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To: Mr. Pascal Saint-Amans, Director, OECD Center for Tax Policy and Administration
Members of the Inclusive Framework

We appreciate the opportunity to comment on the *OECD Secretariat Proposal for a “Unified Approach” Under Pillar One, 9 October 2019–12 November 2019*, as requested in the seven “questions for public comment” on pages 17-18.

Given that the Pillar One proposals raise both general and specific issues, we have organized our commentary, first, as a general assessment of the Pillar One proposals and, second, an assessment of the individual components (Amounts A, B and C) together with our recommendations.

We both have extensive experience in transfer pricing that includes advising and consulting, teaching and training, writing articles and textbooks, and expert witness and transfer pricing controversy work. Our curriculum vitae are available at: Lorraine Eden (<http://www.voxprof.com/eden/eden-profile.html>) and Oliver Treidler (<http://www.tp-and-c.com/About/CV/>).

Our comments are drawn from Lorraine Eden and Oliver Treidler, “Taxing the Digital Economy: Pillar One Is Not BEPS 2”, *Tax Management International Journal* (forthcoming November 2019), with the permission of Bloomberg Tax, The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>. We thank William Byrnes, Niraja Srinivasan, and other transfer pricing professionals who shared their views with us and provided helpful comments on earlier drafts; the responsibility for all opinions expressed herein is ours. Our comments are made in our capacities as private academicians and commentators only and do not represent an official statement or view of our organizations or The Bureau of National Affairs.

We hope that our comments will contribute to the ongoing discussions on “Taxing the Digital Economy” and would welcome the opportunity to provide further input.

Sincerely yours,

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COMMENTS ON THE OECD SECRETARIAT'S *UNIFIED APPROACH*
BY LORRAINE EDEN AND OLIVER TREIDLER

I. EXECUTIVE SUMMARY

A. Assessment of the Pillar One Proposals

The Pillar One proposals in the *Unified Approach* are the OECD's most recent attempt to find international consensus on BEPS Action Item 1, "Taxing the Digital Economy." Our assessment is that the proposals suffer from several defects, the most important of which is their apparent abandonment of the arm's-length principle (ALP). The overarching goal behind the 15 BEPS Action Items issued in 2013 was to strengthen the international tax system by removing egregious tax loopholes and ensuring that profits were taxed where economic activities occurred and value was created. The Pillar One proposals, however, are not "BEPS 2"; they do not share the same agenda, do not build on international tax and transfer pricing principles, and will weaken not strengthen the current system. We believe that the current tax and transfer pricing rules, inclusive of BEPS 1 changes, can encompass the digital economy. We offer six policy recommendations designed to move the global economy onto the BEPS 2 path, a path appropriate for 21st century digital multinationals that will benefit both developed and developing countries.

B. Summary of Our Recommendations

The OECD Secretariat and Members of the Inclusive Framework should:

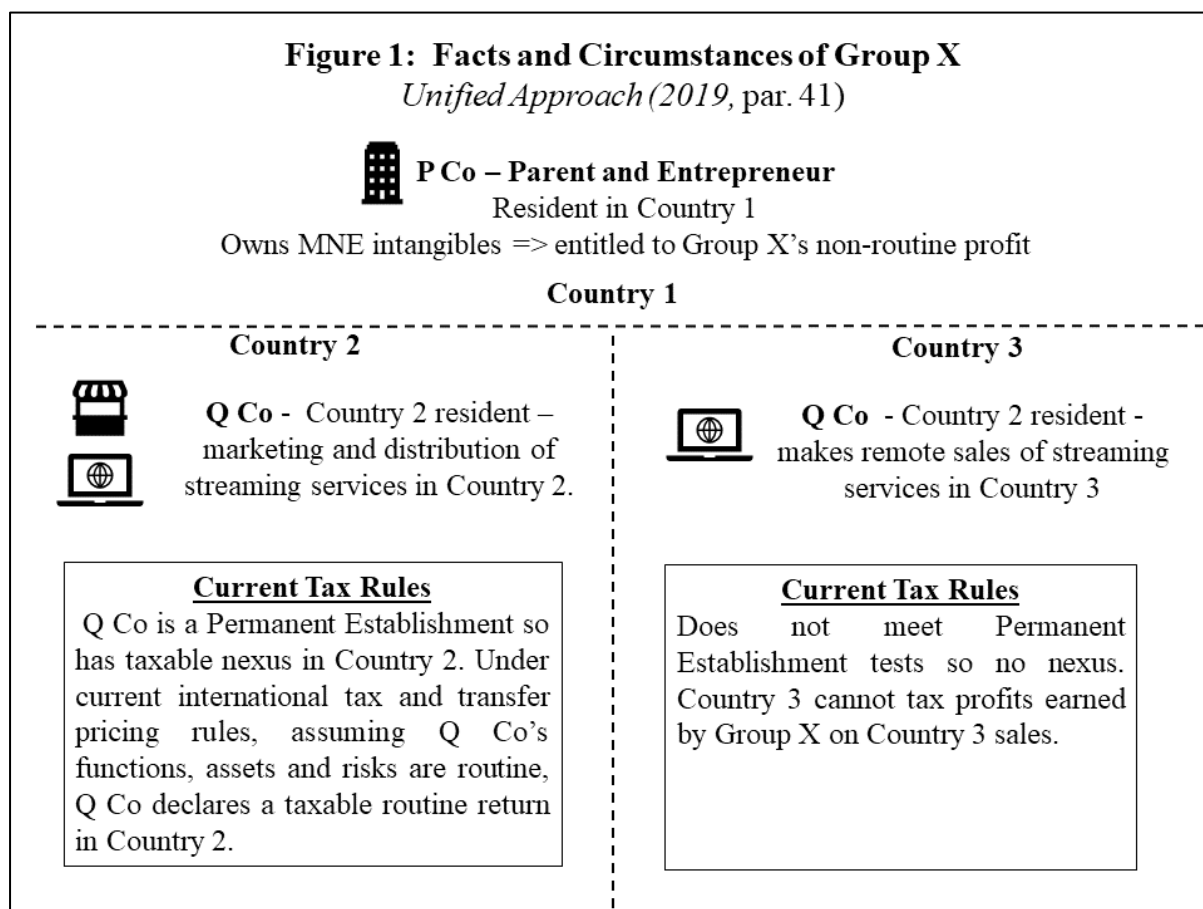
1. Reaffirm their commitment to the current international tax rules (inclusive of earlier BEPS reforms) as the "bedrock" for taxing MNEs and their activities, both digital and non-digital.
2. Reaffirm their commitment to the arm's-length principle (ALP) under Articles 7 and 9 of the OECD Model Tax Convention and their rejection of formulary apportionment.
3. Replace Amount A ("new taxing right") with a proposal for a Virtual Permanent Establishment (VPE), which covers digital business investments in market jurisdictions, builds on post-BEPS Articles 5 and 7 of the OECD Model Tax Convention, and expands the AOA approach to encompass VPEs.
4. Withdraw the proposal for Amount B (which would also obviate the need for Amount C) and reaffirm their commitment to the arm's length principle for taxing the digital economy.
5. Prepare a new chapter for the OECD *Transfer Pricing Guidelines* on transfer pricing of digital transactions and businesses.
6. Use multilateral rather than unilateral advance pricing agreements (APAs) as a dispute avoidance and settlement mechanism for taxing digital MNEs and activities.

