

Via email

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Lausanne, November 12th, 2019

Comments to Public Consultation Document: *Secretariat Proposal for a "Unified Approach" under Pillar One*

Dear David,

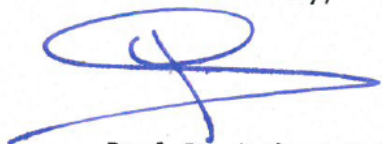
On behalf of the Tax Policy Center (www.unil.ch/taxpolicy) of the University of Lausanne (Switzerland), we are pleased to attach herewith our comments relating to the *Public Consultation Document: Secretariat Proposal for a "Unified Approach" under Pillar One*.

These comments were prepared by the undersigned together with the assistance of the research team of our institute dedicated to the analysis of Pillar One and Two.

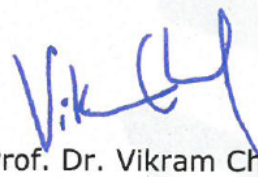
We appreciate the opportunity to provide these comments as the tax policy and technical issues raised by this project represent a core research priority of our institute. As a matter of principle, we fully and strongly support the efforts of the Inclusive Framework on BEPS to arrive at a multilateral consensus in this area.

We both would be glad to attend the public consultation and present the views expressed in the attached document.

Yours sincerely,



Prof. Dr. Robert J. Danon



Prof. Dr. Vikram Chand

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1. Introduction¹

1. The Secretariat's proposal for a Unified Approach under Pillar One represents an important starting point for a multilateral consensus among the members of the Inclusive Framework on BEPS.
2. From a policy perspective, the proposal seeks to allocate additional fiscal revenues to market countries. In order to achieve this objective, the proposal entails a significant departure – specifically as regards Amount A – from the consensus around the separate entity and arm's length principles reaffirmed again by the 2017 OECD Transfer Pricing Guidelines².
3. It is not the purpose of the present submission to assess this policy shift. Similarly, the present submission does not generally discuss possible interactions (or implementation issues) of the Secretariat's proposal with international law, including European Union law. Rather, in line with the consultation document, our comments are exclusively intended to contribute to the elaboration of a "Unified Approach" that is as much as possible principles based and pursues the path of achieving simplicity and legal certainty with a view to minimize disputes³. We generally

¹ The authors are grateful to the members of the research team of the Tax Policy Center of the University of Lausanne dedicated to Pillar One and Two, in particular to Mr. Lionel Reboh and Mr. Benjamin Malek for their help in selecting the various sources relating to the preparation of this submission.

² *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, para. 1.14: «*OECD member countries reiterate their support for the consensus on the use of the arm's length principle that has emerged over the years among member and non-member countries and agree that the theoretical alternative to the arm's length principle represented by global formulary apportionment should be rejected*».

³ These concerns have already been echoed in our previous submissions *Comments on Addressing the Tax Challenges of the Digitalisation of the Economy – Public Consultation Document*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, February 2019) available on <https://www.dropbox.com/s/hou6dvuckmahoft/OECD-Comments-Received-Digital-March-2019.zip?dl=0>

welcome the fact that the Secretariat's proposal for a Unified Approach⁴ is fully aware of these important challenges.

4. Our submission is structured in seven main sections. We begin with Scope and Nexus (sections 2 and 3). Next, we turn to profit allocation and successively discuss Amount A (4), Amount B (5) and Amount C (6). Finally, we briefly discuss some implementation issues relating to Amounts A, B and C.

2. Scope

2.1. Application to consumer / user facing businesses

5. Although not explicitly stated, out of the three proposals that were presented earlier this year⁵, from a conceptual perspective the Unified Approach seems to be built on the market related intangibles idea. That latter proposal was premised on the policy rationale that a traditional or digital MNE (or business) can be actively present in a Market Country on a remote basis (for instance, digitally) or through a local presence to develop existing or new market related intangibles such as brands, trade names, customer data, customer lists, and customer relationships⁶. The market related intangibles proposal essentially argued that, if a non-resident supplier actively intervenes in a Market Country through its own efforts and develops market related intangibles therein, then the latter State should have a right to tax the profits (at least a part of it) linked to the intangibles. This proposal is justified by the fact that an intrinsic functional link exists between the marketing intangibles and the market

⁴ OECD, *Secretariat Proposal for a "Unified Approach" under Pillar One*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, October 2019).

⁵ *Addressing the Tax Challenges of the Digitalisation of the Economy – Public Consultation Document*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, February 2019).

⁶ OECD, *supra* n. 5, at para. 30.

jurisdiction⁷.

6. From an intrinsic link perspective, some scholars have argued that the use of IP (and profits associated with it) could be 'sourced' to the Country whose laws provide legal protection for that property⁸. In particular, it has been argued that '*marketing intangibles like trademark and goodwill ... are inherently connected to the sales market*', especially, sales made in a business to consumer context⁹. Other commentators share a similar opinion and state that, under existing principles, '*a strong argument can be made that the jurisdiction where the base of customers or a network exists is a natural source for goodwill and customer-based intangibles*'¹⁰. If this line of reasoning is correct, the question arises as to why Amount A of the Unified Approach would only apply to consumer facing and user facing businesses (the latter are prominently Highly Digitalized Businesses)¹¹? In our view, a possible justification is that the intrinsic functional link is stronger in consumer / user facing businesses as opposed to non-consumer (user) facing businesses. We believe however that it would be desirable to further substantiate this limitation to consumer facing and user facing businesses. More important and discussed below is obviously the definition of "consumer / user facing" which needs to be clarified.
7. Assuming that a Market country could be justified to exercise its taxing

⁷ OECD, *supra* n. 5, at paras. 31-32.

⁸ L. Lokken, *The Sources of Income From International Uses and Dispositions of Intellectual Property*, 36 Tax Law Rev. 233, 242 (1981); M.A. Kane, *A Defense of Source Rules in International Taxation*, 32 Yale J. on Regulation 311, 341-342 (2015); R. Vann, *Reflections on Business Profits and the Arm's-Length Principle*, in *The Taxation of Business Profits under Tax Treaties*, 145-146 (B. J. Arnold, J. Sasseville & E. M. Zolt eds, Canadian Tax Foundation, 2003).

⁹ R.Vann, *Taxing International Business Income: Hard Boiled Wonderland and the End of the World*, 2 WTJ 3, p. 337 (2010) Journals IBFD.

¹⁰ P. Oosterhuis & A. Parsons, *Destination Based Income Taxation: Neither Principled Nor Practical?*, 71 Tax Law Rev. 515, 522-524 (2018). V. Chand, *Allocation of taxing rights in the Digitalized Economy: Assessment of potential policy solutions and recommendation for a Simplified Profit Split Method?*, 47 (12) Intertax, 2019, section 5.3.

¹¹ OECD, *supra* n.5, at para. 19.

right over the profits linked to these intangibles, the profits that could be taxed by this country should not be excessive and should remain in proportion to the 'benefits' provided by that State. In other words, an excessive re-allocation of profits to the Market countries should not be made under Amount A. This is because the production countries also need to be compensated for generating profits¹². Naturally, as the Market countries would be allowed to tax a part of the profits linked to market related intangibles, the starting point for an allocation under Amount A needs to be built mainly around sales (turnover) made in a market and, depending on the business model, the presence of users in a jurisdiction.

8. Further, it should be noted that any solution that targets consumer / user facing businesses should be built on well-established tax policy principles such as those agreed in the context of the 'Ottawa' Framework¹³. For instance, any solution should be as neutral¹⁴ as possible in the sense that it should apply to all consumer / user facing businesses unless certain exceptions can be justified. Second, as echoed previously, a solution should pursue the path of certainty and simplicity, especially, with respect to profit allocation¹⁵. Third, a solution should be efficient in that the compliance costs should be low for both tax administrations and taxpayers¹⁶. Fourth, the solution should be effective in the sense that taxes can be easily collected by the tax administration and fair so that opportunities for tax avoidance are minimized¹⁷.

¹² OECD, Public Consultation Document, *supra* n. 4, at para. 57.

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

¹⁴ OECD, *Electronic Commerce*, *supra* n. 13, at para. 9 (i).

¹⁵ OECD, *Electronic Commerce*, *supra* n. 13, at para. 9 (iii).

¹⁶ OECD, *Electronic Commerce*, *supra* n. 13, at para. 9 (ii).

¹⁷ OECD, *Electronic Commerce*, *supra* n. 13, at para. 9 (iv).

