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The OECD "Unified Approach"

Have the Card Been Reshuffled?

Raffaele Petruzzi / Raphael Holzinger / Mirna Solange Screpante / Svitlana Buriak / Gabriela Capristano Cardoso

In the course of the last years, the OECD extensively dealt with tax issues generated by the increasing digitalisation of business models. While the focus on BEPS action 1 was clearly on the taxation of *"digital business"*, the OECD constantly enlarged the potential scope of its contemplations via *"digitalised businesses"* and finally ended up with a focus on *"consumer-facing businesses"* in the recent Secretariat Proposal of a "Unified Approach" under Pillar One.

Accordingly, it can be reasonably concluded already from a prima vista perspective that the proposal presented by the OECD Secretariat is far-reaching and could be applicable for all businesses, since – at the end of the day – all businesses are eventually intended to be consumer-facing. On the basis of the far-reaching scope, the OECD proposed a new sales-based nexus in order to overcome the pitfalls of the currently applicable (and to a certain extent outdated) concept of permanent establishments, which is solely based on a certain degree of physical presence in a host state. Finally, based upon the scope and nexus, the market jurisdictions should (ideally) profit from the proposal, as those states are intended to be allocated (additional) profits based on a formulaic approach that would work in parallel to the current arm's length approach.

This paper is meant to illustrate the rationale of the Unified Approach and is based on the comments of the WU Transfer Pricing Center at the Institute for Austrian and International Tax Law at WU Vienna submitted during the course of the OECD public consultation.

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1. Introduction

1.1. General Comments

The discussion on the taxation of the increasing digitalisation of business models was one of the major areas of interest of the OECD BEPS project; in fact, it was dealt with in the first action item, namely *"BEPS Action 1 – Addressing the Tax Challenges of the Digital Economy"*.[1] However, even though this topic was one of the major areas of interest, the final report eventually did not provide any solid solution in order to overcome situations of BEPS with respect to the *"digital economy"*.

As a result, the OECD further worked on the issue and has come up with different publications during the last year.[2] Especially the public consultation document on addressing the tax challenges of the digitalisation of the economy (hereinafter: OECD PCD 2019) is of major relevance, since the different proposals on revised profit allocation and nexus rules (i.e. the "user participation" proposal,[3] the "marketing intangibles" proposal,[4] and the "significant economic presence" proposal[5]) were addressed for the first time in a rather elaborated way.

However, during the course of the public consultation on the OECD PCD 2019, the different proposals were subject to plenty of criticism;[6] none of the approaches was considered "*the* solution" in order to overcome the challenges of the digital or digitalised economy. This is one of the major reasons why the OECD PCD 2019 did not result in a final report but rather in a "programme of work" in March 2019 (hereinafter: OECD PoW 2019).[7] However, the different proposals on revised profit allocation and nexus rules laid down in the OECD PCD 2019 have not been dropped; if one carefully reads the recent *"Secretariat Proposal on a 'Unified Approach' under Pillar One"*[8] (hereinafter: Unified Approach), one will come to the conclusion that all of those proposals are resembled to a certain extent in the proposed solution, thus being considered a "unified solution" by the OECD Secretariat. Preliminarily, it is worth highlighting that this proposal has not been agreed upon by any country at this stage.

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1 See *OECD*, Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report (2015).
2 *OECD*, Request for Input on Work regarding the Tax Challenges of the Digitalised Economy (2017); *OECD*, Tax Challenges Arising from Digitalisation – Interim Report 2018 (2018); *OECD*, Public Consultation Document, Addressing The Tax Challenges of The Digitalisation of the Economy (2019), in the following: OECD PCD 2019; *OECD*, Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy (2019), in the following: OECD PoW 2019.
3 Cf OECD PCD 2019, para 17 et seq.
4 Cf OECD PCD 2019, para 29 et seq.
5 Cf OECD PCD 2019, para 50 et seq.
6 Cf Comments on OECD PCD 2019.
7 Please see OECD PoW 2019, para 1 et seq.
8 See *OECD*, Public Consultation Document, Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October 2019 – 12 November 2019 (2019), in the following: OECD Unified Approach.

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1.2. How the Unified Approach Could Be Understood

The Unified Approach introduces a three-tier mechanism of profit allocation between residence, source, and market states. In this respect, the source state is the state where an MNE has a traditional fixed place of business PE,[9] while there is no requirement for any physical presence in the market jurisdiction. A practical example will illustrate how the Unified Approach could apply to a hypothetical MNE called *SolematesCo*.

The *SolematesCo* group manufactures tailor-made shoes in southern Italy and sells them in various European countries. In the fiscal year, the *SolematesCo* group generated revenues of 800 million €, consolidated (financial) profits of 100 million €, and was considered a consumer-facing business. *SolematesCo IT* is a fully-fledged manufacturer and owns (and performs the related DEMPE functions) all intangibles (both R&D and marketing). The *SolematesCo* group sells its shoes in the following countries:

- Italy: total sales of 240 million €;
- France: various shops (registered entities working as limited risk distributors [LRDs]) with total sales of 300 million €;
- Germany: various shops (non-registered entities with functions of LRDs) with total sales of 200 million €;
- Poland: online sales of 50 million €;
- Austria: online sales of 10 million €.

In order to improve its business, the group has developed an AI system that collects and analyses data received from its customers in all these countries. For the purposes of the underlying example, we assume that 50 million € is the threshold of sales revenue required for the market jurisdiction to get taxing rights (i.e. nexus) and that the countries have agreed (under the implementation of the Unified Approach in their own legislation) to consider this threshold of 50 million € of sales as the relevant one to define the new nexus.

According to the Unified Approach, the first step of profit allocation is the calculation of the worldwide group operating profit derived from the group's consolidated financial statements. In our example, *SolematesCo* generated 100 million € in the fiscal year, which resembles an overall profit margin of 12.5 % (i.e. 100 million € : 800 million €).