II. GENERAL COMMENTS ON THE PILLAR ONE PROPOSALS

A. Analysis of Pillar One

Given the level of complexity of the Pillar One proposal, it may be helpful to illustrate Amounts A, B, and C with both graphical and numerical examples. Figure 1 provides a graph of the Appendix example in paragraphs 41–49 of the *Unified Approach*. In the example, Group X consists of parent firm P Co resident in Country 1, and its subsidiary Q C resident in Country 2. P Co owns the

group intangibles and so is entitled to Group X’s non-routine group profits.¹ Q Co markets and distributes P Co’s streaming services in Countries 2 and 3.



Under the current international tax and transfer pricing rules,² Country 1 is the residence (home) country of P Co and therefore has the right to tax or exempt P Co’s foreign-source income. Most residence countries currently exempt foreign-source income (notably, active business income) from taxation. The United States, for example, recently moved from worldwide to quasi-territorial taxation in the 2017 Tax Cuts and Jobs Act.³

Q Co, as a foreign subsidiary of P Co, has nexus (a taxable presence) in Country 2. Therefore, Country 2 has “first crack”, as a source country, at taxing Q Co’s income. Country 1 must make “tax room” for Country 2’s tax, by providing either a foreign tax credit or a deduction for Country 2’s corporate income and withholding taxes, should Country 1 choose to tax P Co’s worldwide income. Country 2 can therefore levy a corporate income tax (CIT) and withholding taxes on Q Co’s profits, and transfer pricing rules, applying the arm’s-length principle (ALP), must be used to determine arm’s-length prices between P Co and Q Co. Under current approaches to the ALP (giving rise to one of the core complaints that developing countries have about the ALP), Q Co would often be treated as a routine distributor and allocated a minimal taxable return in Country 2.

P Co does not have a foreign affiliate in Country 3. As a result, Country 3 is neither a

¹ Note that “owns” must be interpreted here as P Co having economic ownership of the intangibles since legal title is no longer sufficient to claim rights to intangible returns after BEPS Action Items 8–10 were incorporated into the OECD *Transfer Pricing Guidelines* in 2017.

² For a more detailed explanation of the international tax system, see Lorraine Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (Toronto: Univ. of Toronto Press 1998), Ch. 2 and App. 2.1.

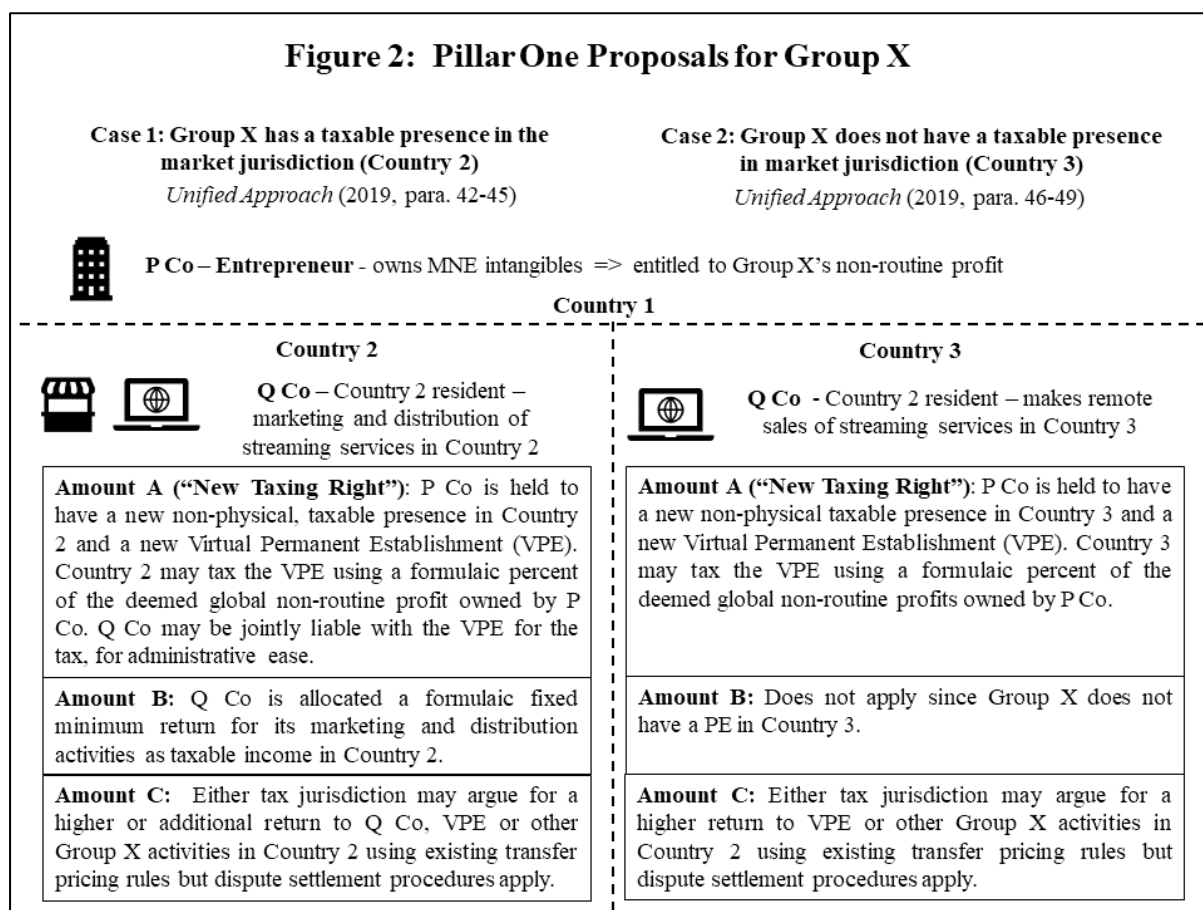
³ See Lorraine Eden, *The Arm’s-Length Standard Is Not the Problem*, 48 *Tax Mgmt. Int’l J.* 499 (Oct. 11, 2019).

residence nor a source country under current international tax rules and does not have the right to tax any of Group X’s income that is earned in its jurisdiction.