2.2. Illustrative list of businesses that could be possibly carved in

9. In this section, we provide our comments separately for consumer facing and user facing businesses.
10. Turning first to consumer facing businesses, it should be noted that a business should be carved in to the extent it's focal point is to create a brand or trade name that resonates in the minds of potential individual consumers¹⁸. Moreover, seen from the perspective of the business, the objective of the enterprise should be to create a final product / or provide a service for an individual consumer. In this sense, a difference should not be made as to whether the product / service is sold in a business to consumer (B2C) or Business to Business (B2B) context. The controlling criteria is – for whom does the business develop the product / service? If the business makes the product / service primarily for consumption by an individual, then it should be carved in. For example, a MNE, which is in the business of making branded chocolates should be carved in. It should not matter whether the MNE sells branded chocolates directly to an individual (through its own store) or to another business that gives it to its employees for consumption. By contrast, businesses that do not create products or provide services targeted at consumers should not be carved in. This said, it remains challenging to develop a definition of what constitutes a consumer facing business. Ideally, a reference needs to be made towards certain international benchmarks / information available in the public domain to understand what constitutes a consumer facing business.
11. With respect to defining consumer facing businesses (consumers being individuals)¹⁹, one possibility would be to refer to certain international benchmarks such as the Industrial Classification Benchmark²⁰ or Global

¹⁸ OECD, *supra* n. 5, at para. 31.

¹⁹ OECD, Public Consultation Document, *supra* n. 4, at para. 19 (and footnote 7).

²⁰ Available on https://research.ftserussell.com/products/downloads/ICB_Rules.pdf

Industry Standard Classification²¹ benchmark or other benchmarks²². Based on these benchmarks, the following businesses may fall within the scope of this proposal (non-exhaustive list).

- **Consumer Goods Business** such as:
 - food & beverages business (examples – food products, soft drinks, alcoholic beverages);
 - personal goods business (examples – luxury goods, fashionable goods, consumer electronics, hygiene / health care goods, tobacco);
 - household goods business (examples, household furnishing products or household appliances or cleaning products);
 - automobiles and automobile component businesses (examples – cars, motorcycles, bikes);
 - pharmaceutical business (examples – medicines that are made for individual consumption);
 - businesses whose core business is wholesaling or retailing goods (foods, drugs, clothes etc) can also fall within this category.

- **Consumer Services Business** such as:
 - media business (examples – broadcasting through television or radio, publishing, entertainment business such as motion pictures);
 - travel and leisure businesses (examples – passenger airlines or cruises) or brick and mortar business that sell travel or leisure packages;
 - telecommunication businesses (examples – mobile phone operators),

²¹ Available on https://www.spglobal.com/marketintelligence/en/documents/112727-gics-mapbook_2018_v3_letter_digitalspreads.pdf

²² For example, see International Standard of Industrial Classification available on https://unstats.un.org/unsd/publication/seriesm/seriesm_4rev4e.pdf. Also see, Statistical Classification of Economic Activities in the European Community available on [https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Statistical_classification_of_economic_activities_in_the_European_Community_\(NACE\)](https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Statistical_classification_of_economic_activities_in_the_European_Community_(NACE))

- financial services (examples – consumer finance services such as credit cards, private banking, private insurance or investment advisory services) and so on.
- **Franchising businesses** that are often seen in either consumer goods or consumer services space such as:
 - businesses that franchise fast food restaurant concepts;
 - businesses that franchise fashion concepts;
 - businesses that franchise hotel concepts.
12. With respect to user facing businesses, sufficient work has already been done with respect to highly digitalized businesses (HDBs) by policy making organisations / tax administrations²³. For instance, businesses that develop a large user base for monetization purposes include, for example, businesses engaged in social media platforms, search engines and online market places²⁴. On the other hand, it seems that other HDBs such as online content providers (online streaming of music and videos) and E-retailers (that purchase products for reselling) and so on have been classified as businesses in which user participation is less relevant²⁵. Nevertheless, it seems that these HDBs can be classified as consumer facing businesses.

2.3. Illustrative list of businesses that could be possibly carved out

13. If the proposal applies to consumer / user facing businesses, then certain businesses will need to be carved out. Once again, a reference

²³ OECD, *supra* n. 5, at para. 19; European Commission, *Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services*, COM(2018) 148 final, 2018/0073(CNS), (21 Mar. 2018); Also see Central Board of Direct Taxes, Income department – Government of India, *Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment* (CBDT, 2019); UK: HM Treasury, *Corporate tax and the Digital Economy: Position Paper Update* (2018).

²⁴ European Commission, *supra* n. 23, at pp. 7-9; Central Board of Direct Taxes, *supra* n. 23, para. 175; UK: HM Treasury, *supra* n. 23, Para 2.45 (2018).

²⁵ Central Board of Direct Taxes, *supra* n. 23, para. 175; UK: HM Treasury, *supra* n. 23, Para 2.45 (2018).

could be made to certain international benchmarks (listed previously) to design the scope of the carve out. Possible exclusions could include for instance (non-exhaustive list):

- businesses engaged in the extractive sector such as businesses engaged in mining (examples – metals, minerals, coal and so on) or businesses engaged in extraction of petroleum and natural gas²⁶.
- businesses that sell materials that are used in other businesses (examples – commodities, chemical material, construction material, forest products like paper etc);
- business that operate in the capital goods space (business that develop equipment that are used by other businesses);
- businesses that operate in the industrial sector;
- businesses that provide business to business consulting services;
- businesses that provide financial services to other businesses (business to business lending or business to business advisory services).

2.4. Special considerations for certain businesses

14. Special attention should be given to some businesses that could be considered to be consumer or user facing as special rules apply to them under the current framework.
15. The first example relates to shipping and airlines businesses. Cross border taxation of such businesses is covered under Article 8 OECD

²⁶ OECD, Public Consultation Document, *supra* n. 4, at para. 20; OECD, *supra* n. 5, at para. 71. Another reason could be used to justify the carve out for these kinds of businesses. For instance, when a non-resident extractive business operates in another State, that business will typically trigger a permanent establishment therein under Article 5. For example, Article 5(2)(f) provides that a PE includes a 'mine, an oil or gas well, a quarry or any other place of extraction of natural resources'. Moreover, see A. Auerbach, M. Devereux, M. Keen & J. Vella, *Destination-Based Cash Flow Taxation*, Saïd Business School Working Paper 2017/09 (2017), pp. 37-38. These authors also argue that the extractive industry should be carved out from the scope of their proposal because the State in which a product is extracted always has the right to tax the profits derived from the extraction of the product (national resources and immovable property).

MC²⁷. The Article provides that, in many situations, the profits of such businesses are taxed in one State alone²⁸. That country could be the State where the enterprise has its place of effective management or its place of residence. In other words, other countries in which the consumers reside (which could be market countries) are not allowed to tax such profits. The main policy reasons for adopting this approach relates to either preventing over taxation of such enterprises or practical difficulties that could arise with respect to determination and allocation of taxable profit to market countries²⁹. Thus, such businesses could be carved out from the scope of the proposal (Amount A) as under the current framework they are not taxed in the market countries even if they operate with physical presence in those States. Moreover, from a practical standpoint, it would be extremely difficult to pin down the location of sales of such businesses (*see section 4.4*).

16. A second example pertains to consumer financial services. In many situations, businesses such as banks³⁰ and insurance³¹ companies operate with substantial presence in the market countries (branches or subsidiaries) and carry out core commercial activities therein. This is mainly because of local market regulations. Moreover, some financial services businesses, when they operate on a cross border basis could be subject to high withholding taxes on a gross basis. For instance, banks, which are engaged in providing cross border loans, could be subject to high withholding taxes on under Article 11 OECD MC ³². Similarly, widely

²⁷ See Art. 8 *OECD Model Tax Convention* (2017).

²⁸ *OECD Model Tax Convention (2017): Commentary on Article 8*, para. 1

²⁹ *UN Model Tax Convention (2017): Commentary on Article 8*, paras. 2-3. Also see Maisto, Guglielmo. "The history of article 8 of the OECD model treaty on taxation of shipping and air transport." *Intertax* 31.6 (2003): 232-244.

³⁰ See: OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD Publishing, 2010), Part II, para. 4.

³¹ See: OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD Publishing, 2010), Part IV, para. 2.

³² See Art. 11 *OECD Model Tax Convention* (2017). See also *OECD Model Tax Convention (2017): Commentary on Article 11*, para. 7.7. and Danon, Robert. "Interest (Article 11 OECD Model Convention", in Lang M. (ed.) *Source Versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives*, 2008, p. 81 et seq.

held investment funds or other funds (such as private equity funds) that invest in other countries (equity or debt instruments) could be subject to high withholding taxes under Article 10 OECD MC or Article 11 OECD MC. Moreover, if the investment is targeted at real estate (through real estate investment funds) then the State of situs of the property has a right to tax the income generated by that property, either under Article 6 OECD MC or Article 13 OECD MC³³. Thus, further analysis would be required to ascertain whether such businesses should be carved out from the scope of the proposal (Amount A) as under the current framework they either operate with presence in market countries or they may be subject to high market country taxation on a gross basis.

17. Special attention should also be given to some other businesses that intuitively cannot be considered to be consumer or user facing.
18. The first example relates to oil and gas MNEs. This industry is usually divided into upstream, midstream and downstream businesses³⁴. Arguably, some parts of downstream businesses are consumer facing (for example, selling petrol through petrol pumps to ultimate consumers). Thus, further consideration should be given to whether such businesses are to be carved in or carved out.
19. The second example relates to HDBs that could derive significant revenues from selling primarily in the B2B space, for instance, cloud computing businesses. Arguably, such businesses are not user facing or user participation by individuals plays a limited role in them³⁵. Thus, further consideration should be given to whether such HDBs are to be

³³ See Art. 6(1) *OECD Model Tax Convention* (2017); Also see Art. 13(1) and 13(4) *OECD Model Tax Convention* (2017).