Based on the rationale laid down in the Unified Approach, the second step would then be to extract the amount of *"deemed routine profits"* from the total amount of operating profit in order to be able to calculate the amount of so-called *"deemed residual profits"*. The deemed residual profit is aimed to be an approximation of the group's profits attributable to intangibles, including trade intangibles in the market states. In the underlying example, the authors assume that the countries have agreed (under the implementation of the Unified Approach in their own legislation) to consider 10 % as the amount to be deemed as routine profits. Hence, a margin of deemed residual profits of 2.5 % results from the difference between total and routine profit margins (being, hence, the deemed non-routine/residual profits).

The third step would be to allocate a portion of the amount of deemed residual profits between the market jurisdictions of the *SolematesCo* group (the rest being deemed residual profits due to trade intangibles, capital etc that would not be allocated to the market jurisdictions). In this example, the authors assume that the countries have agreed (under the implementation of the Unified Approach in their own legislation) to consider 50 % of the deemed residual profits to be allocated to the market states that meet a threshold of sales revenue under the new taxing right (i.e. nexus).[10] Hence, the amount of profits to be distributed between the market states makes a margin of 1.25 %. Italy, France, Germany, and Poland meet the condition of 50 million €, while Austria would not have the right to tax the profits of *SolematesCo*. The Unified Approach suggests that the residual profits attributable to the market jurisdictions should be split among them on a previously agreed allocation key such as sales.[11] Therefore, as a final step in determining Amount A, the authors allocate the margin of 1.25 % to the sales derived from each market state (except Austria). As outcome, the profits under the new taxing right are 3 million € attributable to Italy, 3.75 million € to France, 2.5 million € to Germany, and 0.63 million € to Poland.

	Agreed threshold / splitting factor	Calculations (in million €)	Results (in million €)
Countries with new taxing rights	50 million €		ITA, FRA, GER, POL
1) Consolidated profit margin	Consolidated profits : Conslidated revenues	100 : 800	12.5 %

[9] Art 5 OECD MC 2017.
[10] For solving this example, agreed thresholds and splitting factors have been assumed discretionally by us.
[11] OECD Unified Approach, para 60.

	Agreed threshold / splitting factor	Calculations (in million €)	Results (in million €)
2) Exclude deemed routine profits residual	10 %	12.5 % – 10 %	2.5 %
3) Non-routine profits attributable to trade intangbiles, capital, …	50 % x (2)	50 % x 2.5 %	1.25 %
Non-routine profits to share with markets (% of revenues)	(2) – (3)	2.5 % – 1.25 %	1.25 %
4) Share of non-routine profits	Revenues	ITA: 1.25 % x 240	3.00
		FRA: 1.25 % x 300	3.75
		GER: 1.25 % x 200	2.50
		POL: 1.25 % x 50	0.63

Table 1: Calculation of Amount A based on a margin approach

With respect to Amount B and Amount C, the current transfer pricing rules based on the arm's length principle (hereinafter: ALP) apply. Therefore, the following taxable profits are allocated to the various countries where *SolematesCo* is operating and has a physical presence or a PE:

- France: 30 million € (i.e., 10 % return on sales, based on a pan-European benchmarking study, eventually in line with pre-agreed safe-harbours);
- Germany: 20 million € (i.e., 10 % return on sales, based on a pan-European benchmarking study, eventually in line with pre-agreed safe-harbours);
- Poland: 0 €;
- Austria: 0 €;
- Italy: 50 million €, i.e.:
  - Routine: 24 million € (i.e., 10 % return on sales, based on a pan-European benchmarking study, eventually in line with pre-agreed safe-harbours);
  - Residual: 26 million € (residual income, assuming that taxable profits are equal to consolidated [financial] profits).

As a result, the total taxable profit of *SolematesCo* is 109.88 million €, while the actual operating profit is only 100 million €. Accordingly, a profit of 9.88 million € will be subject to double taxation from a clash between the newly introduced system of formulary apportionment under Amount A and the existing transfer pricing rules operating on a bilateral basis under Amounts B and C.

2. Comments on the Unified Approach

As already indicated above, the Unified Approach addressed different aspects like

- the *"Scope"* of the applicability of the proposed solution,
- the *"Nexus"*, which is required in order to create a taxing right for a market jurisdiction based upon the proposed solution, and
- the *"Profit Allocations Rules"*, which are based on Amount A, Amount B, and Amount C, and intended to allocate certain (additional) profits to market jurisdictions, based upon the proposed solution.

Before going into further details, it is worth noting that the tax treatment of highly digitalised businesses should not and cannot be ring-fenced, but a comprehensive solution should be adopted. The newly adopted approach, focussing on consumer-facing businesses, can be seen as a viable approach in order to minimise the ring-fencing tendencies from a general perspective. However, it should be analysed in-depth whether the carve-outs of certain industries actually minimise ring-fencing.

Moreover, in order to make international profit attribution within MNEs – or more widely spoken the attribution of taxing rights among different jurisdictions – robust and subject to legal certainty for both taxpayers and tax administrations, it is essential that the new framework for international taxation of business activities of MNEs is founded on a principle-based solution. To this end, it might be worth to better highlight the principles underlying the solutions identified by the Unified Approach.

The currently applicable rationale of profit attribution within MNEs – or more widely spoken the attribution of taxing rights among different jurisdictions – is based upon the notion of value creation. In case value is created in a certain jurisdiction based upon the functions performed, risks assumed and assets used therein, this jurisdiction is entitled to tax the resulting profits (losses). However, the currently intended formulaic approach of attributing taxing rights to market jurisdictions based upon sales under Amount A does not appear to be interlinked with value creation. This is

caused by the fact that sales generally do not create value, but are rather functions, assets, and risks within an MNE, which eventually lead to value creation.

As pointed out above, sales might not be seen as a proper reference point in order to align the attribution of profits within MNEs – or more widely spoken the attribution of taxing rights among different jurisdictions – with the notion of value creation. This reference rather results in a situation under which the general understanding of corporate income taxes is pushed closer to indirect tax (e.g., VAT) principles. In order words, the current rationale seems to promote a direct tax with a teleological proximity to indirect taxes at least to the fact that the rules are intended to be strongly interlinked with sales, which themselves are strongly interlinked with consumption. Analysing Amount A, it is thus questionable whether it refers to corporate income taxes or a different form of taxation, which raises the question whether or not Amount A (i.e., *"the different form of taxation"*) will eventually even be covered by the scope of double tax treaties (DTCs).