Both Countries 2 and 3 are “market jurisdictions” since their residents purchase and/or consume Group X’s remote streaming services. In the example, the services are provided free of charge to users/consumers (e.g., on social media platforms such as Facebook) but they could also be sold by subscription. P Co receives remote sales income from selling advertising space on the social platform to third parties, directly selling the data collected from the platform, or by subscription sales.

If Countries 2 and 3 wish to tax these revenues, they could levy a value-added or sales tax on P Co’s remote exports to their countries. The market jurisdictions could also levy a customs duty on the remote sales, but a tariff would likely be declared a violation of WTO rules and therefore subject to retaliation by Country 1. The example, however, assumes that neither Country 2 nor Country 3 could levy a corporate income tax on the profits earned by P Co in their countries because the remote sales do not meet the nexus tests required for a permanent establishment.

Let us now turn to the three-piece proposal for taxing Group X’s streaming sales into market jurisdictions. Figure 2 shows the three amounts proposed under the *Unified Approach*.



The steps involved in determining Amounts A, B, and C are the following. First, the firms and industries to which the Pillar One proposals apply (i.e., the scope) must be determined. The current proposal favors “market-facing industries.” Next, the countries where P Co provides remote streaming services must be identified (i.e., Countries 2 and 3 in the example). As market jurisdictions, they are deemed eligible for Amount A and possibly Amounts B and C.

Third, Amount A must be calculated, and pages 13–15 of the *Unified Approach* provide an algebraic example of how to do it. Assume the MNE group’s profits are z% of worldwide sales. Routine returns are assumed to be x% so that non-routine returns are z% – x% = y%. In the example, all non-routine profits belong to P Co, the entrepreneur, so P Co has a taxable return of y% in Country 1. Non-routine returns are then separated into two categories: intangibles and “market jurisdiction”

returns. The return to intangibles includes all sources of non-routine returns such as non-routine trade and marketing intangibles and risks. Assume the return to intangibles is $v\%$. That leaves $y\% - v\% = w\%$ as the (virtual) market jurisdiction return. If N is the number of market jurisdictions, some allocation key (for example, sales) is used to allocate the $w\%$ return among the N jurisdictions.

Fourth, Amount B creates a floor (minimum rate of return) for Group X's local activities in each market jurisdiction. In the example, this would be Q Co's marketing and distribution activities in Country 2 but could also be defined more broadly. Local activities in each market jurisdiction are assigned a formulaic fixed minimum return.

Fifth, Amount C occurs only if a tax authority or P Co wishes to assign a return to Group X's local activities in a market jurisdiction that is higher than the floor under Amount B. They can do so by applying the ALP, but the result is subject to dispute settlement procedures (e.g., dispute settlement procedures under the double tax treaty between the two countries, assuming one exists). Otherwise, double taxation occurs.

Finally, note that that Country 2 could, in theory, receive all three forms of return (Amounts A, B, and C); whereas Country 3 is limited to Amount A (and possibly C).

B. Pillar One Is Not BEPS 2

A core question for stakeholders, in evaluating the Pillar One proposals, is to ask whether they are an integral part of the original BEPS reforms (i.e., BEPS 2 or BEPS 2.0) or if their underlying policy rationale is different. The earlier BEPS reforms, notably those reflected in the revised 2017 OECD *Transfer Pricing Guidelines*, were targeted at (1) eliminating tax loopholes and (2) aligning profit allocation with value creation by improving ("modernizing") the application of the arm's-length principle (ALP).

A brief history of the OECD's attempt to build consensus on taxing the digital economy under BEPS Action Item 1 suggests that the general public and the media view Pillar One as a continuation of the earlier BEPS project and therefore as "BEPS 2." The media portrays Pillar One as targeting the "tax dodging" behavior of digital MNEs (i.e., the first BEPS goal) and thus an extension of earlier BEPS reforms. See, for example, Tankersley (2019).⁴ The Pillar One proposals also address the second BEPS goal, aligning profit allocation with value creation, which suggests a second reason for viewing Pillar One as BEPS 2.

We believe that Pillar One is not BEPS 2 and has a different agenda from the earlier BEPS reforms. Pillar One attempts to redefine (broaden) the conception of what constitutes value creation in relation to digital/non-physical business models and to design a new way to tax this "value creation." The proposals essentially demand the inclusion of "external inputs" into the value creation attributable to a digital MNE, i.e., to tax currently "untaxed digital activity" such as remote sales of digital firms.

These new manifestations of value creation remain highly debatable. A key problem with the argument used to justify Pillar One, i.e., there are huge untaxed digital activities, is that the concept reflects a rather hazy and new understanding of what constitutes a "value contribution." Whether there are untaxed digital activities depends on whether one accepts the underlying premises of the user participation argument, namely

[...] the idea that soliciting the sustained engagement and active participation of users is a critical component of value creation for certain highly digitalised businesses. The activities and participation of these users contribute to the creation of the brand, the generation of valuable data, and the development of a critical mass of users which helps to establish market power (Public Consultation Document, para. 18).

The notion of "BEPS 2" therefore seems ill-conceived for describing the nature of Pillar One, which appears to be antithetical to the BEPS 1 value creation approach. Rather, we view Pillar One as closer to "value capture disguised (masquerading) as value creation." Even if one subscribes to this

⁴ Jim Tankersley, *Tech Giants Shift Profits to Avoid Taxes. There's a Plan to Stop Them*, New York Times (Oct. 9, 2019).

new approach to value creation, it is important to recognize that the Pillar One proposals have moved a long way from the DEMPE concepts embedded in the 2017 OECD *Transfer Pricing Guidelines*.⁵

Moreover, Amount A in the Pillar One proposals applies not only to digital MNEs but to all “consumer-facing” businesses (the scope of which still needs to be defined). BEPS Action Item 1 was about taxing the digital economy; Amount A, on the other hand, could tax almost all businesses. Amount B also is much broader, applying to all marketing and distribution activities in user/market jurisdictions. Not wanting to “ring fence” the digital economy appears to be the motivation behind Amounts A and B, but broadening the scope means that the proposals are no longer about “taxing the digital economy.”

