taxing the Digital Economy Post-BEPS ... Seriously* (University of Florida Levin College of Law, Legal Studies Research Paper Series Paper No. 19-16, 2019).

<sup>87</sup> Michael P. Devereux, Alan J. Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön, & John Vella, *Taxing Profit in a Global Economy* (Oxford University Press 2021), Ch. 7.

<sup>88</sup> European Commission, *Proposal for a Council Directive on a Common Corporate Tax Base* (SWD 341, SWD 342 2016); European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)* (SWD 341 final, SWD 342 final 2016).

<sup>89</sup> European Commission, *Communication from the Commission to the European Parliament and the Council – Business Taxation for the 21st Century 12* (COM(2021) 251 final 2021); European Commission, *Call for Evidence for an Impact Assessment – Business in Europe: Framework for Income Taxation (BEFIT) 5* (2023).

<sup>90</sup> Since they apply simultaneously, it leads to the issue of which system is applied first.

<sup>91</sup> OECD, *Addressing the Tax Challenges of the Digital Economy 30* (OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing 2014).

MNE group for the period must be greater than EUR twenty billion.<sup>92</sup> The latter entails that an MNE group must have a pre-tax profit margin greater than 10% to be in scope.<sup>93</sup> These thresholds were introduced to ensure that the reform would only apply to the largest and most profitable MNE groups. However, the authors believe these thresholds can breach the principle of neutrality since the group approach only applies to the largest and most profitable MNE groups. If the profit reallocation mechanism was to be reformed, it should apply consistently to all MNE groups (or should not be restricted to only digital MNEs). In this context, solutions such as digital PEs, DSTs, or WHT on digital services could also be considered non-neutral.

Third, taking into account another realistic option (e.g., the SEP), it is essential to design a cap that would restrict profit allocation to market countries when an MNE group is operating with substantial activities in the market countries. To elaborate, it is clear that the SEP concept applies to remote sales made by a non-resident. Some countries' national law also indicates that it also applies in situations when the non-resident or the MNE group to which the non-resident belongs operates with a substantial physical presence. In the latter cases, an approximate justice cap similar to the MDSH needs to be developed, otherwise, there could be excessive taxation in the market countries.

Finally, on a more political aspect, the process that led to the adoption of the Blueprint and the Progress Report is not similar. Indeed, the Blueprint was born from a political consensus:

Against this background, despite their differences, and the COVID-19 pandemic, which has had an impact on the work, the members of the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework) have made substantial progress towards building consensus. The Inclusive Framework is releasing today a package consisting of the Reports on the Blueprints of Pillar One and Pillar Two, which reflects convergent views on a number of key policy features, principles and parameters of both Pillars, and identifies remaining political and technical issues where differences of views remain to be bridged, and next steps.<sup>94</sup>

It must be stressed that, as of November 2021, the Inclusive Framework comprised 141 countries and jurisdictions.<sup>95</sup> Arguably, the Blueprint is a reflection of

an international consensus. However, this statement must be nuanced given that certain aspects of Amount A as detailed in the Blueprint were subject to different views of the IF members.<sup>96</sup>

On the contrary, the Progress Report seems to reflect a consensus to a lesser degree. Indeed, it is clearly stated: 'The proposals included in this consultation document have been prepared by the OECD Secretariat, and do not represent the consensus views of the Inclusive Framework, the Committee on Fiscal Affairs (CFA) or their subsidiary bodies'.<sup>97</sup>

Therefore, the authors question the policy reasons of why the Progress Report is deliberately departing from the MDSH mechanism as designed under the Blueprint to embrace a pure formulaic and quantitative approach. While quantitative and formulaic approaches (like in the MDSH) would seem easier to implement and administer, the authors' recommendation would be to either support some of its design components with a facts and circumstances analysis or make it a taxpayer elective.

## 7 CONCLUSION

The primary question raised in this article was whether the MDSH mechanism fulfils its policy objective. The question was analysed from the perspective of LMs and centralized business models.

The analysis leads to the conclusion that the MDSH as designed in the Progress Report does not necessarily meet its policy objective of preventing double counting under both the LM and the centralized business models.

Thus, one possible policy option is to redraft it and return to the test as originally conceived in the Blueprint. As an alternate, the domestic business exemption test may possibly be reconsidered.

A second possibility is to further reflect on some of the MDSH components, in particular, the manner in which jurisdictional routine and residual profits are calculated with the overall aim of achieving simplicity as well as accuracy.

With respect to determining jurisdictional routine profits, our main recommendation is to deem a certain percentage of jurisdictional EPs to represent routine profits (e.g., 25%). Such a mechanism would be simpler than the existing mechanism to determine jurisdictional routine profits, which seems to be rather complicated.

### Notes

<sup>92</sup> OECD, *Progress Report on Amount A of Pillar One*, *supra* n. 1, Art. 1(2)(a).

<sup>93</sup> *Ibid.*, Art. 1(2)(b).

<sup>94</sup> OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, at 7–8.

<sup>95</sup> OECD, *Members of the OECD/G20 Inclusive Framework on BEPS*, <https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf>.

<sup>96</sup> For instance, some members of the IF were not entirely in favour of applying the elimination of double taxation mechanism to prevent double counting for centralized business models. See OECD, *Tax Challenges Arising from Digitalisation*, *supra* n. 5, at 528.

<sup>97</sup> OECD, *Progress Report on Amount A of Pillar One*, *supra* n. 1, at 7.

With respect to jurisdictional residual profits, our main recommendation is to support the Y% with a facts and circumstances analysis to achieve accurate results (at least, in certain cases). For instance, the Y% will be deemed to be 100% in a country when the MNE group operates with a fully or partly decentralized business model such as a LM (or similar business models such as franchise models). It will be regarded as being 0% in a country when it operates with limited risk sales entities or/and entities that have access to the simplification offered by the Amount B project. In all other cases, the Y% could be considered to be, for example, 25% in a country (which would be a compromise).

Moreover, our recommendation with respect to WHT (if they are taken into account) is to restrict its scope to only selected payments e.g., royalties or service fees and to

provide a downward adjustment in the residence jurisdiction of the recipient.

More broadly, if the Amount A project does not achieve fruition, the authors believe that some lessons can be learned from the Amount A reform, in general, and the MDSH for future alternate reforms. If this is the future way forward, then the commencement for any new solution would be to take a firm stance on whether to follow the MNE group approach or the separate entity approach (and ensure there is no interaction between the two systems). Second, it needs to be as neutral as possible and, third, it may be remarked that it should not grant the market country excessive taxing rights (e.g., SEP proposal). A cap to the allocation of profits needs to be applied especially when an MNE is operating with a substantial entrepreneurial presence in the market countries.