Since the rationale of Amount A aims at attributing parts of the consolidated profits to market jurisdictions, the question is whether or not these attributable profits will be derived from or determined based upon the information in the country-by-country reporting (CbCR). In this respect, it should be pointed out that this hypothesis/approach was explicitly excluded under BEPS action 13.

What is more, it seems to be a logical result that extra taxes (including the potential taxes resulting from the double taxation under Amount A as shown above) will be embedded in the costs and, consequently, if market permits, increase the price of the products or services provided to the final customers.

Moreover, the proposal seems to disregard that countries have diverging tax policies (e.g., some are capital importing, some are capital exporting); hence, further considerations on this regard might be needed.

Finally, it will be of key relevance to clarify how the system under Amount A (outside the ALP) and the one under Amount B and Amount C (inside the ALP) will eventually co-exist.

2.1. Scope

There are four main areas of concern with respect to the determination of the scope under the Unified Approach. First, in our opinion, ringfencing of some businesses (e.g., the ones that are able to operate remotely) should not be intended, since traditional business models and highly digitalised businesses must be put on equal footing in order to ensure the safeguard of the principle of neutrality as laid down in the Ottawa Taxation Framework.[12] The authors think that soon all traditional business models will be highly digitalised. Lastly (and more importantly), a distinction between traditional business models and highly digitalised businesses is simply not possible and extremely subjective. Accordingly, the scope should be based upon the understanding that all traditional businesses are (or will soon be) digitalised and all digitalised businesses are traditional, thus meaning that ringfencing is not possible.[13]

Secondly, and following this line of thinking, the newly introduced focus on consumer-facing businesses might potentially result in the unintended ringfencing of some businesses. This is caused by the fact that from a factual and economic perspective all businesses (i.e., B2B and B2C) are consumer-facing. Even in case of B2B relations the products or services delivered or rendered will resemble an input factor for any B2C relation, since all businesses are – at the end – intended to result in a relation with end customers. Therefore, a well-founded definition of the meaning of *"consumer-facing business"* would be necessary to achieve some degree of legal certainty. From our point of view, if a solid definition cannot be achieved, the newly developed notion of consumer-facing businesses shall be left out from the Unified Approach. To a similar extent, the foreseen carve-out for specific sectors (e.g., extractive and financial) is another way of emphasising the ringfencing of digitalised businesses and, in our view, should not occur. A fundamental issue with this distinction stands in the fact that, if B2B would be excluded, MNEs would tend to distort economically efficient decisions by means of selling their products or providing their services by means of independent parties.

Thirdly, it should be also taken into account that if the Unified Approach applies only to some businesses and under certain conditions (e.g., threshold for amount of sales), there will be issues related to the co-existence of multiple tax systems (e.g., the current one and the new one, the latter being characterised by two different systems) which implies that a MNE might intermittently fall within the scope.

Furthermore, the authors see that the main problematic is that there is no fundamental underlying principle behind the Unified Approach. There is an assumption that the method of doing business in a highly digitalised way somehow is a jurisdictional principle. Actually, in terms of tax jurisdiction and the legitimate entitlement to tax of a country, it should not matter whether the mode of

[12] Cf *OECD*, Action 1 – 2015 Final Report, para 6.

[13] *Morton*, Profit splits and value chain analysis key to addressing transfer pricing issues in the digital economy, TP Week (18. 8. 2014), available at https://www.tpweek.com/articles/profit-splits-and-value-chain-analysis-key-to-addressing-transfer-pricing-issues-in-the-digital-economy/aratdfql (last accessed 28. 11. 2019).

conducting commercial activities is digital or not. Under a system characterised by legal certainty, a company should be subject to tax in a country based on objectively identifiable factors (e.g., residence or nexus to that country) rather than on subjectively identifiable factors (e.g., the business model or the scope of the activities).

Last but not least, the scope as currently defined by the Unified Approach might raise issues of discrimination/restriction of fundamental freedoms and/or State Aid within the European Union.

2.2. Nexus

The current Unified Approach proposal intends to create a new nexus to address situations in which a business has a sustainable and significant involvement in the economy of a market and, at the same time, it creates meaningful value without having physical presence in the market, i.e., significant economic presence (SEP).

As a proxy for the SEP, the proposal considers revenue thresholds in the market jurisdiction. However, those revenues (or sales) per se do not lead to value creation but are rather only means to or a result of value realisation; value is created based on the functions performed, risks assumed, and assets used throughout the entire supply chain of products or services. Having said that and considering that traditional business models and highly digitalised business models must be put on equal footing, not only remote sales should be considered but also sales through distributors. Notwithstanding that, it is questionable whether the SEP nexus should also include situations in which MNEs have presence in a market through a distributor (whether a related or a non-related local entity). Essentially, the reason against this is that the portion of value creation, which is generated by this local distributor based upon the functions performed, risks assumed, and assets used, can already be properly taxed in the market jurisdiction on the basis of the currently applicable set of rules (i.e., physical presence-based rules), thus meaning that there is generally no need for additional presence resulting from the distribution activity. The inclusion of any specificity for distributors would function more as a guarantee not to ringfence digitalised from traditional sales rather than an affirmative inclusion rule. However, an MNE might not be able to know where its products are sold or services provided by a non-related distributor, if the distributor sells those products or provides those services in other countries. On the other hand, distinguishing between sales of products and provision of services made with related and unrelated distributors might distort economically efficient decisions, as companies might prefer selling their products or providing their services by means of independent parties.