Our view is different. The international tax and transfer pricing rules, once the 2017 BEPS reforms have been diffused and adopted through the Multilateral Instrument, are more than adequate as a general framework for taxing MNEs in the digital economy. If specific rules need to be written for a particular digital business model due to some unique facet of the business model, better to write specific rules to cover the exception (as the IRS is proposing for cloud computing), than to force the same rules on all or most businesses, which the Pillar One proposals recommend.

C. If Pillar One Is Not BEPS 2, What Is the Agenda Behind Pillar One?

We argue that the political agenda for Pillar One had its birth in the combination of highly visible (and apparently highly profitable) digital MNEs, together with the desire of market/user jurisdictions to raise more tax revenues. This combination was the triggering factor behind, first, the rapid introduction of digital sales/service taxes (DSTs) and, second, the OECD/G20 attempts to craft a viable counter proposal to DSTs.

At the individual country level, the political agenda driving Pillar One varies across different constituencies. For example, the big emerging countries (e.g., India, China, Brazil) have huge actual and potential markets. While their per capita incomes are not high relative to developed economies, their numbers of users/consumers (actual and potential) are much larger. Thus, their “consumption power” offers a big tax base, one that they can tap with a general sales or value added tax – or a DST. Remote digital sales by foreign firms can be particularly attractive as a taxing opportunity to large market/user jurisdictions. The incentive to tax remote digital transactions should also be strongest in high-income countries that attract remote digital sales but have few digital MNE headquartered there – for example, European Union member countries. For them, DSTs could look like an attractive income source and tit-for-tax retaliation from other governments is less likely.

Governments such as United States that are headquarters to the “Big Five” (Alphabet (Google), Amazon, Apple, Facebook, and Microsoft) and other “born digital” MNEs⁶, on the other hand, are unlikely to want DSTs, particularly when their own MNEs either have or are trying to build a dominant market position on a worldwide basis. Their goal is to contain the spread of other countries adopting DSTs that could target their digital MNEs. The Pillar One proposals offer a useful second-best alternative to DSTs, particularly if the policy focus on digital MNEs is removed. Thus, broadening Amount A to cover “consumer-facing” industries is an attractive option. Having a large, high-income market where there is little public support for introducing a federal general sales tax or VAT (e.g., the United States) also helps. Attempts to squash or at least limit the floor for Amount B on marketing and distribution activities in host jurisdictions would also benefit their MNEs.

Another constituency involves small and medium-sized developing countries that have neither large consumer bases nor are home to digital MNEs. Their ability to capture benefits from either the spread of DSTs or the Pillar One proposals (especially Amount A) appears limited. Moreover, small

⁵ See Lorraine Eden, Niraja Srinivasan and Srinilal Lalapet, *Transfer Pricing Challenges in the Digital Economy: Hic Sunt Dracones? (Part I of II)*, 48 *Tax Mgmt. Int'l J.* 251 (June 14, 2019).

⁶ On born digital and going digital MNEs, see Lorraine Eden, *The Fourth Industrial Revolution: Seven Lessons from the Past*, in *International Business in the Information and Digital Age* (Alain Verbeke, Robert van Tulder & Lucia Piscitello, eds.), *Progress in Int'l Bus. Research*, Vol. 13. (European Int'l Bus. Academy and Emerald Pub., 2019).

countries are price takers, not price makers, and thus bear the burden not only of their own taxes but also those levied by other countries. Our assessment is that small, less resource-rich market jurisdictions are unlikely to win from either DSTs or the Pillar One proposals.

There is also an ideological agenda behind Pillar One that has been regularly voiced, primarily by academics and non-governmental organizations, who want to replace the arm's length principle with global formulary apportionment (GFA). The Pillar One proposals have at their core a heavy emphasis on dividing the worldwide profits of MNEs into pieces that are then distributed among market jurisdictions (Amounts A and B) and host countries (Amount B) using elements of fractional apportionment methods. A second agenda behind Pillar One is therefore captured by the metaphor of the "Trojan Horse": Pillar One provides a unique opportunity to get rid of the arm's length principle and bring in formulary apportionment through the back door.

In sum, we believe that a combination of politics and ideology is driving the Pillar One proposals. Pillar One is not BEPS 2 and has a different agenda. The OECD Secretariat needs to directly confront the question as to how and why Pillar One is different from BEPS 1. The political impetus to tax digital MNEs in market countries is understandable but it needs to be kept in a "reasonable" perspective. The political pressure may also be somewhat self-inflicted. By not clearly delineating BEPS 1 effects from "untaxed digital activities", the OECD Secretariat may have facilitated the general public's perception that digital MNEs are engaged in tax avoidance in market jurisdictions.

The OECD Secretariat should clarify whether Pillar One – at its core – has a completely different agenda: creating a "new taxing right" for user/market jurisdictions (i.e., a new way of reallocating MNE income by international agreement) together with bringing in formulary apportionment through the back door. We are strongly against both items in this agenda, which we view as antithetical to the current international tax and transfer pricing system.

D. Pillar One Does Not Share the Same Empirical Support as BEPS 1

In addition, the lack of empirical foundation for the Pillar One proposals should demand a high level of caution. There simply are no advantages — and many dangers — to hastily constructing fundamentally new principles for taxing the digital economy, especially ones that are poorly targeted due to a lack of understanding of the nature of the challenges, especially in the short timeframe for consensus. We should therefore be careful, when evaluating whether BEPS 1 reforms such as DEMPE work in the context of day-to-day transfer pricing, to not apply an ill-defined "yardstick." For example, to infer from BEPS 1 tax-gap estimates that taxing the digital economy presents a substantial challenge, at least at this stage of the digitalization of the economy, seems presumptuous and most likely erroneous.

It is also important to recognize that, at this point in time, there has been little empirical work evaluating the impact of the BEPS reforms implemented since 2017. It is simply too soon to know whether they will achieve their original goal of reducing/eliminating base erosion and profit shifting. Over time, as these studies become available and MNE strategies and structures adjust to the 2017 reforms, we will have a much better understanding of the remaining challenges (tax gaps) in general, and then specifically with respect to taxing digital business models for "born digital" and "going digitals" MNEs.