³⁴ See UN, *Taxation of the Extractive Industries by Developing Countries*, pp. 11-16.

³⁵ OECD, *Tax Challenges Arising From Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, , OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2018), para. 157; Central Board of Direct Taxes, *supra* n. 23, para. 175; UK: HM Treasury, *supra* n. 23, Para 2.47-2.48 (2018).

carved in? In this regard, it should be noted that such businesses (along with other HDBs) were within the scope of the EU Directive on Significant Digital Presence³⁶.

20. Moreover, special attention should also be given to branded businesses that sell branded products to other businesses, which in turn use them for their own goods. For example, a branded tyre manufacturer (MNE M) could sell tyres to a branded car manufacturer (MNE W). MNE W installs those tyres in its cars and sells them to individual consumers. While MNE W will be within the scope of the proposal, the question arises as to whether MNE M will fall within the scope of this proposal. Arguably, they should as they can be classified under the automobile components business. However, further consideration should be given to these type of businesses as they represent border line cases.

2.5. Further criteria to carve out MNEs: MNE Turnover thresholds

21. At the outset, it is desirable that the new rules should apply only to in scope MNE Groups that exceed a certain consolidated revenue threshold. From an efficiency perspective (compliance costs) this would make sense. The consultation draft indicates that the threshold could be Euro 750 Million³⁷ which is similar to the threshold set in the Country by Country Reporting (CBCR) standard³⁸. This threshold, although used in a different context, is also found in proposals with respect to digital service taxes (or DSTs) proposed either by policy making organisations (EU³⁹ or OECD⁴⁰) or national governments of some countries such as

³⁶ See European Commission, Proposal for a Council Directive laying down rules relating to the Corporate Taxation of a Significant Digital Presence, (21 Mar. 2018), pp. 1-19.

³⁷ OECD, Public Consultation Document, *supra* n. 4, at para. 20.

³⁸ OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, Oct. 2015).

³⁹ European Commission, *supra* n. 23.

⁴⁰ OECD, Interim Report, *supra* n. 35, para. 454.

Austria⁴¹, Spain⁴², France⁴³, Italy⁴⁴ and New Zealand⁴⁵. Also, the UK⁴⁶ uses a comparable threshold of GBP 500 Million. While we welcome the use of a high threshold, further clarification should be provided as to why a threshold of Euro 750 Million is considered to be appropriate.

22. Moreover, if a profit allocation solution (*see section 4*) is built on the basis of a MNE Business Line approach then a relevant MNE Business Line Turnover Threshold should also be built in the potential solution. From an efficiency perspective, this threshold also needs to be high in order to ensure that small revenue generating business lines of a MNE are carved out from the scope of the proposal.

3. Nexus

3.1. New Distributive Rule vs amending the Permanent Establishment (PE) Definition

23. As a starting point, we agree that a new nexus should not be built into the PE definition but should rather be structured as an independent distributive rule⁴⁷ as both authors of this submission have already argued previously⁴⁸. We agree with this approach as it avoids

⁴¹ Austria: Digitalsteuergesetz 2020 (132/ME), Art. 1, para 2.

⁴² Spain: Proyecto de Ley del Impuesto sobre Determinados Servicios Digitales, Art. 8.

⁴³ France: LOI n° 2019-759 du 24 juillet 2019 portant création d'une taxe sur les services numériques et modification de la trajectoire de baisse de l'impôt sur les sociétés, *ad Art. 299, §III*.

⁴⁴ Italy: Bilancio di previsione dello Stato per l'anno finanziario 2019 e bilancio pluriennale per il triennio 2019-2021, n. 36, p. 8.

⁴⁵ NZ: New Zealand Government, Options for Taxing the Digital Economy – a Government Discussion Document, (June 2019).

⁴⁶ UK: Draft Legislation on the New Digital Services Tax, p. 4.

⁴⁷ OECD, Public Consultation Document, *supra* n. 4, at para. 22.

⁴⁸ R. Danon, *Can Tax Treaty Policy Save Us? The Case of the Digital Economy*, in Arnold B (ed), *Tax Treaties After the BEPS Project: A Tribute to Jacques Sasseville*, Canadian Tax Foundation, 2018, p. 75 et seq; V. Chand, *supra* n. 10, section 6.2 and L. Spinosa & V. Chand, *A Long-Term Solution for Taxing Digitalized Business Models: Should the Permanent Establishment Definition be Modified to resolve the Issue or Should the Focus be on a Shared Taxing Rights Mechanism?*, 46 (6/7) *Intertax* 476 (2018).

unnecessary spill over effects that could arise with other existing treaty distributive rules that use the PE concept, for example, the PE concept used in Articles 10, 11, 12, 13, 15, 21 and 24 OECD MC. Moreover, frictions could arise with existing profit attribution rules contained in Article 7 OECD MC⁴⁹.

3.2. MNE Group vs separate entity approach

24. If a profit allocation solution for Amount A (see section 4) is built on a MNE basis then the nexus rule should, naturally, also be built on a MNE Group basis. The objective would be to ascertain the entire MNE Groups involvement in a market jurisdiction. Accordingly, the initial question that would arise is how you define a MNE Group for the purpose of this proposal.
25. A first possibility would be to refer to various accounting standards to derive a definition. One possible approach to derive a definition involves referring to consolidated financial statements that have been prepared in accordance with the rules mandated by the jurisdiction of the Ultimate Parent Company of the MNE Group⁵⁰. These statements, which could be based on local GAAP or International Financial Reporting Standards (IFRS)⁵¹ could be considered as a starting point for the analysis (in particular, IFRS 10⁵²).
26. A second option would be to refer to the concept of associated enterprises under Article 9 OECD MC⁵³.

⁴⁹ See L. Spinosa & V. Chand, *supra* n. 48..

⁵⁰ OECD, Public Consultation Document, *supra* n. 4, at para. 53.

⁵¹ OECD/G20, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4: 2015 Final Report* (OECD/G20 Base Erosion and Profit Shifting Project, 2015), Para. 121-126.

⁵² See <https://www.iasplus.com/en/standards/ifrs/ifrs10>

⁵³ See Art. 9(1) OECD Model Tax Convention (2017). This Article provides that 'two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if "the same persons participate

27. Another option would be to resort to Article 5(8) OECD MC⁵⁴ which deals with the concept of closely related enterprises⁵⁵.
28. A common feature of the aforementioned provisions / guidance is their reference to control (either direct or indirect or through common control). Accordingly, by referring to the aforementioned provisions, in particular, the concept of 'control' the definition of a MNE Group could be developed.

3.3. Quantitative vs qualitative thresholds

29. Several scholars, even prior to the BEPS project, have supported using local market turnover thresholds to develop a new nexus⁵⁶. Such a quantitative threshold, in addition to the MNE Group Revenue threshold, is also found in proposals with respect to DSTs⁵⁷ proposed either by

directly or indirectly in the management, control, or capital" of both enterprises (i.e. if both enterprises are under common control)'.

⁵⁴ See Art. 5(8) OECD Model Tax Convention (2017).

⁵⁵ The Article states '*For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises'.*

⁵⁶ For instance, see B. Arnold, *Threshold Requirements for Taxing Business Profits under Tax Treaties*, 57 Bull. Int'l Tax'n 10, 476-492 (2003); A.J. Cockfield, *Balancing National Interests in the Taxation of Electronic Commerce Business Profits*, 74 Tulane Law Review 133, 198-206 (1999); R. Avi-Yonah, & O. Halabi, *A Model Treaty for the Age of BEPS*, Law & Economics Working Papers, Paper 103, 15 (2014); R. Avi-Yonah, *Designing a 21st century Taxing Threshold: Some International implications of South Dakota vs. Wayfair*, Public law and Legal Theory research paper no. 611 (2018).

⁵⁷ OECD, Interim Report, *supra* n. 35, para. 455.

policy making organisations such as the EU (Euro 50 Million)⁵⁸ or national governments of some countries such as UK⁵⁹ (GBP 25 Million), Austria (Euro 25 Million)⁶⁰, Spain (Euro 3 Million)⁶¹, France (Euro 25 Million)⁶², Italy (Euro 5 Million)⁶³ and New-Zealand⁶⁴ (\$3.5 Million). We agree with the approach that nexus rules should predominantly be based on sales linked to a market or in the context of certain HDBs, users in a market⁶⁵.

30. It would be conceivable to combine the sales threshold with other qualitative factors. This latter approach would however need to be balanced with the need to achieve legal certainty, simplicity and prevent disputes. For instance, qualitative factors were considered in the context of the SEP proposal⁶⁶ such as user factors (for instance, collection of data from users), digital factors (for instance, maintaining a website in the local language and payment options in the local currency) or factors such as responsibility for the final delivery of goods to customers / the provision by the enterprise of other support services or sustained advertising, marketing and promotional activities. However, if a similar path were to be followed, it should be borne in mind that such factors could lead to rather subjective / imprecise outcomes which in turn could lead to differences in interpretation and, ultimately, disputes.