Having said that, in our opinion, the new nexus could rather be based on the following criteria (that were suggested by the previous OECD discussion draft):

- the existence of a user base and the associated data input;
- the volume of digital content derived from the jurisdiction;
- the billing and collection in local currency or with a local form of payment;
- the maintenance of a website in a local language;
- the responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales service or repairs and maintenance;
- sustainable marketing and sales promotion activities, either online or otherwise, to attract customers; and/or
- time period for which sustainable business interaction occurs.[14]

What is more, it might be reasonable to reconsider implementing the new nexus through a standalone rule (on top of the current permanent establishment rule). Even though the general intention to limit any unintended spill-over effects between the new nexus and the current rule set is valid, an implementation of the new nexus in Art 5 OECD Model – as a *lex specialis* to the general rule of Art 5 para 1 OECD Model – might be useful; in this respect, the new nexus could be inserted as a new paragraph in Art 5 OECD Model, which will be applicable as a fall-back rule if none of the other paragraphs in Art 5 OECD Model is applicable. Accordingly, those parts of the currently applicable rationale of Art 5 OECD Model, which are valid for all kinds of business models, could easily be captured via the respective references to the general understanding, whereas those parts of the existing rules, which are currently not capable of capturing different remote business models, could simply be replaced by other proxies.

2.3. Amount A

As already pointed out above, Amount A is the amount of profits that should be allocated to the market jurisdictions of consumer-facing businesses reaching the threshold of sales that is supposed to evidence a significant value derived from those jurisdictions. The introduction of the new formulary apportionment rules for Amount A raises a number of significant considerations with respect to

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[14] See also Comments of the WU TPC on the OECD PoW 2019.

- the calculation of group profits for Amount A,
- the determination of that amount, and
- the elimination of double taxation.

Dealing with the calculation of group profits for Amount A, the following issues should be highlighted. As a starting point, it is important to underline that local GAAPs (including US GAAP) or IFRS are only the reporting standards, the international application of which undoubtedly would guarantee that financial statements have a greater comparability. However, financial and accounting standards aim to ensure that all stakeholders of a company are properly informed about the financial status of that company, whereas tax accounting aims at ensuring that the company pays the correct amount of taxes in a country, in line with the tax policies and rules defined by that country. Tax laws of each state provide the rules on adjustments to the accounted profits that should be made to calculate a tax base. A generic, worldwide applicable taxable base cannot be computed based on the local GAAPs or IFRS rules. Therefore, referring to accounting standards in order to determine taxable profits seems to be questionable from various perspectives:

- accounting rules and tax rules are generally intended to fulfil different objectives;
- there is no uniform (i.e., worldwide) GAAP standard (hence, countries will have to determine their tax revenues based on accounting rules of other countries they might not be able to understand or might not be agreeing with);
- potentially, tax planning opportunities may derive from accounting practices.

What is more, the Unified Approach seems to focus mainly on profitable situations. Analysing the general rationale of Amount A, it appears that there should not be an Amount A in case of overall loss-making situations of MNEs. However, considering that (based on scope and nexus) a certain market jurisdiction may be attributed any kind of additional Amount A profit in terms of an overall profit-making situation of the MNE, it seems questionable from a "fairness perspective" why the same market jurisdiction should not be attributed any kind of Amount A loss in case of an overall loss-making situation of the MNE. This would, however, be very difficult to implement.

If Amount A is implemented by business lines or regional segmentation, assuming that not all business lines or regions within an MNE have the same level of profitability (i.e., some business lines or regions may be profit-making, whereas others may be loss-making), a calculation of group profits based on business lines or regional segmentation might eventually result in situations in which Amount A profits might be attributable to market jurisdictions even though the MNE is loss-making on an overall perspective. Moreover, it might not be easy to determine the amount of profits per business line or regional segmentation. Therefore, it would be advisable not to implement Amount A by business lines or regional segmentation.

When determining Amount A, it is important to underline that the usage of the terms *"deemed routine profits"* and *"deemed residual profits"* tend to be strongly misleading from a transfer pricing perspective. The term *"deemed routine profits"* (and the derived *"deemed residual profits"*) in Amount A is meant to address any kind of percentage amount, which will most likely result out of arbitrary determinations and which will – at the end of the day – simply resemble a baseline portion of an MNE's profits that are excluded from a potential allocation to the market jurisdictions on the merits. Accordingly, it is strongly recommendable that the terms *"deemed routine profits"* and *"deemed residual profits"* should be reconsidered or totally removed from the Unified Approach.

What is more, using the same baseline percentage amounts of deemed routine profits for all different kinds of industries and sectors obviously lacks economic rationale and would disregard all economically relevant characteristics of MNE business activities. Accordingly, if such baseline percentage amounts for deemed routine profits might eventually be applied, it would rather seem to be appropriate that those percentage amounts should be set based on some economic studies. Moreover, the risk of each country choosing a different percentage during the implementation of the agreed proposal should be avoided.

Bearing in mind the potential magnitude of taxable profits that might be reattributed to different jurisdictions, it seems to be an absolute necessity to be clear, precise, and to avoid any kind of misleading usage of terms and notions. What is more, it has to be pointed out that any kind of variations in the percentage amounts (e.g., 15 % instead of 10 % for a baseline percentage amount of deemed routine profits or 60 % instead of 50 % of the deemed residual profits which might be attributable to the market jurisdictions) may eventually result in significant shifts of taxable income in light of the Unified Approach.

Finally, there are some considerable concerns regarding the elimination of double taxation with respect to Amount A. When ensuring elimination of double taxation, the first issue to address is how DTCs should apply with respect to subjective and objective scope.

Since Amount A is determined when calculating profits on the headquarters' level, in principle, the DTC between the headquarters' state and market state(s) could apply. However, since there are no direct transactions between headquarters and the market states, attributing higher profits to the

market states cannot lead to any adjustment on the headquarters' level. Likewise, the DTC between other group members and market states can hardly help, since the determination of income allocated to the market jurisdictions does not depend on the attribution to any other state and *vice versa*.

Moreover, if any double taxation arises from a simultaneous application of such an approach and the ALP by source and residence states, there will be no unanimous ground for the tax authorities to resolve such double taxation (e.g., in the current system, a proper application of the ALP can be challenged) and no leeway for treaty interpretation. The tax authorities of the market states will argue that Amount A is calculated correctly, while the source and residence states will claim the same with respect to the ALP amount; one tax authority being right does not exclude the other.