III. COMMENTS ON AMOUNT A (QUESTIONS 1-5)

A. Amount A Introduces New and Untested International Tax Policies

Clearly the most revolutionary piece of the Pillar One proposals is Amount A. It involves three "game changing" policy changes—nexus, unitary allocation, and formulary apportionment — all of which are antithetical to the current tax/transfer pricing rules and with which countries have little to no practical experience at the subfederal level, much less at the international level.

- *Nexus*: The nexus rules under Article 5 (Permanent Establishment) of the OECD Model Tax

Convention are to be modified using some (unspecified) new criteria. Under the new nexus rules, the parent firm P Co is deemed to have a new non-physical, taxable presence in Countries 2 and 3. A Virtual Permanent Establishment (VPE) is created in each market jurisdiction and its tax authority now has the right to tax the VPE's income. In effect, Country 2 now has two permanent establishments, Q Co and the new VPE, which can be taxed separately or together (the latter should be more easily administered). Country 3 has now become a new "source" country by virtue of its VPE and can claim "first crack" source taxation rights for its VPE.

- *Unitary Allocation*: The profit allocation rules in Article 7 (Business Profits) and Article 9 (Associated Enterprises) of the OECD (and UN) Model Tax Conventions, which underpin the arm's-length principle, are ignored. The ALP is replaced by "unitary allocation" where the MNE group is treated as a unitary enterprise and some portion of its worldwide profits are allocated to market jurisdictions. The MNE's profits are aggregated in some manner, either as a whole or by business line, and then a series of calculations that are based not on the ALP but rather on arbitrary percentages are used to determine the aggregate residual profit to be allocated to market jurisdictions. Thus, Amount A contradicts the ALP in Articles 7 and 9.
- *Formulary Apportionment*: A formulary approach (with the fractions yet to be determined) is used to allocate Amount A among the market jurisdictions.

Presumably the residence country (Country 1) must now make "tax room" for the new taxing right (Amount A) allocated to each VPE by providing a foreign tax credit or deduction for the new taxes being levied by Countries 2 and 3 on their VPEs. If Country 1 refuses, then double taxation will result. Layering a "new taxing right" for user/market jurisdictions on top of the existing tax rights for source and residence jurisdictions, in effect, stacks one set of taxing rights on top of another. Adding a "new taxing right" must be a zero-sum game if the new right takes away an old taxing right from another jurisdiction or jurisdictions. In such cases, unless the source or residence jurisdictions provide "tax room," the clear result will be double taxation. For countries without extensive tax treaty networks, the message is clear: use the "new taxing right" and face double taxation in the short run and less inward FDI and economic growth over the long run.

We believe that Amount A in the *Unified Approach* represents a clear and present danger to the ALP. Not only does Amount A include a new and undefined nexus rule, it also creates an allocation mechanism based on unitary taxation and formulary apportionment. If introduced, Amount A could be the Trojan Horse that spells the death of the arm's-length principle and its replacement by global formulary apportionment. We therefore make the following two recommendations.

- **Recommendation 1: The OECD Secretariat and Members of the Inclusive Framework should reaffirm their commitment to the current international tax rules (inclusive of earlier BEPS reforms) as the "bedrock" for taxing MNEs and their activities, both digital and non-digital.**
- **Recommendation 2: The OECD Secretariat and Members of the Inclusive Framework should reaffirm their commitment to the arm's-length principle under Articles 7 and 9 of the OECD Model Tax Convention and their rejection of formulary apportionment.**

B. Amount A Ignores the Difference Between Exports and FDI

The corporate income tax (CIT) is a direct tax on the return to investments made by firms at home or abroad through foreign direct investment (FDI). The international tax rules are designed to tax MNE profits from engaging in FDI by setting up offshore branches or subsidiaries. There are other modes of entry that firms can use to go abroad instead of FDI, for example, exporting or importing goods and services. However, when firms engage in international trade, their sales or purchases do not create a taxable entity in the trading partner country. The "tax menu" for the trading partner is a general sales/VAT and/or an export/import tax, not a corporate income tax levied on profits.

There may be cases, of course, where it is difficult to determine whether a firm's offshore

activities are export/import activities or rise to the level of FDI. To resolve this issue, the permanent establishment (PE) rules under Article 5 of the OECD Model Tax Convention are used to determine whether an entity has sufficient attachment to or economic presence in a jurisdiction to create a taxable entity; in effect, whether the foreign activity is trade or FDI. If sufficient nexus exists, a PE is created and then taxed under treaties following the terms of Article 7 of the OECD (or UN) Model Tax Convention.

Amount A in the *Unified Approach* distorts the existing tax rules by creating a “new taxing right” for user/market jurisdictions. While the term “user/market jurisdiction” (the scope question) is unclear, the text suggests the new taxing right would apply to products imported from foreign firms, i.e., to “remote sales” or exports. Moreover, while the justification for the new taxing right is remote sales by digital businesses, the text of the proposal suggests a much wider scope that is “broadly focusing on consumer-facing businesses” (para. 15). Amount A therefore does not build on existing international tax principles. “Remote sales” are simply exports, not FDI, and should be taxed (if taxed at all) in the importing jurisdiction by a sales tax or VAT, not a corporate income tax.⁷

We therefore agree with Schön’s (2019) assessment that the appropriate way to tax the exports of digital businesses is to determine whether their activities are simply export/importing activities or rise to the level of FDI.⁸ If the activities are trade not FDI, there is no nexus and the CIT is not an appropriate tax. A market jurisdiction that wants to tax remote digital sales should do so with a general sales or value-added tax. If, on the other hand, the digital activities in the market jurisdiction rise to the level of FDI — the MNE is making remote investments in the local jurisdiction — there is the potential to find nexus under the post-BEPS Article 5 of the OECD Model Tax Convention (see below for details). If a VPE is created, its profits should be taxed according to the ALP as outlined in Article 7 of the Convention. In such cases, both types of taxes -- a CIT on the VPE’s profits and a sales/VAT tax on its sales -- could be levied by the market/source jurisdiction.

C. Amount A Should Be Replaced by Broadened Interpretations of Articles 5 and 7

Historically, Article 5 of the OECD (or UN) Model Tax Convention created a PE when there was a “fixed physical presence” tied to the export/import activity. Preparatory, ancillary, and warehouse activities (among others) were carved out and did not create a PE. The example in the *Unified Approach* is built on this “physical presence” assumption (see para. 41 on page 11).