⁵⁸ European Commission, *supra* n. 23.

⁵⁹ UK: Draft Legislation on the New Digital Services Tax, p. 4.

⁶⁰ Austria: Digitalsteuergesetz 2020 (132/ME), Art. 1, para 2.

⁶¹ Spain: Proyecto de Ley del Impuesto sobre Determinados Servicios Digitales, Art. 8.

⁶² France: LOI n° 2019-759 du 24 juillet 2019 portant création d'une taxe sur les services numériques et modification de la trajectoire de baisse de l'impôt sur les sociétés, *ad Art. 299, §III*.

⁶³ Bilancio di previsione dello Stato per l'anno finanziario 2019 e bilancio pluriennale per il triennio 2019-2021, n. 36, p. 8

⁶⁴ NZ: New Zealand Government, Options for Taxing the Digital Economy – a Government Discussion Document, (June 2019).

⁶⁵ V. Chand, *Allocation of Taxing Rights, supra* n. 10, section 6.2.

⁶⁶ OECD, *supra* n. 5, at paras. 50-55.

3.4. Time or temporal requirements

31. We also believe that the nexus rule will need a temporal requirement to be built into it to show '*sustained and significant involvement*'⁶⁷ in the market jurisdiction. This will also ensure that isolated / one-off transactions are not caught by this provision.
32. One option to demonstrate this requirement is to resort to subjective factors found in the existing PE definition such as the degree of permanence requirement⁶⁸. However, such a test could lead to tax uncertainty as the analysis will depend on the facts and circumstances of each taxpayer.
33. An alternative approach could be contemplated which essentially states that the MNE will be considered to have a taxable nexus with a country if it exceeds the revenue thresholds in each year over the past three or five years. Another approach would be to resort to objective thresholds already discussed in the EU Commission draft proposal on a Significant Digital Presence⁶⁹. For instance, number of contracts concluded with third parties in a particular country or the number of users in a particular jurisdiction in the context of certain HDBs. The foregoing two approaches could also be combined to develop a legal nexus test.

3.5. Setting the local revenue threshold

34. At the outset, the question arises as to whether the amount reflected in this threshold should be the sovereign choice of each State or should a threshold be suggested? Our analysis of various DSTs (as discussed

⁶⁷ OECD, Public Consultation Document, *supra* n. 4, at para. 22.

⁶⁸ *OECD Model Tax Convention (2017): Commentary on Article 5*, para. 28.

⁶⁹ See European Commission, Proposal for a Council Directive, *supra* n. 36, pp. 1 – 19.

above) indicates that countries contemplate different local revenue thresholds. Thus, we are inclined to say that each country should be free to set its own threshold. This said, we would like to highlight that a minimum threshold should also be proposed. If countries start adopting low threshold (for instance, INR 100,000 for the Indian equalization levy which is approximately USD 1,400)⁷⁰ then the costs of compliance with respect to administering this proposal becomes high. Thus, a minimum revenue threshold, which is substantially high, needs to be proposed. This would imply that a country cannot go below the proposed minimum threshold.

35. The minimum revenue threshold would also need to be expressed in a certain common currency. One possible option is to link it to a globally accepted currency, for instance, USD or Euro⁷¹. However, issues could then arise with respect to converting USD / Euro into local currencies. Another option, which is found in the context of Article 17 OECD MC⁷², is to refer to the IMF Special Drawing Rights (SDR). That standard provides the possibility to avoid referring to any local currency. Moreover, as outlined in the BEPS Action 1 report, the threshold should be set taking into consideration the size of a countries market⁷³ (for instance, by referring to the GDP of a country for a particular year or a combination of a few years). Another important issue pertains to determination of the Country in which the revenue arises for an in scope MNE (consumer or user country). This issue is discussed subsequently (*see section 4.4*).

4. Profit Allocation: Amount A

⁷⁰ India: Finance Act 2016, Section 165, 2(b).

⁷¹ European Commission, *supra* n. 23, Art. 4(2).

⁷² *OECD Model Tax Convention (2017): Commentary on Article 17*, para. 10.1.

⁷³ OECD, *Addressing the Tax Challenges of the Digital Economy*, *supra* n. 13, at para. 278.

4.1. Overview of the method

4.1.1. Introductory comments

36. In order to apply this method, this approach requires⁷⁴:

- Step 1: Identification of the total profits of the MNE Group Business Line, for example, the overall profit margin (Z%)⁷⁵.
- Step 2: Calculate deemed routine profits margin (X%). This margin will then be deducted from the overall profit margin in order to arrive at non-routine profit margin (Y%)⁷⁶.
- Step 3: The non-routine profit margin (Y%) will be split between a profit margin allocable to production activities such as trade intangibles (V%) and profit allocable to market related activities such as a market related margin (W%)⁷⁷.
- Step 4: The profit allocable to a market related margin (W%) will then be allocated to the Market Country on the basis of an allocation key such as sales⁷⁸.

4.1.2. Step 1: Calculation of MNE Group Profits or MNE Group Profit Margin

37. At the outset, the question arises whether the proposal applies to the whole MNE group (if it has more than one business line) or the relevant

⁷⁴ OECD, Public Consultation Document, *supra* n. 4, at paras. 51-61.

⁷⁵ OECD, Public Consultation Document, *supra* n. 4, at para. 53.

⁷⁶ OECD, Public Consultation Document, *supra* n. 4, at paras. 54-56.

⁷⁷ OECD, Public Consultation Document, *supra* n. 4, at paras. 57-59.

⁷⁸ OECD, Public Consultation Document, *supra* n. 4, at paras. 60-61.

business line within a MNE⁷⁹. Arguably, devising a potential solution with respect to a consolidated group (consolidated business lines) seems simpler and more predictable. However, such an approach may not provide accurate results as different businesses could be mixed with each other. Accordingly, a relevant MNE business line approach should be followed in order to have more accurate results⁸⁰. However, if the levels of details that are required for applying this approach get extremely cumbersome then the consolidated business line approach should be considered (at least as a safe harbour for Amount A) ⁸¹.

38. If a MNE Business Line approach is followed, an initial question that arises is what is a MNE Business Line? Some MNEs may operate with a centralized business line, that is, through a centralized entrepreneur in one country. Others may have decentralized business lines with local entrepreneurs in many countries. Some other MNEs may report a particular business line on a regional basis (USA, Europe, Asia Pacific and so on). Thus, it would be difficult to provide hard guidance with respect to the definition of a business line.
39. Another issue pertains to the extent to which a MNE could go granular with respect to its business line information. Consider the following example:
- *Level A:* If a MNE (X) is engaged in selling food products and automobiles then what are the business lines? In this situation, it is easy to state the MNE has two different businesses.
 - *Level B:* What happens if the food business of MNE X is divided between food for humans and food for pets. Will the pet food and human food constitute two different business lines or are they a part of the same business line?

⁷⁹ OECD, Public Consultation Document, *supra* n. 4, at para. 32.

⁸⁰ OECD, Public Consultation Document, *supra* n. 4, at para. 30, para. 51, para. 53.

⁸¹ V. Chand, *Allocation of Taxing Rights*, *supra* n. 10, section 6.3.

- *Level C:* Within the pet food business, food products could be developed for dogs and cats. Are the dog food or cat food business two different business lines or same business line?
 - *Level D:* Within the dog food business, the operating margins could be different for the USA market in comparison with the European market. In this regard, should the dog food business line be further segmented into a regional business line?
40. The next issue relates to determination of consolidated profits (losses) of the MNE business line. As discussed previously, one could refer to consolidated financial statements that have been prepared in accordance with the rules mandated by the jurisdiction of the Ultimate Parent Company of the MNE Group⁸². These statements could be considered as a starting point for the analysis (local GAAP or IFRS)⁸³. This said, although consolidated statements provide a good overview of the MNE, they may not contain detailed information about a MNE Business Line. Thus, this information needs to be gathered perhaps by looking into internal data such as managerial accounting records. However, the information from such records is less regulated than financial accounting information that is prepared for external stakeholders. Thus, the information obtained from such managerial records will need to be cross checked with the consolidated financial statements to ensure consistency with the numbers that are being reported. This said, we do acknowledge that it could be challenging to obtain MNE business line profit (loss) details. Specifically, issues could arise with respect to splitting common costs⁸⁴.
41. At this stage, we would like to state that further work needs to be done in this area of MNE Business Lines. One possibility that could be

⁸² OECD, Public Consultation Document, *supra* n. 4, at para. 53.

⁸³ OECD/G20, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4: 2015 Final Report* (OECD/G20 Base Erosion and Profit Shifting Project, 2015), Para. 121-126.

⁸⁴ UK: HM Treasury, *Digital Services Tax Draft Guidance* (2019), pp. 49-50.

considered to develop guidance on this matter is to resort to IFRS 8 which deals with reporting operating segments⁸⁵. Another possibility is to give the taxpayer the option to report MNE business line information which could then be audited by an independent auditor.