One could argue that Amount A would be exempted from further taxation of the group, i.e., the group's financial result would decrease on the Amount A and the profits left would be allocated among source and residence states. However, since the ALP applies on a bilateral basis to specific controlled transactions, the overall group profits will not even be considered by the tax administrations of the two contracting states if the traditional transactional transfer pricing methods apply. To conclude, the simultaneous application of two non-compatible systems will not facilitate eliminating double taxation for MNEs and promoting international trade activities.

If it is assumed that the headquarters' state should provide relief from double taxation, it should be questioned whether this would be the case under the scenario that the profits attributable to the headquarters' state are lower than the ones to provide relief for or if the headquarter company only earns dividends. Moreover, it should be questioned whether this solution is appropriate from a principle-based understanding.

2.4. Amount B

Amount B of the Unified Approach proposal provides for a fixed margin for baseline distribution and marketing activities. In this regard, it seeks to provide simplicity and increased tax certainty for tax administrations and taxpayers. It should also collaborate to relieve compliance burden from taxpayers and exonerate some resources from tax administrations in dealing with routine transactions. From a general perspective, such a willingness to simplify current (routine) transfer pricing analysis is to be welcomed.[15]

The fixed margin approach seems to be similar to safe harbours (although technically safe harbours and pre-determined rebuttable margins are not the same). In this regard, a significant amount of the guidance already provided by the OECD (also in the Annex to Chapter IV of the OECD TPG 2017, on the Sample Memoranda of Understanding for Competent Authorities to Establish Bilateral Safe Harbours[16]) can be useful. The Annex also encourages the implementation of safe harbours for LRD activities. Moreover, the UN Transfer Pricing Manual as well as the work of the Platform for Collaboration on Tax[17] can serve as inspiration.

It is important to encourage the use of simplification measures in transfer pricing. However, the scope and applicable margins to such measures should be well defined. Failing to do so would promote more disputes and add more complexity to the system. Moreover, although safe harbours might provide many advantages, careful attention should be given also to the numerous disadvantages they embed.[18]

Regarding the scope of Amount B, the Unified Approach underlines that simplification measures could be applied to *"baseline distribution and marketing activities"*. It is not clear, however, what *"baseline"* means. The authors understand *"baseline"* to mean *"routine functions, assets, and risks"*. The term *"routine"* is also not well defined, neither in the OECD TPG 2017 nor in literature, and can be the subject of numerous disputes in practice. However, the notion is to be understood as an activity that is subject to a limited functional, asset and risk profile, thus resulting in an entitlement for small and stable profits, which is easily benchmarkable and does not lead to the creation of unique and valuable intangibles from a dogmatic perspective.

A proper transfer pricing analysis is based on the following four steps:

- the accurate delineation of the actual transaction;
- the recognition of the accurately delineated transaction;
- the selection of the most appropriate transfer pricing method; and
- the application of the most appropriate transfer pricing method.[19]

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15 For a more in-depth analysis of simplification measures in transfer pricing, see *Capristano Cardoso/Petruzzi*, Simplifying the transfer pricing analysis: an illusory Chimaera or a realistic ambition? WTJ 2019 (forthcoming).

16 Annex I to Chapter IV of the OECD TPG 2017.

17 *The Platform for Collaboration on Tax* (PCT), A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses (2017).

18 Cf para 4.110 et seq OECD TPG 2017.

19 *Petruzzi/Cottani/Sollund/Prasanna*, Introduction to Transfer Pricing, in *Lang/Cottani/Petruzzi/Storck*, Fundamentals of Transfer Pricing (2019).

Based on this understanding, it has to be pointed out that a fixed margin to the routine distribution and marketing functions would only simplify the last step of the transfer pricing analysis, i.e., the application of the most appropriate transfer pricing method. It does not provide any kind of relief from the other three steps mentioned above. Depending on how the simplification measure is designed, step 3 could also be simplified (e.g., certain safe harbour provisions do not require the selection of a transfer pricing method[20]). However, steps 1 and 2 are of extreme relevance to support the scope of the simplification measure and ensure that the transaction is *de facto* eligible for any kind of safe harbour approach based on a routine functional and risk profile.

Once the scope of the simplification measure for Amount B is well defined, the actual applicable margin should be determined. The safe harbour should still aim at being in line with the ALP in order to avoid duplications in counting the profits of distribution and marketing activities when the market jurisdiction also applies the ALP for any remaining functions performed in its territory. Moreover, the closer to the arm's length remuneration the better to avoid potential disputes on the other side of the transaction if the related country does not follow the same safe harbour.

However, in light of the currently applicable rationale in order to price routine activities, state-of-the art benchmarking analysis eventually result in a range of profit levels which are equally compliant with the ALP. Based on this understanding, it might be appropriate to not just contemplate exact safe harbour amounts, but rather safe harbour ranges for specific industries or sectors. Such an approach could eventually also enable taxpayers to account for the actual profitability of the entire group and thus being able to set the pricing for routine functionalities in light of the value creation from a group-wide perspective. In such a setting, it might be necessary for the intended fixed margins to be rebuttable, in order to not contradict the entire rationale of the ALP. Naturally, it is not the intention that the taxpayer could always deviate from the fixed margin. A balance should be achieved between giving this option to the taxpayer without a disproportional compliance burden and the tax certainty character of the simplification measure. Moreover, losses should be taken into consideration.

The Unified Approach aims at achieving simplicity, stabilisation of the tax system and increased tax certainty in implementation. However, this can only be achieved with enhanced multilateral co-operation. For Amount B, this means that the safe harbour would only work if set multilaterally. Agreeing on fixed margins multilaterally and keeping them updated can present a significant challenge, in particular because the countries in the Inclusive Framework have very different economies and tax systems. Indeed, the profitability margin of a distribution centre in India may be different than in Norway, e.g., due to labour and facilities costs. Finally, another challenge of this approach is the delineation of the baseline activities, as due to the different economies Inclusive Framework countries may have different views on what is considered to be routine and what generates residual profits.

