International Tax Policy Forum
and
Institute of International Economic Law

Who Should Tax International Income?

February 1, 2019

Georgetown University Law Center
120 F Street NW
Washington, D.C. 20001

ITPF & IIEL Conference

Who Should Tax International Income?

February 1, 2019

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Who Should Tax International Income?

Featuring Keynote Remarks by
Lafayette "Chip" Harter
Deputy Assistant Secretary (International Tax Affairs)
U.S. Treasury (invited)

Friday, February 1st, 2019
8:30 a.m. – 1:30 p.m.
Georgetown Law
Gewirz Student Center, 600 New Jersey Avenue NW, Washington, DC 20001

Join Georgetown Law's Institute of International Economic Law (IIEL) and the International Tax Policy Forum (ITPF) on February 1st for a conference on the international allocation of rights to tax cross-border income.

Conventions and concepts developed under the auspices of the League of Nations have served as the architecture for international tax relations among developed economies for almost 100 years. Over the last few years, however, historic concepts regarding jurisdiction to tax, attribution of profits to permanent establishments, and arm's-length transfer pricing have come under pressure. Notable national developments include the UK diverted profits tax, the German royalty barrier, the French and Italian digital services taxes, and the U.S. Base Erosion and Anti-abuse Tax (BEAT), to name just a few.

In a related development, the scope of the Organisation for Economic Co-operation and Development's (OECD) ongoing study on taxation of the digitalizing economy has broadened to encompass a fundamental reexamination of the allocation of taxing rights, including a proposal that would establish a minimum tax on the income earned by the foreign affiliates of domestic companies and proposals that would increase taxing rights of market countries.

The 2017 U.S. tax reform both increases U.S. taxation of certain low-taxed income earned by the foreign affiliates of U.S. companies (i.e., the residence-based Global Intangible Low-Taxed Income rules, or GILTI) and increases U.S. taxation of income earned by foreign companies in the provision of services abroad for related U.S. parties (i.e., the source-based BEAT rules).

This conference brings together experts from academia, government, and private practice to share their views on challenges to the international income tax architecture. The closing panel will consider how governments might realistically move forward in an environment where international economic cooperation is under strain.

ITPF/Georgetown Conference Program

Who Should Tax International Income?

Georgetown Law - February 1, 2019

8:30 a.m. **Registration**

8:50 a.m. **Introductory Remarks**
John Samuels
Chairman
International Tax Policy Forum (ITPF)

William Treanor
Executive Vice President and Dean
Georgetown Law

9:00 a.m. **Recent Efforts to Assert Taxing Rights**
Moderator: **James R. Hines, Jr.**
L. Hart Wright Collegiate Professor of Law
Michigan Law

Presenters: **William Morris**
Deputy Global Tax Policy Leader
PwC

9:40 a.m. **Expanding Source, Destination, and User Taxation**
Moderator: **Mihir A. Desai**
Mizuho Financial Group Professor of Finance
Harvard Business School

Presenters: **Michael Devereux**
Director of the Oxford University Centre for Business Taxation and
Professor of Business Taxation at Saïd Business School
Oxford University

Lilian V. Faulhaber
Professor of Law
Georgetown Law

Ruud de Mooij
Division Chief, Tax Policy Division
International Monetary Fund

10:20 a.m. **Strengthening Residence-Basis Taxation**

Moderator: **Michelle Hanlon**
Howard W. Johnson Professor and Professor, Accounting
Massachusetts Institute of Technology (MIT)

Presenters: **Reuven Avi-Yonah**
Professor of Law
Michigan Law

Itai Grinberg
Professor of Law
Georgetown Law

Alan D. Viard
Resident Scholar
American Enterprise Institute (AEI)

11:00 a.m. **Break**

11:15 a.m. **Appropriate Responses to Rising Assertions of Taxing Rights**

Moderator: **Michael J. Graetz**
Columbia Alumni Professor of Tax Law
Columbia Law School

Presenters: **Giorgia Maffini**
Special Advisor
PwC

Paul W. Oosterhuis
Of Counsel, International Tax
Skadden

Ruth Mason
Class of 1957 Research Professor of Law
University of Virginia School of Law

Jeff VanderWolk
Partner
Squire Patton Boggs

12:15 p.m. **Luncheon**

12:30 p.m. **Luncheon Address**

Introduction: **John Samuels**
Chairman
International Tax Policy Forum (ITPF)

Speaker: **Lafayette “Chip” Harter**
Deputy Assistant Secretary (International Tax Affairs)
Department of the U.S. Treasury (*invited*)

1:30 pm **Adjourn**

All interested members of the public are welcome; there is no cost to attend.
Please register here.
Please contact Christine Washington,
IIEL’s Director of Programs & External Affairs,
at 202.662.4193, or lawiiel@georgetown.edu, with any questions.