42. Several questions also arise with respect to determining the overall profit (loss) margin as contemplated under this step.
43. Firstly, should gross or net profits (operating profits) be considered? As the objective of the proposal is to allocate profits to market countries, we believe that net profit (or operating profit) information should be considered.
44. Second, if net or operating profits, should these profits be based on an Earnings Before Taxation (EBT), Earning Before Interest and Taxation (EBIT) or Earning Before Interest Taxation Depreciation and Amortization (EBITDA) figures? In other words, what is the numerator for determining the overall profit margin? In this regard, it should be noted that in BEPS Action 4, it seems that the OECD gave a preference towards using EBITDA as it reflects an objective measure of economic activity⁸⁶. Also, India in the context of discussing the fractional apportionment method showed a preference towards EBITDA⁸⁷. On the other hand, EBIT figures are commonly used in a transfer pricing analysis⁸⁸. While there are pros and cons towards using the foregoing two indicators, we believe that consideration should also be given to EBT as it is the most appropriate indicator to determine the true profitability of a business⁸⁹. Of course, certain adjustments will be required for

⁸⁵ See <https://www.iasplus.com/en/standards/ifrs/ifrs8>.

⁸⁶ OECD/G20, *Action 4: 2015 Final Report*, *supra* n. 83, Para. 141.

⁸⁷ Central Board of Direct Taxes, *supra* n. 23, para. 159.

⁸⁸ To calculate net profits (although in a separate entity context), see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, paras. 2.83 - 2.91 (with an emphasis on para. 2.86). The UK also seems to prefer using this indicator in order to determine the operating margin. See UK: HM Treasury, *Digital Services Tax Draft Guidance* (2019), pp. 47-48.

⁸⁹ V.Chand, *Allocation of Taxing Rights*, *supra* n. 10, section 6.3.

exceptional or extra ordinary income / expenses (for example, expenditure connected with acquisitions)⁹⁰.

45. Third, what should the numerator be weighed against in order to obtain a profit margin? As the objective of this new taxing right is to reallocate profits to the market jurisdiction on the basis on sales, an appropriate denominator would be sales of the relevant business line⁹¹. For the purpose of the rest of this document we will assume that EBT / Sales is used as a profitability indicator.

4.1.3. **Step 2: Calculation of Routine and Non Routine Operating Profit Margin**

46. Under this step, a certain percentage of the overall EBT margin of the MNE Group is deemed to be a routine return margin. For example, if a MNE Group has an overall EBT margin of 40% then a certain percentage (for example, 10% of that margin) will be considered to be a deemed routine EBT margin and the balance (30%) will be deemed to be non-routine EBT margin. This would imply that if a MNE Group has an EBT margin less than 10% then it will fall outside the scope of this method. Consequently, no profits will be allocated under Amount A. If this is the situation, then the compliance requirements on the taxpayer should be relaxed (for instance, in determining nexus).

4.1.4. **Step 3: Splitting the Non-Routine Margin**

47. Continuing with the above, countries may agree upon a pre-determined split. For example, a 75%-25% split which divides the non-routine margin between production related activities (for instance, trade

⁹⁰ UK: HM Treasury, *Digital Services Tax Draft Guidance* (2019), p. 48.

⁹¹ Also, see *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, paras. 2.96 - 2.97.

intangibles) and market related activities (for instance, marketing intangibles). For example, if a MNE Group has a non-routine EBT margin of 30% (as in this example) then 75% of that is allocated to production related activities whereas 25% is allocated to market related activities. This would imply that 7.25% of the overall EBT margin will be allocated to market related activities.

4.1.5. **Step 4: Allocation to Market (sales) countries**

48. Under this step, 7.25% of the MNEs business lines revenue will be considered to be allocable to the sales / market countries. The allocation can be made on the basis of sales made in the respective jurisdiction. A key question that arises is with respect to determination of the sales location. This is discussed later on in this submission (*see section 4.4*).

4.1.6. **High level illustration of this method⁹²**

49. To understand the application of this approach, consider the following example. SF Group, which has its listed ultimate parent entity in Country R (Company R), sells branded product X in several countries (this is the only business). According to its consolidated financial statements for year 2021, SF Group has: (A) consolidated group operating revenue = \$1 billion and (B) consolidated expenses = \$600 million. Therefore, the Group profits (C) amount to \$400 million. This amount (C) represents the Groups Earning Before Taxation. Let us assume that the Group generates ten percent of its global revenue from Country S (\$100 million) and twenty percent of its global revenue from Country S1 (\$200 million). Under the current transfer pricing rules, all of SF Group's residual or non-routine profit is returned in Country R as the parent entity is the owner of the relevant trade and market related intangibles.

⁹² For a similar example, see V. Chand, *Allocation of Taxing Rights*, *supra* n. 10, section 6.3.

In order to allocate profits to Country S or Country S1, the method would apply as follows:

50. **Step 1:** The Group EBT amounts to \$400 Million and EBT margin amounts to 40% (EBT / operating revenues).
51. **Step 2:** The deemed routine EBT margin is 10% and thus 30% will be deemed to be non-routine EBT margin.
52. **Step 3:** The non-routine EBT margin of 30% is split between production activities (75%) and market activities (25%). Essentially, 7.25% of the EBT margin will be allocated to market related activities.
53. **Step 4:** MS Group's market related profits is determined to be 7.25% of the overall revenues, which amounts to \$ 72.5 Million (\$ 1 Billion *7.25%). The reallocation will work as follows. **Country S:** As ten percent of the global sales are derived from Country S it will be allocated USD \$ 7.25 Million ($72.5 \times 100 / 1000 = 7.25$) of that profit. **Country S1:** As twenty percent of the global sales are derived from Country S1 it will be allocated USD \$ 14.5 Million ($72.5 \times 200 / 1000 = 14.5$) of that profit. Country S and Country S1 will tax this profit at its ordinary corporate tax rate, regardless of whether the MNE Group has a physical presence in those countries. The question then arises as to which Country would alleviate double taxation. This is further discussed below.

4.2. Elimination of double taxation: Surrender jurisdiction⁹³

54. The first issue pertains to identification of the relevant taxable person who would provide relief for the taxes paid in the market countries. As

⁹³ V. Chand, *Allocation of Taxing Rights*, supra n. 10, section 6.4.

the objective of Amount A is to reallocate a part of the residual profits to the market countries, we believe that the relevant taxpayer(s) that should provide relief is/are the entities in the MNE Group that book residual profits under the current transfer pricing rules. In the aforementioned example, the relevant taxpayer would be Company R in Country R.

55. Of course, several issues arise when multiple entities within an MNE group can be considered to be the owner of non routine or deemed residual profits. For example, consider the situation of Company R in Country R that has developed all trade and marketing intangibles. Company R sells its products in the State R market. Further, for its overseas operations, Company R establishes a centralized business model (Company P – a principal entity) in Country P. Company P employs the intangibles for its operations and derives business income on a remote basis from several countries (including State S) and pays an arm's length amount of royalties to Company R. If a tax liability arises in State S for the MNE Group under Amount A, then the question arises as to who is the taxpayer to whom the tax liability could be attributed, i.e., is it Company R (who is the owner of the intangible) or Company P (the taxpayer that has used the intangible)?⁹⁴ In this case, both entities (who are characterized as entrepreneurs for transfer pricing purposes) could be identified as the relevant taxpayers. This would imply that both Country R (Company R) and Country P (Company P) could provide the relief. The relief could be divided in a predetermined proportion, for instance, based on the entities operating revenues.
56. Consider another example of a decentralized MNE. MNE P, which is headquartered in Country S through Company P, owns all trade and marketing intangibles of the Group with respect to Product X. Company P sets up a licensed manufacturer in Country R (Company R) to which all intangibles are licenced. Company R makes and sells products in

⁹⁴ OECD, *supra* n. 5, at para. 83.

Country R. Company R pays an arm's length royalty to Company P. If a tax liability arises for MNE P under Amount A then the relevant taxpayers will be both Company P and Company R. On a separate note, from a Country R's perspective, there could also be an overlap between Amount A and Amount C (which is further discussed below in *section 6*).

57. The next question pertains to which method should be used to alleviate double taxation. Currently, countries follow either the credit method or exemption method depending on whether they favour a policy based on capital-import or capital-export neutrality. Art. 23 A and B OECD MC mirrors this policy difference. On the other hand, to alleviate economic double taxation in a transfer pricing context, countries resort to tax base corrections, that is, corresponding adjustments⁹⁵.
58. At this stage, we believe that the manner in which double taxation is alleviated should remain the sovereign choice of each State.

4.3. Dealing with losses

59. Amount A should also consist of a mechanism which provides relief for losses⁹⁶. As a starting point, carry forward of losses for set off against future profits should be considered as opposed to a carry back system as the latter approach raises several administrative issues. Moreover, carry back systems could raise budgetary concerns for governments⁹⁷.
60. SF Group, which has its listed ultimate parent entity in Country R (Company R), sells branded product X in several countries (this is the only business). According to its consolidated financial statements for

⁹⁵ See Art. 9(2) OECD Model Tax Convention (2017).