The Article 5 PE rules were loosened under BEPS Action Item 7 in 2015 and 2018 by providing a broader range of export/import activities that could create a taxable PE.⁹ An anti-fragmentation rule in Article 5.4 was added to prevent MNEs from segmenting its activities in the host country into smaller and smaller functioning units in an attempt to avoid PE status. Article 5.5 added that if there is already a related party in the host country, for example, providing market services for the parent firm with respect to the parent’s sales in the host country, a separate PE could be created for the local sales. Article 5.6 added that even where there was no PE, the host country could look through and create a PE.

In 2018, the OECD provided *Additional Guidance* for applying these changes. Articles 5.5 and 5.6 are illustrated by Example 3 on page 19. The example deals with the remote sale of advertising on a website. This example is consistent with the Q Co case in the *Unified Approach*, which we have illustrated in Figures 1 and 2. Based on Example 3 in *Additional Guidance*, as long as

⁷ Basic international trade theory teaches that small countries (price takers) and immobile factors bear the burden of trade and tax policies. In effect, the tariff or tax is passed forward to consumers/users and not borne by the exporting firms. Thus, the incidence of Amount A will be borne by small market jurisdictions and consumers, not by the digital MNEs.

⁸ Wolfgang Schön, *One Answer to Why and How to Tax the Digitalized Economy*, Max Planck Institute for Tax Law and Public Finance Working Paper 2019-10 (June 2019).

⁹ OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 — 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, Sept. 2015); OECD, *Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7* (Paris: OECD, Mar. 2018) [referred to hereinafter as “*Additional Guidance*”]

Q Co is regularly concluding the contracts with respect to the remote sales, then the market jurisdiction can create a separate PE for the sales activity. The activities of Q Co and the new PE are complementary and can be treated together as one entity for tax purposes (under the anti-fragmentation rule in Article 5.4). Example 3 then brings in the ALP to determine the price between the PE and the affiliate.

The text and examples in OECD (2018) suggest to us that the OECD could use the existing changes to Article 5 (Permanent Establishment) introduced under BEPS Action 7 as a blueprint for market jurisdictions. They could create a virtual PE when the remote digital business activities meet nexus requirements under Articles 5.4–5.7. Creating nexus in this manner, however, should be applied only where the remote activities of the digital MNE rise to the level of FDI in the market jurisdiction. Thus, the determination of nexus would remain a facts-and-circumstances matter that depends on the level of commitment of the digital MNE to the market jurisdiction.

Schön (2019, p. 28) recommends that nexus for remote digital activities should be determined using a two-prong test based on a minimum level of country-specific digital investment and the size of the local user base in the market jurisdiction. There are other possibilities also. See, for example, the discussion of economic presence tests in Cockfield (2002)¹⁰ and Dhuldhoya (2018)¹¹; the list of factors proposed by the Internal Revenue Service in August 2019 (see paragraph 1.861-19(c)) for determining whether cloud computing transactions are a lease of property or the provision of services¹²; and the factor presence tests for nexus (e.g., *South Dakota v. Wayfair, Inc*) that are explored in Gianni (2018).¹³ Once nexus has been established, the transfer pricing rules under Article 7 (Business Profits) of the Tax Convention should be used to determine the VPE's taxable profits. We agree with Schön's (2019) assessment that the VPE's profits for tax purposes should take account of the digital MNE's return on its invested capital (i.e., the riskless rate of return, a risk premium and any rents) in the market jurisdiction.

One concern that would need to be addressed is that under the AOA (Authorized OECD Approach) to Article 7, the PE is treated as a hypothetical separate entity and value creation is assigned based on where the significant people functions are located. The AOA would therefore create problems for VPEs, given that the digital activity is typically carried out from remote locations. However, most OECD countries have not adopted the AOA nor has the United Nations model. More work is therefore needed to determine how the ALP should apply in VPEs. We therefore argue that broadening interpretations of Articles 5 and 7 is the best way forward, one that builds on and extends existing international tax and transfer pricing principles to the digital economy.

- **Recommendation 3: The OECD Secretariat and Members of the Inclusive Framework should replace Amount A ("New Taxing Right") with a proposal for a Virtual Permanent Establishment (VPE), which covers digital business investments in market jurisdictions, builds on post-BEPS Articles 5 and 7 of the OECD Model Tax Convention, and expands the AOA approach to encompass VPEs.**

IV. COMMENTS ON AMOUNT B (QUESTION 6)

The joint application of formulary apportionment and the ALP under the proposed Amounts B

¹⁰ Arthur Cockfield, *The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles*, International Bureau of Fiscal Documentation Bulletin (December 2002), pp. 606-619.

¹¹ Vishesh Dhuldhoya, *The Future of the Permanent Establishment Concept*, Bulletin for International Taxation, Vol.72, No. 4a (Special Issue), (published online March 26, 2018).

¹² US Department of the Treasury, Internal Revenue Service, *Classification of Cloud Transactions and Transactions Involving Digital Content, Proposed Rules*, 26 CFR Part 1 [REG-130700-14], Federal Register Vol. 84, No. 157 (August 14, 2019), pp. 40317-40329.

¹³ Monica Gianni, *OECD BEPS (in)Action 1: Factor Presence as a Solution to Tax Issues of the Digital Economy*, Tax Lawyer, Vol. 72, No. 1, 2018, pp. 255-298.

(based on the formulary approach) and C (based on the ALP) suggests a further “stacking” of taxation rights. Even if stakeholders were inclined to accept that the policy objective of allocating additional taxing rights to market jurisdictions is an inevitable political necessity, it is not at all clear that attaining this objective necessitates the potential abandonment of the ALP and its replacement by formulary apportionment.