2.5. Amount C

Amount C of the Unified Approach seems to consist of any other amount that countries may attribute to taxpayers following the ALP that is not covered by Amount A or Amount B. It may be difficult to avoid duplication completely, as essentially the ALP would also cover the amounts related to marketing intangibles (also covered by Amount A) and routine distribution and marketing functions (covered by Amount B). In this regard, a more pragmatic approach may be followed:

- For Amount A: For simplification, if an MNE has a distribution centre in a country and performs non-routine marketing and distribution activities therein, it would be better if only the ALP would be applicable. Some transfer pricing adjustments could be performed to account for marketing intangibles and location specific advantages and, therefore, attribute more profits to the market jurisdiction. However, they should not calculate Amount A separately, as it would be very difficult to avoid any duplication.
- For Amount B: Where the activities in the country go beyond Amount B for distribution and marketing activities, these functions should be analysed solely in line with the traditional application of the ALP. There should not be a fixed margin and in addition a separate application of the ALP in order to avoid duplications. However, as indicated above, one might also consider applying the fixed margins in light of Amount B with respect to the routine functionalities.

The Unified Approach points out that the interpretation and practical application of Art 9 and 7 OECD Model, in particular in respect to distribution and marketing activities, is the topic of a large proportion of tax disputes. If Amount B is implemented consistently and multilaterally, it could be an effective way to avoid disputes in this area (at least with respect to routine functionalities).

Other approaches to dispute avoidance might be multilateral advance pricing arrangements (APAs).[21] Experiences from countries, such as the United States, could be useful. Moreover, Art 25

[20] As an example, in Brazil, taxpayers staying within the safe harbours are exempt from applying any of the transfer pricing methods, whereas in Israel, the safe harbour only relieves taxpayers from providing support-benchmarking studies to support the remuneration.

para 3 OECD Model and many tax treaties could be used as a legal basis to negotiate bilateral and (if different applicable bilateral treaties are in place) multilateral APAs.

Cooperative compliance programmes[22] might also be useful in avoiding disputes. Moreover, the multilateral cooperative compliance programme, ICAP[23] (International Compliance Assurance Programme), might be a good option for large MNEs operating in many different countries. However, more countries need to be on board of the programme and one should be aware that cooperative compliance programmes could still be challenging for developing countries or countries with aggressive tax administrations. The OECD and other international organisations might have pilot programmes involving developing countries and provide training for those more challenging situations. Finally, in case of audits, joint audits[24] could be encouraged, as the result of a joint audit would be one single outcome applicable to all tax administrations involved.

It is a better policy to avoid disputes rather than resolving them. However, if a dispute cannot be avoided, a mandatory binding dispute resolution should be in place for resolving conflicts arising from the application of the entire Unified Approach (Amounts A, B and C). Despite Part VI of the MLI, not many tax treaties currently have a clause for mandatory arbitration.[25] As the Unified Approach calls for a legally binding dispute resolution mechanism, countries would need to implement mandatory arbitration in their tax treaties together with the new nexus rule. That could be dependent on each other as a package deal – the new nexus rules would only be applicable as a whole with mandatory arbitration (instead of mandatory arbitration only being linked to Amount C as it reads currently in the Unified Approach).

This could pose a challenge to reaching consensus, as especially developing countries and countries with less experience on MAPs may be reluctant in adopting mandatory arbitration. In this respect, although mandatory arbitration should be in place for all transfer pricing cases,[26] it may be easier for countries to agree, as a first step, on mandatory arbitration for cases related only to the new nexus rule. This could help in the future to expand the scope of mandatory arbitration for other cases once countries gain more experience with MAPs and mandatory arbitration.

Many countries have implemented unilateral measures aiming at taxing highly digitalised businesses. Such unilateral measures should be abolished in the context of the new solution. Anyway, disputes between the new rules and any remaining unilateral measures should be covered by the mandatory arbitration provision. The interaction between unilateral measures adopted by different countries, the new allocation rule, fixed margins, and the ALP might create multiple taxation (i.e., taxation in more than two jurisdictions at the same time). Multilateral dispute resolution should be encouraged. In this respect, paras 38.1 and 38.2 of the Commentary on Art 25 OECD Model state that, if there are bilateral tax treaties in force between all jurisdictions involved, there may be one single multilateral MAP. However, many of the developing countries of the Inclusive Framework have a limited tax treaty network, rendering this multilateral procedure based on a network of bilateral tax treaties unworkable. Moreover, there is no guidance on procedural rules for such a multilateral MAP.

With this in mind, the OECD should provide further guidance on multilateral MAPs and create a framework for multilateral dispute avoidance and resolution, including multilateral APAs, ICAP, as well as multilateral safe harbours. There could also be a multilateral agreement for dispute avoidance and resolution in order to mitigate the poor tax treaty network of some developing countries. Alternatively, the OECD could promote and facilitate the negotiation of bilateral tax treaties – however, this option may be more burdensome than a multilateral agreement, as the negotiation of a tax treaty is not only about dispute resolution and countries may disagree on various allocation rules and other treaty provisions.

Finally, the lack of legal protection, enforceability, and taxpayer's rights in MAPs and mandatory arbitration should also be addressed. For this purpose, the EU Tax Dispute Resolution Directive[27] might serve as inspiration as it provides several procedural rules to enhance enforceability in the procedure.

If, finally, the dispute cannot be avoided or resolved, double taxation should be relieved by the credit or exemption method. For this, the taxpayer needs to be identified and the OECD has to clarify how the mechanism of applying Art 23 OECD Model would work, since, in Amount A, there is no transaction and currently no allocation rule in the tax treaties. If it is too difficult to identify the tax-

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21 *Mulachella*, Improving the Effectiveness of the International Advance Pricing Agreement Process, ITPJ 2018/2.

22 *Bronżewska/Majdańska*, The New Wave of Cooperative Compliance Programmes and the Impact of New Technology, ET 2019, 99.

23 *OECD*, International Compliance Assurance Programme, Pilot Handbook 2.0 (2019).

24 *Čičin-Šain/Ehrke-Rabel/Englisch*, Joint Audits: Applicable Law and Taxpayer Rights, WTJ 2018, 100.