⁹⁶ OECD, Public Consultation Document, *supra* n. 4, at para. 29, para. 37 & para. 51.

⁹⁷ See OECD, *Corporate Loss Utilisation through Aggressive Tax Planning*, (OECD Publishing, Aug. 2011); V.Chand, *Allocation of Taxing Rights*, *supra* n. 10, section 6.3.

year 2020, SF Group has: (A) consolidated group operating revenue = \$1 billion and (B) consolidated operating expenses = \$1.2 billion. Therefore, the Group loss (C) amount to \$200 million. This amount (C) represents the Groups Earning Before Taxation. In order to deal with losses, the method would apply as follows:

61. **Step 1:** The Group EBT amounts to negative \$200 Million and negative EBT margin amounts to approximately 20%.
62. **Step 2:** The deemed routine EBT margin is 10%. This margin will equally apply to losses. This would imply that if a MNE Group has a negative EBT margin then this fixed deemed routine percentage will be added to the loss margin. This would amount to $20\% + 10\% = 30\%$ and it will represent the non-routine margin.
63. **Step 3:** If the MNE has a non-routine margin of 30% (as in this example) then 75% of that is allocated to production related activities whereas 25% is allocated to market related activities. Essentially, 7.25% of the overall loss margin will be allocated to market related activities.
64. **Step 4:** SF Group's market related loss is determined to be 7.25% of the overall revenues, which amounts to \$ 72.5 Million ($\$ 1 \text{ Billion} * 7.25\%$). This loss will be carried forward for set off against profits for future years. Thereafter, the profit (after taking into consideration the losses) will be reallocated to the market jurisdiction.
65. To illustrate, in year 2021 (*see section 4.1.6*), applying the four step approach will lead to the conclusion that the Market related intangibles profits amount to \$ 72.5 Million. This amount will be reduced by the 2020 loss of \$72.5 Million thus amounting to a profit to be reallocated of zero.

66. The above example represents a situation wherein losses are earned within the Amount A regime. Special consideration should also be given to pre-existing losses that need to be brought into the Amount A regime i.e. before that regime becomes operational. For example, SF Group could be making losses at a consolidated level before entering into the Amount A regime such as in the past four years such as 2016 (50 Million), 2017 (40 Million), 2018 (30 Million) and 2019 (20 Million). One possible simple approach, to deal with such losses is to simply state that the loss carry forward available to SF Group before entering into the regime amounts to the sum total of losses incurred in the past four years. This would amount to 140 Million. This loss amount can then be carried forward on an unlimited basis for set off against profits for future years. Thereafter, the profit (after taking into consideration the losses) will be reallocated to the market jurisdiction.

4.4. Determination of location of sales (market countries) – A common issue with nexus

4.4.1. Developing sourcing rules

67. The new nexus as well as the new profit allocation rule (Amount A) require the determination of the Market Country to whom the taxing rights will be reallocated⁹⁸.

68. In order to determine this, one possible solution would be to refer to direct tax legislation / guidance of certain countries that allocate unitary corporate business profits based on several factors such as the United States. Historically, several US States have used the so-called "Massachusetts formula". That formula allocates the income of a Multi-State corporation among US States by assigning equal weight to factors

⁹⁸ See I. Grinberg, *Stabilizing "Pillar One": Corporate Profit Reallocation in an Uncertain Environment*, Georgetown University Working Paper, p. 41 (2019), retrievable on the SSRN Portal.

such as payroll, assets and sales⁹⁹. However, several US States have moved away from a three-factor formula to a single factor formula, that is, sales¹⁰⁰. Naturally, the question arises as to how do you determine the State of sales for a Multi-State corporation. In this regard, the Multi State Tax Commission¹⁰¹ has developed / proposed a common set of rules, in particular, with respect to the receipts (sales) factor. Specifically, rules have been put forward to determine the location of sales of tangible property¹⁰² and market-based sourcing rules have been developed with respect to transactions that deal with services and intangibles (including franchising). These rules determine the location of sales by using certain approximations¹⁰³.

69. Another possible solution would be to refer to VAT principles that use proxies to determine the jurisdiction in which the final consumption occurs¹⁰⁴. VAT legislations contain place of supply or place of taxation rules for B2B or B2C transactions with respect to goods, services and intangibles. For instance, a reference could be made to the work already done by the OECD in the context of its International VAT / GST guidelines¹⁰⁵.

⁹⁹ Similar but different system also exists in Canada, in particular, its provinces. See European Commission: Taxation Papers, *Formulary Apportionment and Group Taxation In the European Union: Insights From the United States and Canada*, Working Paper No 8 / 2005, pp. 10-15. Also see R. Avi Yonah, K. Clausing & M. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt Formulary Profit Split*, December 2008, Michigan Law Working Paper, pp. 54-55.

¹⁰⁰ See State Apportionment of Corporate Income available on <https://www.taxadmin.org/assets/docs/Research/Rates/apport.pdf>

¹⁰¹ For instance, see Model General Allocation & Apportionment Regulations With Amendments Submitted for Adoption by the Commission February 24, 2017.

¹⁰² *Ibid*, pp. 50 – 52.

¹⁰³ *Ibid*, pp. 52 - 100.

¹⁰⁴ See W. Hellerstein, *A Hitchhiker's Guide to the OECD's International VAT/GST Guidelines*, 18 FLA. Tax Rev. 589, 598 (2016).

¹⁰⁵ OECD, *International VAT/GST Guidelines*, (OECD Publishing, April 2017).

70. Moreover, for certain HDBs, a reference could be made to the work done by the European Commission¹⁰⁶ or national governments (such as the UK)¹⁰⁷ in the context of DSTs.
71. Several commonalities emerge from the above. The first commonality pertains to the use of approximations or proxies to determine the location of sale. Second, the rules focus on the customer (user) or / and the use / consumption by that customer (user). It should be noted that use / consumption could have different meanings in different business models. Therefore, for the purpose of developing sourcing rules we suggest that proxies / approximations be considered which could range, for example, from the location of the purchaser (customer location) or the final place of use / consumption (consumer use or consumer consumption location)¹⁰⁸.
72. This being said, we would find it very important to conduct further research thereupon.

4.4.2. **Consumer product or consumer service businesses**

73. At the outset, if Amount A is based on a MNE business line approach then the focus should be placed on the core commercial activity of that business line. For example, if a MNE (headquartered in Country R) is in the business of making and selling branded chocolates then the focus should be on ascertaining the location in which the branded chocolates are sold to unrelated customers. Consequently, inter-company transactions among related entities will need to be looked through.

¹⁰⁶ European Commission, *supra* n. 23, Art. 5.

¹⁰⁷ UK: HM Treasury, *Digital Services Tax Draft Guidance* (2019).

¹⁰⁸ M. Devereux, R. Fera, *Designing and Implementing a Destination Based Corporate Tax*, Oxford University Center for Business Taxation, WP 14/07, (2014), pp. 14 – 18; A. Auerbach, M. Devereux, M. Keen & J. Vella, *Destination-Based Cash Flow Taxation*, Saïd Business School Working Paper 2017/09 (2017), pp. 80 – 82; M. Devereux, A. Auerbach, M. Keen, P. Oosterhuis, W. Schön & J. Vella, *Residual Profit Allocation by Income*, Saïd Business School Working Paper 19/01, (2019), pp. 86-90.

74. With respect to determining the sales location, as a starting point, the location of the third-party unrelated purchaser (customer location) could be considered as a reasonable proxy. For instance, if Company R of State R, which belongs to a MNE R Group, sells goods / services / franchises to an unrelated business (A) or a private customer (Mrs B) in State S then the sales location is State S. This would be the case even if Company R sells to A or Mrs B through related parties.
75. An issue could arise when A (who is in State S) purchases the goods / services from Company R for its various establishments, for instance, its PEs in Country S1, S2, S3 and so on. In this case, the question arises as to whether the consumption location proxy should be preferred over the customer location proxy? Ideally, this should be the case as a similar source rule is found in the context of Article 11(5) OECD MC¹⁰⁹ (expenses effectively connected to a PE). However, from MNE R Groups perspective (who will be subject to Amount A), this information could be difficult to ascertain. Thus, this is one area in which reasonable approximation rules / proxies will need to be developed.
76. Also, in some situations (mostly B2B), the MNE R Group may wish to avoid taxes by taking advantage of the customer location proxy¹¹⁰. For example there could be situations where a MNE group engaged in selling products could engage in tax planning or tax avoidance strategies such as routing sales through an independent distributor which is established in a no tax or low tax jurisdiction. In such a case, a specific anti avoidance rule could be developed (SAAR). For instance, such a rule could deem the unrelated enterprise (the independent distributor) to be closely related if it substantially depends economically on the MNE. Further research needs to be done to understand such strategies.

¹⁰⁹ See Art. 11(5) *OECD Model Tax Convention* (2017).

¹¹⁰ J.C Fleming, R.J. Peroni, S. Shay, *Formulary Apportionment in the US International Tax System: Putting Lipstick on a Pig?*, 36 *Mich. J. Int'l L.* 1 (2015), pp. 39-46 (2014).