The abandonment of a principled position on the ALP is most evident in the proposed calculation of Amount B, where a profit allocation mechanism is proposed that is alien and contradictory to the core tenets of the ALP. It appears that the OECD Secretariat has succumbed (for no apparent reason) to the notion that the ALP is a failure and needs to be replaced:

Moreover, there seems to be agreement that the arm’s length principle is becoming an increasing source of complexity and that simplification would be desirable to contain the increasing administration and compliance costs of trying to apply it [...therefore...] would introduce formula-based solutions in situations where tensions have increased — notably because of the digitalisation of the economy. (Unified Approach, paras. 17 and 18)

If the OECD Secretariat, despite the contentious claims underlying this evaluation, officially believes that there is such a public agreement, it should take care to point out who is agreeing on what. In any case, such a vague and unsubstantiated claim or statement is hardly a sufficient justification for replacing the ALP with formulary methods, given the well-known theoretical and practical problems that plague formulary apportionment at the subfederal level and the lack of practical experience at the international level.¹⁴

There is also some early evidence that the ALP can handle digital business models. Srinivasan, Lalapet, and Eden (2019), for example, provide a detailed analysis of one type of digital activity — the Internet of Things — and show that the existing transfer pricing rules under the ALP, while not perfect, can be applied to profit allocation within the MNE group.¹⁵

Moreover, with respect to Amount B, the question is whether the “tensions” relate to the application of post-BEPS ALP (including the DEMPE concept) or some “new and different” understanding of value creation. If the focus is on the latter, there is no reason to assume that the ALP would be unsustainable. The “new” concept of value creation (i.e., that value created “outside” of the MNE should be taxable in the market/user jurisdictions) is a purely “political” concept and is thus, in principle, subject to fostering census without diluting or abolishing the ALP.

The *Unified Approach* unfortunately fails to address this important aspect. Instead, the Secretariat assumes that, in addition to a change in nexus rules under Amount A, the rules on profit allocation for Amount B also need to be changed

[...] but also for those where there is [a nexus]. Otherwise, taxpayers could simply side-step the new rules by using alternative forms of an in-country presence (whether a local branch or related entity), making the new taxing right elective for taxpayers and creating an open invitation for tax planning (Unified Approach, para. 16).

Where this notion of a new form of (presumably aggressive and not-to-be-counteracted-by-existing transfer-pricing-regulations) tax planning comes from is not clear. To consider that essentially the entire justification for Amount B hinges on vague and unsubstantiated notions is disheartening. The OECD should provide clearer arguments supporting this critical stance on the ALP. In its present shape and framing, the *Unified Approach* must be seen as a massive — and unnecessary — threat to the ALP.

- **Recommendation 4: The OECD Secretariat and Members of the Inclusive Framework**

¹⁴ See, for example, the discussion in Lorraine Eden, *The Arm’s-Length Standard Is Not the Problem*, 48 Tax Mgmt. Int’l J. 499 (Oct. 2019).

¹⁵ Niraja Srinivasan, Srini Lalapet and Lorraine Eden, *Transfer Pricing Challenges in the Digital Economy: A Case Study of the Internet of Things (Part II of II)*, 48 Tax Mgmt. Int’l J. 256 (June 14, 2019).

should withdraw the proposal for Amount B (which would also obviate the need for Amount C) and reaffirm their commitment to the arm's length principle for taxing the digital economy.

V. COMMENTS ON AMOUNT C/TAX DISPUTES (QUESTION 7)

In the *Unified Approach*, the OECD Secretariat appears determined to put the worldwide residual profits of all consumer-facing businesses on the table. The MNE's residual profits are subsequently to be allocated on a global basis (utilizing some form of formulary apportionment) away from residence to market jurisdictions in Amounts A and B. The promise to improve multilateral arbitration for Amount C is therefore likely to be little more than a placebo. Designing the *Unified Approach* in this manner, almost by definition, will result in double taxation (as any deviation from the baseline scenario of Amount B is likely to do) and thus create more interjurisdictional conflicts.

Whereas earlier international tax disputes were typically between a residence (home) country and a host (source) country, now three different types of jurisdictions will be vying to divvy up the MNE "profit pie": residence, source, and market. Disputes among three parties are typically more difficult to solve than between two, simply because there are more opportunities for disputes.

First, there are likely to be disputes among the market jurisdictions. The totals resulting from Amounts A, B, and C clearly need to be calibrated in a way that the market jurisdictions (however defined) receive a high enough return from taxing their new VPEs to satisfy their demands for tax revenues. MNEs. If the return is not sufficiently high, the call for DSTs could again re-emerge. Moreover, the likelihood of disputes among the market jurisdictions as they attempt to influence the allocation key for apportioning the market jurisdiction return to the newly created VPEs in their jurisdictions seems very high. Even the identification of which jurisdictions are — and are not — market jurisdictions may be grounds for cross-border tax disputes. The history of how the U.S. states (which are sub-federal not sovereign governments) have manipulated the allocation keys for sharing their state-level CIT revenues should provide sufficient warning of the "dragons that lie ahead."

Second are disputes between the residence jurisdiction and market jurisdictions. If the totals of A, B, and C are too high, the countries potentially surrendering their taxing rights will walk away from the table. While the simple example in the Appendix to the *Unified Approach* suggests that only one country (Country 1, the home country) loses taxing rights and taxable income, this will not necessarily be the case in practice. The likelihood that the MNE parent will declare the group's returns from non-routine intangibles in the home country is not high. First, the income could have been earned outside of the home country so that other jurisdictions have "first crack" at taxing those profits. Second, most residence countries have moved to territorial systems where they no longer tax foreign-source income so that MNEs have no incentive to declare intangible income in their home countries. Third, historically, the mobility of intangibles together with holes in the international tax system created incentives for MNEs to park intangible income in tax havens, shifting taxable income and eroding tax bases; the BEPS project should plug the most egregious of those loopholes. It is therefore highly probable that double taxation will emerge as market jurisdictions create VPEs and start taxing the virtual profits, but then cannot find a residence jurisdiction that will provide them with foreign tax credits or deductions. Countries without a tax treaty network will be even more restricted.

A sneak preview of such distributional disputes may come from the reaction of the United States and its key investment locations to the *Unified Approach*. The top 10 countries where U.S. MNEs had direct investments abroad and declared non-U.S. profits in 2015 were the Netherlands, Ireland, the United Kingdom, Luxembourg, Bermuda, Switzerland, the Caribbean Islands, Singapore, Canada, and China.¹⁶ To the extent that U.S. MNEs have shifted their intangible assets and income to these source countries, the new VPEs created by the *Unified Approach* should be looking for "tax

¹⁶ Urban Institute and Brookings Institution, *Key Elements of the U.S. Tax System*, Tax Policy Center Briefing Book (2019), <https://www.taxpolicycenter.org/briefing-book/what-are-consequences-new-us-international-tax-system>.

room,” not only from the United States but from “primary source/secondary residence” jurisdictions for U.S. MNEs such as the Netherlands and Ireland, where the U.S. MNEs currently hold their intangibles and declare that income.