25 *Schiavini*, The MLI's Arbitration Clause: How Many Bilateral Tax Treaties Are Actually Covered? TNI 2018, 591.

26 *Capristano Cardoso*, Tax Arbitration in Transfer Pricing Disputes, Intertax 2020 (forthcoming).

27 Council Directive (EU) 2017/1852 of 10. 10. 2017 on tax dispute resolution mechanisms in the European Union, OJ L 265 of 14. 10. 2017, p 1. See also *Piotrowski et al*, Towards a Standing Committee Pursuant to Article 10 of the EU Tax Dispute Resolution Directive: A Proposal for Implementation, Intertax 2019, 678.

payer, countries should have a pragmatic approach and deem the taxpayer to be the parent company of the group. However, one should bear in mind that the parent company will not always be the taxpayer and the value creation concept should be followed. In light of this, the parent company will not always be entitled to the residual returns from marketing or distribution activities (especially if it only retains the legal ownership such as holdings). Also, both countries have to agree on who the taxpayer is, as the taxpayer would need to claim relief from double taxation. In case of disagreement, it is crucial that the taxpayer has access to an effective MAP or mandatory arbitration (as a disagreement on the identification of the taxpayer might result in unrelieved double taxation). Finally, one should consider that many countries apply the ordinary tax credit method and, therefore, if there are not enough taxes paid in the residence country of the identified taxpayer to cover all taxes levied in all market jurisdictions, double taxation could still remain unrelieved.

3. Unfied Approach and Value Creation: Another Way of Overcoming the Issues?

3.1. The Relevance of the Notion of Value Creation for Profit Attribution Purposes

Based on the previous considerations, the authors attempt at providing a proposal on how to deal with the challenges of nowadays (and future) business models from a profit attribution perspective. In that regard, the authors consider that the OECD should focus on developing a principle-based approach.[28]

The tax treatment of highly digitalised businesses should not and cannot be ringfenced, but a comprehensive solution should be adopted. While digitalisation gave rise to the emergence of new disruptive business models, the technological innovations also enabled the digitalisation of traditional business models and their processes, activities, and marketing (distribution) channels. If a ringfenced solution is now adopted, the near future innovations and emergence of new business models will require a constant modification of the international tax regime. Therefore, no reference to *"consumer-facing businesses"* should be made, there should also be no industry carve-outs, and no threshold (e.g., 750 million €) should be used for purposes of scoping. Significant attention should be devoted to the analysis of the business functions and activities (e.g., data analytics based on AI and Big Data innovations) generating significant value for highly digitalised companies and resources required for performing these functions (e.g., user data).

The change of the current international tax rules does not mean that the current principles of taxation, such as attribution of profits to a source state where economic activities take place and value is created, should be changed. This presumption should be a starting point in negotiations between the countries seeking an international consensus on the issues at stake. Therefore, the authors consider that the concept of value creation – embedded in the ALP – should be the guiding principle for attribution of taxing rights to a jurisdiction where income is produced.[29] Nevertheless, there is a need for further clarifications on what is behind the concepts of *"value"* and *"value creation"*.[30] A concept of value creation should be aligned with the economic activities performed in a jurisdiction that generates income.[31]

At the same time, value creation should not be confused with *"value consumption"*.[32] While the first concept refers to performing economic activities to create value for customers, value consumption is the process of consumption by customers in a market state of the value created by a firm. The processes of value creation and value consumption might happen in two different jurisdictions and historically have been addressed by different types of taxes (i.e., corporate income tax and VAT/GST). While customers in a market jurisdiction may be a source of value creation (input factor), in some circumstances and depending on the specific business model, the users' role should not be overestimated. Even for business models that heavily deploy customers' data, user participation is not the only value generating source (and at times can contribute to destroy value, e.g., in case of poisonous users). Other sources such as intangibles, human resources, algorithms, and group synergies might be equally essential in the value creation process of a business model. Direct income tax should continue taxing value creation, while indirect taxes should continue taxing value consumption.

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[28] See also Comments of the WU TPC on the OECD PoW 2019.

[29] See also *Hongler/Pistone* in *IBFD*, Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy, Working paper 20 January 2015. Contra *Schön*, Ten Questions About Why and How to Tax the Digitalized Economy, BIT 2018, 278; *Grinberg*, International Taxation in an Era of Digital Disruption: Analyzing the Current Debate (2018); *Devereux/Vella*, Implications of digitalization for international corporate tax reform (2017).

[30] For a clarification and a differentiation of the concept of value creation and source of income see *Screpante*, Value Creation and the Arm's Length Principle from Comparability to a Functional (i.e. DEMPE) Formula Standard: a Second-Best? (forthcoming).

[31] For the implications of value creation as an allocation of profits standard see *Screpante*, Rethinking the Arm's Length Principle and Its Impact on the IP Licence Model after OECD/G20 BEPS Actions 8-10, WTJ 2019/3; *Screpante*, Formulaic (or Formulary?!) Apportionment Wearing Value Creation Clothes, Kluwer Tax Blog 10. 9. 2019.

[32] *Petruzzi/Buriak*, Addressing the Tax Challenges of the Digitalization of the Economy – A Possible Answer in the Proper Application of the Transfer Pricing Rules? BIT 2018, 52 (section 3).

Global agreements over the allocation of taxing rights introduced as a comprehensive package should ensure that profits are allocated in a consistent and clear way to reduce the potential instances of double taxation. What is more, any global formulary apportionment mechanism generates numerous issues. Those issues reach from the complex political implications, in order to derive an appropriate formula on a consensus basis, to different implementation issues, which can only hardly be overcome. This is especially true for a "mixed" system (with and without the ALP). Accordingly, the authors are of the opinion that the OECD should rather stick to the currently applicable understanding, according to which profits are attributable within MNEs based upon value creation.

It should further be considered that some countries are capital importing and some are capital exporting, hence, they have different tax policies.

Finally, the new rules should be compatible with current international tax rules. From our point of view, the only way to reflect all of the above is by enhancing the application of the ALP with a new nexus and amending the currently applicable rationale of Art 7 OECD Model from *"significant people functions"* to *"significant functions"*, thus resulting in a greater alignment of Art 7 and 9 OECD Model, which are both based upon the notion of value creation on the merits. To this end, increased rights in countries where users/customers are perceived to contribute to the value of MNEs might be reached by amending the current system, rather than by creating new (and incompatible) ones.