4.4.3. **Highly Digitalized businesses**

77. Special attention should be given to HDBs as the customer location proxy may not be helpful in this area. Accordingly, specific revenue sourcing rules will need to be developed linked to user location or activities of the user.
78. A first example pertains to online advertisers that engage in targeted advertising. Consider the following triangular situation. Company F, which belongs to Group F, is a tax resident in Country R for its European operations and the users that maintain their profiles on the online platform live in Country U. Essentially, Company F gives its users the right to maintain their profiles on the platform and in return users contribute their personal data. Thereafter, the employees in Country R process that raw data and sell targeted advertising services to clients (Company B) in Country B. The service pertains to displaying Company B's product / services to Country U users. The contract stipulates that Company B will pay advertisement fees to Company F based on the number of times a user clicks on the advertisement. In this situation, the payor of the advertisement fee is in Country B (customer location) and the users are in Country U (viewing location).
79. Under the new nexus, the taxing right on Amount A would be allocated to Country U and not Country B. Thus, one possible approach to determine Country U relevant revenues is to ascertain whether the advertising is intended to be viewed by a Country U user. In the above example, all the revenue is linked to Country U as it is intended to be displayed only for Country U users¹¹¹. The analysis becomes more complex when Company B pays Company F for promoting their product / service in more than one user country (assume Country U1 and Country U2). The question then arises as to how do you determine revenues linked to different user countries? In this regard, as discussed

¹¹¹ European Commission, *supra* n. 23, Art. 5.

in the context of the UK DST, the revenue could be apportioned to each Country based on certain criteria which could range from the contractual requirements, the relative volume of users in each jurisdiction, the revenue per user in each jurisdiction, the relative engagement of users in each jurisdiction, the size and maturity of the platform in each jurisdiction, the average profitability or revenue performance in each jurisdiction and so on¹¹². However, such criteria could complicate the analysis. Thus, to ease administration, a safe harbour could be developed and used based on the number of users. The safe harbour would assume that one user = one display¹¹³.

80. The second example pertains to online marketplaces. Such marketplaces could connect users with each other for a wide range of underlying activities such as a service (accommodation service, a transportation service etc), sale of goods activity or match making (dating) and so on. At the outset, a general rule could be developed which could source the revenue to the location of the user¹¹⁴. In fact, the UK HMRC also follows a similar position¹¹⁵. On the other other hand, the general rule could be set aside for a specific rule depending on the underlying transaction. To illustrate, consider the following illustration.
81. Company B, which belongs to Group B, is headquartered in Country B and it runs an online marketplace platform that connects accommodation seekers to accommodation providers. Accommodation providers (users) from Country C (owners of apartments) list their real estate property on the platform. At the same time, Mr A from Country A maintains his profile on the platform. Mr A books an apartment in Country C through the Country B platform. Mr A uses his credit card for

¹¹² UK: HM Treasury, *Digital Services Tax Draft Guidance* (2019), pp. 35-36.

¹¹³ See European Commission, *Impact Assessment Accompanying the document Proposal for a Council Directive laying down rules relating to the Corporate Taxation of a Significant Digital Presence and Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services*, 81 final/2, 2018/ (21 Mar. 2018), Annexure 12, pp. 150-153.

¹¹⁴ European Commission, *Impact Assessment*, *supra* n. 113, pp. 153-155.

¹¹⁵ UK: HM Treasury, *Digital Services Tax Draft Guidance* (2019), p. 37.

the transaction which amounts to USD 100. Company B retains a commission of USD 10 and passes on the balance to the accommodation provider in Country C. It should be noted that the accommodation provider is taxable on USD 90. The question now arises is which country is the location of sale for the new nexus and profit allocation rule from Group Bs perspective. Is it Country A or Country C or both?

82. The EU Commission, in the context of DSTs, considers that taxing rights could be allocated to both 'user' locations¹¹⁶. On the other hand, the UK HMRC states that a special rule applies with respect to the property (land) in the UK even if the owner of the property is outside the UK and a non UK user utilizes that property¹¹⁷. In such a case, the revenue is sourced to the UK. Thus, we believe that further consideration should be given to transactions that involve the use of property (even moveable property such as cars) in the sense that the revenues associated to such transactions could be sourced only to the country where the property is situated or used (which by default, could be the consumption location).
83. A common question in the aforementioned examples pertains to the definition of the term 'user'. Once again, a reference could be made to the various DST proposals to determine the meaning of this term¹¹⁸.

4.5. Collection of taxes by market countries

84. Another question arises with respect to how can market countries collect taxes for Amount A. One possible answer is to give the MNE the option to nominate a constituent entity (as discussed in the EU DST¹¹⁹) or a

¹¹⁶ European Commission, *Impact Assessment*, *supra* n. 113, pp. 153-155.

¹¹⁷ UK: HM Treasury, *Digital Services Tax Draft Guidance* (2019), p. 38.

¹¹⁸ UK: HM Treasury, *Digital Services Tax Draft Guidance* (2019), pp. 31-33; European Commission, *supra* n. 23, Art. 2.

¹¹⁹ European Commission, *Impact Assessment*, *supra* n. 113, p. 156.

responsible member¹²⁰ as discussed in the UK DST. This entity will be liable with other entities of the MNE (to the extent they are there) in the market jurisdiction to remit taxes to the local government. Where Amount A applies in the absence of a physical presence in the Market Country, another possibility would of course be for this country to impose a withholding tax. The problem with this latter approach however is that taxes would then be collected on a gross and not on a net basis. It is questionable whether such a policy would be consistent with the rationale pursued by the allocation of non-routine profits under Amount A. Further, while applicable to dividends, interest and royalties under the OECD MC, this policy is switched off where such items are connected to a permanent establishment situated in the state of source¹²¹. Conceptually, therefore, it would seem inconsistent to switch to gross basis taxation under Amount A.

4.6. Dispute prevention mechanisms

85. Several disputes could arise within the context of Amount A. For example, the disputes could relate to scope, identification of MNE business Lines, the identification of the taxable person and the corresponding relief from double taxation that the relevant State of residence must provide to its resident person. Thus, detailed guidance (commentary) will need to be developed to minimize differences in interpretation. As a result, it would be appropriate to focus on obtaining consensus via multilateral competent authority agreements on areas that are prone for maximum litigation (also see *section 6*). In other words, the focus should be on dispute prevention¹²².

4.7. Information exchange for Amount A

¹²⁰ UK: HM Treasury, *Digital Services Tax Draft Guidance* (2019), p. 52.

¹²¹ Art. 10(4), 11(4) and 12(3) OECD MC

¹²² V. Chand, *Allocation of Taxing Rights*, *supra* n. 10, section 6.5.

86. In order to implement the new method, the aforementioned information (for example, MNE business line profits or losses as well as location of sales) will need to be exchanged among tax administrations. Substantial work has already been done in relation to CBCR. Accordingly, one possibility would be to modify the current version of CBCR documentation in such a way that it would facilitate the implementation of the new taxing right. If this path is followed, then the automatic information exchange framework would need to be amended too.

5. Profit Allocation: Amounts B

87. Unlike Amount A, Amount B is intended to remain within the range of the arm's length principle. With respect to Amount B and Amount C¹²³, firstly, the question arises as to whether it applies to all businesses or whether it is applicable to consumer / user facing businesses? From a neutrality standpoint, we would find it *prima facie* difficult to justify the application of this Amount only to consumer / user businesses. This point would thus deserve further consideration.
88. Second, Amount B should only be applicable to taxpayers (local PE or separate related entity) that mainly do marketing or distribution activities or a combination of them. The proposal should not apply, for example, to a licensed manufacturer (or a local entrepreneur such as a full-fledged manufacturer) of the MNE Group that buys raw materials, makes the products and markets / distributes / sells them.
89. Third, the question arises as to whether this amount is a minimum profit allocation regime or a safe harbor which could be rebutted¹²⁴ (as understood in the transfer pricing context).

¹²³ OECD, Public Consultation Document, *supra* n. 4, at paras. 62-65.

¹²⁴ For a discussion on safe harbors or presumptions, see OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, para. 4.95 - 4.133; A. Turina, *Back To Grass Roots: The Arm's Length Standard, Comparability and Transparency: Some Perspectives From The Emerging World*, 10 World Tax J. 2,

90. Although discussed in a slightly different context, a minimum profit allocation regime had already been advocated by India in the context of the SEP proposal. Essentially, the Central Board of Direct Taxes had proposed that the taxable base in India for a non-residents SEP should, at a minimum, be equal to two percent of Indian revenues even if the non-resident is making losses¹²⁵. In our opinion, such an approach would be very difficult to reconcile with the '*principles of economic capacity and net basis taxation*'¹²⁶, in particular, the ability to pay principle. Moreover, we fail to see the justification for such an approach from a proportionality standpoint. Consequently, we do not favor the application of a minimum profit allocation regime for marketing / distribution / sales activities.
91. On the other hand, we agree that the existing transfer pricing system, in general, could trigger several disputes among taxpayers and tax administrations¹²⁷. Thus, in order to achieve certainty, we agree with certain commentators who argue that countries, in general, should '*return to the issue of transfer pricing safe harbours*'¹²⁸. These safe harbors, as a start, could be applied to low risk marketing / distribution functions¹²⁹ (this is already contemplated in the OECD Transfer Pricing Guidelines)¹³⁰.

pp. 332-336 (2018); S. Picciotto, *Problems of Transfer Pricing and Possibilities for Simplification*, ICTD Working Paper 86, p. 29 (Box 4) (Nov. 2018).