This could trigger disputes between the residence countries of the ultimate parent and the regional headquarters of an MNE group in terms of which jurisdiction gives up tax room. Many of the U.S. digital MNEs have their European headquarters in Ireland or the Netherlands. Their governments, particularly in small countries, are unlikely to favor of shifting their tax base to market jurisdictions. It will be interesting to see the responses of Ireland and the Netherlands as well as small exporting countries and investment hubs, all of which seem likely candidates to walk away from the table if market jurisdictions begin creating VPEs and taxing their formerly source-based income.¹⁷

Moreover, countries such as Germany, Japan and South Korea may start to consider the potential long-term implications of an Amount B type of income allocation being applied beyond highly digitalized business models to their respective tax bases. Their domestic MNEs currently accumulate the bulk of residual profits at their headquarters, which is commensurate with the ALP. The prospect of having to share a substantial share of the profits realized by Daimler or Samsung with market jurisdictions may also be unwelcome. See, for example, Lee Kyung-mi (1019).¹⁸

In addition to these likely multi-country tax disputes, it is important to remember the institutional framework under which international tax laws apply. The international tax system is a network of double tax treaties, not trilateral or multilateral treaties. Many countries, especially developing countries, have very few double tax treaties and so will have no tax relief if they impose these new taxes. For those inside a treaty network, disputes often take years to resolve through existing dispute settlement procedures. Moreover, if some countries retain the ALP and others move to the Pillar One formulary apportionment approach for Amounts A and B, the resulting cross-border tax disputes are likely to lead to chaos and gridlock.

Our conclusion is that the way forward should not be through the *Unified Approach* — there are too many unknowns and too many likely pitfalls. Rather, the OECD should build on the BEPS 1 reforms. We make two proposals for moving forward, both of which build on existing international tax institutions and practices.

Our first proposal is to convene a working group to develop a chapter for the OECD *Transfer Pricing Guidelines* on transfer pricing of digital transactions, where both “born digital” and “going digital” business models are examined. The new chapter should parallel the existing chapters on goods, services, intangibles and financial transactions. The chapter should also take account of differences between two-sided (buyer/user-seller/supplier) and multi-sided (platform) digital business models. In preparing this chapter, the OECD should work with economics and business faculty around the world who are studying these new digital businesses. In this way, the new fields of digital economics and digital business strategy can inform — and we believe strengthen and update—the ALP for 21st century MNEs. The new chapter should also reaffirm that the ALP remains the core principle guiding taxation for all related-party transactions. In addition, if areas are identified where the interpretation of the *Transfer Pricing Guidelines* is insufficient, treaty changes can also be recommended, but with a view to minimizing such changes.

- **Recommendation 5: The OECD Secretariat and Members of the Inclusive Framework should prepare a new chapter for the OECD *Transfer Pricing Guidelines* on transfer pricing of digital transactions and businesses.**

¹⁷ See, for example, Padraic Halpin, *OECD Tax Overhaul Must Recognize Value Created in Ireland: Minister*, Reuters Bus. News (Oct. 24, 2019), which quotes the Irish Minister of Finance as saying that “The significant and substantial value creating activity that happens in exporting countries like Ireland must continue to be recognized and rewarded.”

¹⁸ Lee Kyung-mi, *OECD’s Digital Taxation May Expand to Target All Multinationals: South Korea’s Large Corporations Could Face Heavier Tax Burden*, Hankyoreh, November 3, 2019. http://english.hani.co.kr/arti/english_edition/e_business/915558.html

Our second proposal is to focus more on resolving disputes through the use of multilateral advance pricing agreements (APAs) involving two or more governments and a digital MNE. APAs have long been used as the vehicle to bring the taxpayer and tax authority to a negotiated arm's-length result, one that provides clarity and certainty for both parties. APAs not only build on existing international tax and transfer pricing principles but also offer flexibility and room for maneuver. They can also include old-fashioned bargaining tactics whereby a government that negotiates well can achieve new taxing rights for its jurisdiction. Multilateral APAs can bring willing parties to the table, eager to broker a win-win settlement. Bringing source, residence, and market jurisdictions to the table together with a digital MNE and hammering out a multilateral APA for the digital MNE's business offers the opportunity for horse trading that can create both new taxing rights and negotiated arm's-length results.

- **Recommendation 6: The OECD Secretariat and Members of the Inclusive Framework should use multilateral rather than unilateral advance pricing agreements (APAs) as a dispute avoidance and settlement mechanism for taxing digital MNEs and activities.**

VI. CONCLUSIONS

From a conceptual perspective, the *Unified Approach* reflects an unsustainable “muddling through” approach to international tax reform, and the implied compromises are likely to have detrimental consequences for both the international tax system and the arm's-length principle. Specifically, there is no conceivable scenario for limiting the scope of the “compromises” to the digital economy. The statement that the Unified Approach “[...] largely retains the current transfer pricing rules based on the arm's length principle but complements them with formula based solutions in areas where tensions in the current system are the highest” (*Unified Approach*, para. 15) amounts to wishful thinking.

The proposals also convey an overly pessimistic view of the ALP where the impact of BEPS reforms on MNE tax avoidance has been trivialized or underestimated. The OECD Secretariat has apparently decided the ALP is not suitable (even post-BEPS) for ensuring that value creation and taxation are appropriately aligned. Even where a taxable nexus exists, this distrust of the ALP will inadvertently lead to second-guessing the efficiency of the ALP beyond digital businesses. Stakeholders should pause to consider whether the problems ascribed to the ALP (or the potential abuse of transfer pricing rules by MNEs) really necessitate such a broad re-shuffling of taxing rights and underlying paradigms.

If the Pillar One proposals are adopted, we believe the OECD will be trading a comparatively minor short-term gain (prevention of unilateral digital service taxes in market/user jurisdictions) for a potentially disastrous long-term consequence, namely, the erosion of the existing international tax system and the consensus on the ALP. The policy proposals — particularly Amount A with its changes to nexus, unitary allocation, and formulary apportionment — are ground-breaking but they are not based on international tax principles nor have they been tested at the international level. We also fear that the proposals will lead to an over-politicization of international taxation, translating to more severe distributional conflicts between countries in the future. In such disputes it is the smaller, poorer countries and those without bilateral tax treaties that are most likely to suffer. Thus, we see few potential upside benefits and many possible downside risks to developing countries if they commit to these proposals.

The current international tax rules and the ALP are robust and flexible enough to handle 21st century MNEs. Our recommendations lay out a roadmap designed to move the global economy onto the BEPS 2 path, a path that we believe will benefit both developed and developing countries in their roles as source, residence, and market jurisdictions.