The new nexus could be identified by referencing thresholds that are more in line with value creation, e.g.:[33]

- the existence of a user base and the associated data input;
- the volume of digital content derived from the jurisdiction;
- billing and collection in local currency or with a local form of payment;
- the maintenance of a website in a local language;
- responsibility for the final delivery of goods to customers or the provision by the enterprise of other support services such as after-sales services or repairs and maintenance;
- sustained marketing and sales promotion activities, either online or otherwise, to attract customers;
- time period for which sustained business interaction occurs.

The above proposal could be supported by introducing an addition to Art 5 OECD Model. As for the profit attribution to the new nexus (as well as the old one), this should be guided by the performance of a proper transfer pricing analysis. When attributing profits, focus should be placed on the concept of significant functions rather than significant people functions. Indeed, the wording of Art 7 OECD Model already refers to *"functions"* and not to *"people"*.

3.2. Suggested Solution for the Example Shown Above

Based upon the issues addressed in section 3.1., the initially presented example in section 1.2. will now be solved under consideration of the notion of value creation and another proxy for SEP in the market jurisdictions. With respect to the usual distribution activities (which are subject to an arm's length profit attribution in light of Art 9 OECD Model), the authors are of the opinion that the following attributable profits could be seen as being properly compliant with the ALP:

- France: 30 million € (i.e., 10 % return on sales, based on a pan-European benchmarking study, in line with pre-agreed safe-harbours);
- Germany: 20 million € (i.e., 10 % return on sales, based on a pan-European benchmarking study, in line with pre-agreed safe-harbours);
- Poland: 0 €;
- Austria: 0 €;
- Italy: 50 million €, i.e.:
  - Routine: 24 million € (i.e., 10 % return on sales, based on a pan-European benchmarking study, in line with pre-agreed safe-harbours);
  - Residual: some 26 million € (residual income, assuming that taxable profits are equal to consolidated (financial) profits).

With respect to the profit attribution resulting from customers' value, the authors would suggest an approach which can be derived from the application of the ALP. Based upon an analysis of the functions performed by the customers providing data in each country, it could be assumed that, in the specific case illustrated above, those customers are performing the function of limited-risk data collection.

This function could be benchmarked by observing what independent third-party data collectors in different market jurisdictions would earn. Such profitability of independent data collectors would represent the attributable profits to the new nexus, which would be more in line with the value cre-

[33] Cf OECD PoW 2019; see also Comments of the WU TPC on the OECD PoW 2019.

ation generated by the customers, thus not contradicting the actually applicable understanding of profit attribution within MNEs.

A very simplistic benchmarking study performed to understand potential FCMUs (i.e., TNMM based upon the application of the PLI *"full cost mark-up"*) for data collection activities evidences an interquartile range (excluding loss-makers and extreme values) between 1.35 % to 14.29 % with a median of 7.32 %.[34] The following table illustrates the outcome of such a cost-based attribution of additional tax base to the market jurisdiction for user participations.

	Italy (Co)	France (Co)	Germany (PE)	Poland	Austria	Total
Costs for collecting data	10	–	–	–	–	**10**
Share of costs, based on allocation key (e.g. revenues)	240 : 800 = 30 %	300 : 800 = 37.5 %	300 : 800 = 25 %	50 : 800 = 6.25 %	10 : 800 = 1.25 %	**100 %**
Costs allocation	3	3.75	2.5	0.625	0.125	**10**
TNMM (7.32 % FCMU, based on a pan-European benchmarking study)	0.22	0.27	0.18	0.05	0.01	**0.73**

Table 2: Allocation of profits (in million €) derived from the data collection activities to the market jurisdictions

Combining the results shown above, one can see that all jurisdictions would eventually earn a certain portion of the total profits, without leading to double taxation. Based thereupon, the usual distribution activities (carried out in Italy, France, and Germany) would be captured appropriately by the currently applicable transfer pricing/profit attribution understanding; what is more, all market jurisdictions would additionally earn a certain cost-based share of profits in order to account for the value-creation resulting from customers' value. Moreover, the residual profit would be attributed to Italy in the underlying example, which is perfectly in line with the notion of value creation (based upon functions performed, risks assumed, and assets used). The following table illustrates the overall outcome.

	Italy (Co)	France (Co)	Germany (PE)	Poland	Austria	Total
Distribution activities	24	30	20	0	0	**74**
User's contribution activities	0.22	0.27	0.18	0.05	0.01	**0.73**
Residual profits	25.27	–	–	–	–	**25.27**
Total profits	49.49	30.27	20.18	0.05	0.01	**100**
Taxes (assuming tax rate 30 %)	14.8463	9.0824	6.0549	0.0137	0.0027	**30**

Table 3: An overall outcome of the profit allocation in line with the ALP (in million €)

In a Nutshell

Based on the issues pointed out, it becomes evident that the current version of the suggested Unified Approach under Pillar One still seems to be subject to various pitfalls. The Unified Approach is intended to a change of paradigm in international tax law, which is not consensus-based so far; accordingly, even in case one assumes that the current version of the Unified Approach will eventually be published by the OECD in form of a final report, it is unlikely that all countries would eventually implement the new approach, thus meaning that MNEs would – at the end of the day – face numerous situations of double taxation.

Therefore, it would be more efficient to simply adapt the currently applicable principle-based understanding of international profit attribution (profit allocation) between different business units within MNEs in order to capture business models, which are not necessarily dependent on a physical presence in certain jurisdictions, and tax those business units based on their (part of the) value creation.

[34] Please note that the analysis was only carried out based on a quantitative analysis with no further qualitative assessment of the comparables. Moreover, the authors took into account various parameters that might not be valid for the specific case at hand (e.g., the auhtors considered the NACE Rev. 2 code *"631 – Data processing, hosting and related activities; web portals"*). Therefore, these numbers are for exemplification purposes only.