¹²⁵ Central Board of Direct Taxes, *supra* n. 23, paras. 161-163.

¹²⁶ See OECD, *Corporate Loss Utilisation*, *supra* n. 97. See also under Swiss law Danon R, Com. ad Art. 57-58 N 177 et seq.. in: Noël Y/Aubry-Girardin F. (eds.) *Impôt fédéral direct: Commentaire de la loi sur l'impôt fédéral direct*, 2017.

¹²⁷ See J. Andrus & P. Oosterhuis, *Transfer Pricing After BEPS: Where Are We and Where Should We Be Going*, 95 *Taxes The Tax Magazine* 89, p. 104 (March 2017). Also, see V. Chand, *Achieving Certainty in an Uncertain Profit Allocation Environment (Editorial)*, 47 (12) *Intertax*, 2019.

¹²⁸ R. Collier & J. Andrus, *Transfer Pricing and the Arm's Length Principle* (Oxford University Press, 2017), at 269-270.

¹²⁹ Thereafter, they could be broadened to other areas such as contract research and development, low risk procurement operations and contract and toll manufacturing.

¹³⁰ *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, pp. 459-463.

92. In fact, such an approach is already followed by the tax administration in *Israel*¹³¹. Their guidance states that a 3%-4% (return on sales) profitability margin applies for distributions activities and a 10%-12% (return on costs) margin for marketing activities. Moreover, their guidance contains a detailed discussion on low risk distribution and marketing activities. Thus, references could be made to their guidance to derive a definition of distribution / marketing activities that could be within the scope of this proposal. It should be noted that these activities should not amount to i) '*unique and valuable contributions*', especially, activities that create valuable local intangibles; ii) be classified as '*highly integrated*' operations, or iii) lead to '*shared assumption of economically significant risks*' or '*separate assumption of closely related risks*'¹³². If they do, then the activities need to be analysed under Amount C.
93. While in some situations MNEs could distinguish between distribution and marketing activities, we do acknowledge that, in many situations, such activities could be intertwined with each other.¹³³ For instance, see the various decisions rendered by Indian Courts on Advertising, Marketing and Sales promotion expenses¹³⁴.
94. Also, contrary to the approach followed in Israel, we are of the opinion that the different margins need to be proposed for different businesses.

¹³¹ For more details, see Circular 11/2018, available at <https://home.kpmg/content/dam/kpmg/xx/pdf/2018/10/tnf-israel-11-oct9-2018.pdf> (unofficial translation) and Circular 12/2018, available at <https://home.kpmg/content/dam/kpmg/xx/pdf/2018/10/tnf-israel-12-oct9-2018.pdf> (unofficial translation). Also see, Israel's OECD, *Transfer Pricing Country Profile*, Updated May 2019, question 24, available at <https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-israel.pdf>.

¹³² OECD, *Revised Guidance on the Application of the Transactional Profit Split Method*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 4 Jun. 2018). Also see EU Commission - EU Joint Transfer Pricing Forum (EUJTPF), *The Application of the Profit Split Method within the EU*, Doc JTPF/002/2019 (March, 2019).

¹³³ For instance, see the watch example. See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Annex To Chapter VI: Examples on Intangibles, Example 8, pp. 570-572.

¹³⁴ See *Maruti Suzuki India Ltd. v. Addl. CIT TPO* [2010]; *LG Electronics India (P.) Ltd. v. Asstt. CIT* [2013]; *Sony Ericsson Mobile Communications India (P.) Ltd. v. CIT* [2015] 3; *Bausch & Lomb Eyecare India (P.) Ltd. V. Addl. CIT* [2016]; *CIT-LTU v. Whirlpool of India Ltd.* [2016].

In our experience, the margins applied for low risk distribution / marketing activities differ from industry to industry. Thus, a range of margins will need to be proposed.

6. Profit Allocation: Amounts C

95. Once again, at the outset, we would like to submit that this amount should only be applicable to taxpayers (local PE or separate related entity) that mainly do valuable marketing or distribution activities or a combination of them. For example, this Amount could apply to Full Fledged Distributors (FFD). Once again, one could refer to the guidance provided by the tax administration in Israel to understand the concept of a FFD¹³⁵. Moreover, a reference could be made to the various 'watch' examples found in the transfer pricing guidelines¹³⁶. As stated previously, we submit that the Amount should not apply, for example, to a licensed manufacturer (or a local entrepreneur such as a full-fledged manufacturer).
96. In many situations, local FFDs could also be booking residual profits especially, a part of profits linked to marketing intangibles. Thus, there could be an overlap between Amount C and Amount, A which also seeks to reallocate a part of the residual profits to the market countries. Consider the following example.
97. Co G, a tax resident of Country G (EU State), is the parent entity of an MNE Group that is active in several countries. Co G has developed its products in Country G and sells in that market and in other markets. In Country Y, the products are sold through a related distributor (FFD), Co Y, which reports an arm's length operating margin of 10% on sales (this

¹³⁵ For more details, see Circular 11/2018, available at <https://home.kpmg/content/dam/kpmg/xx/pdf/2018/10/tnf-israel-11-oct9-2018.pdf> (unofficial translation)

¹³⁶ See *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Annex To Chapter VI: Examples on Intangibles, Examples 9-10, pp. 572-576.

amount could be based on a comparability study or could have been agreed in an Advance Pricing Agreement). **Financial information:** The overall consolidated operating revenue of the Group is USD 1,000, and the overall EBT is USD 400. The sales to end customers in Country Y amount to USD 300.

98. **Amount A:** In order to calculate this amount, the overall profit margin of the Group is 40%. The routine profit margin deemed to be is 10%. Accordingly, the residual profit margin is 30%. One fourth of that margin is attributable to marketing intangibles that are linked to the Market Countries. This would lead to the conclusion that the profit attributable to marketing intangibles linked to the Market Countries is 7.5% of the overall revenues, which amounts to USD 75 ($USD\ 1,000 * 7.5\%$). Country Y will be allocated USD 22.5 ($75 * 300 / 1000 = 22.5$) of that profit under Amount A.
99. **Amount C:** Co Y (FFD) is reporting an arm's length margin of 10% on local sales. This amounts to USD ($300 * 10 / 100 = 30$).
100. To a certain extent there is an overlap between Amount A and Amount C. Thus, in order to reduce this overlap, one possibility is to reduce the entire Amount C from Amount A liability. This would thus lead to the conclusion that the MNE Group does not pay any taxes in the market country under Amount A.
101. Another option, which is more nuanced, is to reduce from Amount A, an amount that is linked to non routine margins. Assume that routine remuneration for low risk distribution / marketing functions in Country Y amount to 4% on sales (**Amount B**). Thus, the amount that will be reduced from Amount A will be linked to the non routine margin, that is, 6% on Country Y sales which amounts to USD 18 ($300 * 6 / 100 = 18$). Thus the taxable amount under Amount A in Country Y amounts to $USD\ 22.5 - 18 = USD\ 4.5$.

102. Clearly, several disputes could arise in relation to Amount A, Amount B and Amount C. With respect to Amount A, we strongly believe that the OECD Secretariat should primarily focus on dispute prevention mechanisms. For instance, multilateral competent authority arrangements should be developed which would reflect a common understanding of several issues in the proposal. Similarly, with respect to Amount C, the focus should be on enhancing the existing dispute prevention framework such as by encouraging the use of multilateral APAs¹³⁷ or enhancing the participation of countries in the ICAP project¹³⁸.

7. Implementation: Amount A, B and C

103. Several alternatives could be contemplated to implement the solutions on a multilateral basis. With respect to the MNE Group approach and Amount A, one possibility is to modify the existing Multilateral Instrument (MLI). However, the MLI only modifies existing tax treaties¹³⁹. Thus, this approach may not be suitable to implement the Amount A approach. Another possibility is to develop a new standalone Multilateral Convention dealing with substantive matters (scope, nexus, profit (loss) allocation, relief and so on). We believe that this approach should be adopted and consideration should be given to a new Multilateral Convention. With respect to rules that will deal with Amount B, we foresee a Multilateral Memorandum of Understanding that could be attached to the new multilateral convention.

¹³⁷ For a discussion on safe harbors or presumptions, see OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, para. 4.141.

¹³⁸ See OECD, *International Compliance Assurance Programme Pilot Handbook*, OECD publishing, Paris 2018; OECD, *International Compliance Assurance Programme Pilot Handbook 2.0*, OECD Publishing, Paris 2019.

¹³⁹ See thereupon Danon R/Salomé H, *The BEPS Multilateral Instrument: General overview and focus on treaty abuse*, IFF Forum für Steuerrecht 2017, p. 197 et seq.

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