International Tax Policy Forum

Web site: www.itpf.org

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About the International Tax Policy Forum

Founded in 1992, the International Tax Policy Forum (ITPF) is an independent group of about 50 major multinational companies with diverse industry representation. The Forum's mission is to promote research and education on the taxation of multinational companies.

ITPF sponsors annual public conferences on a major international tax policy issues. The February 1, 2018, conference on "*Who Should Tax International Income?*" is co-sponsored by the Georgetown University Law Center.

On the research front, the Forum has commissioned over 20 papers on international tax policy topics such as the effects of the interest allocation rules on the competitiveness of U.S. firms, the compliance costs of taxing foreign source income, and the linkages between foreign direct investment and domestic economic activity (*see* www.ITPF.org).

Members of the Forum meet three times per year in Washington, DC to discuss key international tax policy issues with leading experts in government, academia, and private practice.

The Forum is chaired by **John Samuels**, Chairman of Global Tax at Blackstone. The Board of Academic Advisors includes ITPF Research Director **James Hines** (University of Michigan), **Alan Auerbach** (University of California, Berkeley), **Mihir Desai** (Harvard), **Michael Devereux** (Oxford), **Michael Graetz** (Columbia), **Michelle Hanlon** (MIT), and **Matthew Slaughter** (Dartmouth).

ITPF Mission Statement

The primary purpose of the Forum is to promote research and education on U.S. taxation of income from cross-border investment. To this end, the Forum sponsors research and conferences on international tax issues and meets periodically with academic and government experts. The Forum does not take positions on specific legislative proposals.

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INSTITUTE OF INTERNATIONAL ECONOMIC LAW
GEORGETOWN UNIVERSITY LAW CENTER

EU, Slovak, French & German Ambassadors on Europe After Brexit

Jason Furman - Chairman of the Council of Economic Advisers

IIEL Executive Education — Annual Conference on WTO Law

ABOUT IIEL

The Institute of International Economic Law (IIEL) is the focal point for the study of international economic law at **Georgetown Law**. IIEL's faculty include leading scholars and practitioners at the forefront of all areas of international economic law. The Institute's original focus on trade has grown significantly to encompass leading capabilities in a range of areas including investment and financial regulation, tax, trade, business and monetary law. IIEL's programs have grown exponentially to impact national and international policymaking, private sector planning and academic discourse. Its publications and updates are routinely read by thousands of policymakers, lawyers and financial professionals each week.

SIGNATURE EVENTS

IIEL hosts programs for policy debate, stakeholder engagement and Executive Education with a wide range of global organizations, law and consulting firms, NGOs and governments.

ILLUSTRATIVE PROGRAMS

- Annual Fintech Week
- Anti-Corruption & Multilateral Organization General Counsel Roundtables
- Systemic Risk in the Global Economy
- Annual Global Trade Academy
- Ambassadors on Europe After Brexit
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- Making IEL Work: Integrating Disciplines & Broadening Policy Choices
- Sovereign Debt Research & Management Conference
- EU State Aid
- Taxation of Intellectual Property in a Global Economy
- Conference on Tax Competition
- Annual Conference on WTO Law
- Reception for Incoming Members of the Congressional Black Caucus

SPEAKERS

Scores of visitors participate in IIEL events each year. Recent speakers have included:

- **Usman Ahmed**, Head of Global Public Policy, PayPal
- **Gérard Araud**, French Ambassador to the United States
- **Kevin Brady,** Chairman of Ways and Means Committee, U.S. House of Representatives
- **Anthony G. Brown,** U.S. House of Representatives
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- **Jason Furman,** Chairman of the Council of Economic Advisors
- **Amias Gerety**, Acting Assistant Secretary of the Treasury for Financial Institutions
- **Sean Hagan,** General Counsel, International Monetary Fund (IMF)
- **Richard Kerschner,** Chief Corporate Development Officer, NEX Optimisation
- **Peter Kerstens,** Lead Counsel, EU Sanctions, European Commission
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- **Julie Nutter,** Head, Sanctions Desk, U.S. Department of State
- **David O'Sullivan,** Ambassador and Head of the EU Delegation to the United States
- **James Pickup,** General Counsel, the Aspen Institute & President and CEO, Middle East Investment Initiative
- **Matthew P. Reed,** Chief Counsel, Office of Financial Research, U.S. Treasury
- **Kenneth Smith Ramos,** Head, NAFTA and Trade Office, Mexico
- **Peter Wittig,** German Ambassador to the United States
- **Brian Wynter,** Governor, Central Bank of Jamaica

IIEL IMPACT

"In an era of global legal practice, Georgetown Law is recognized as a leader in transnational law. As the international commercial architecture evolves, IIEL is at the forefront of our work on the most cutting-edge, complex and multidisciplinary issues. Engagement with the Institute offers students, alumni and practitioners unparalleled opportunities to enhance their legal education and practice."
— William M. Treanor, Executive Vice President and Dean of Georgetown University Law Center

IIEL Faculty Director Chris Brummer with Thomas J. Curry, Comptroller of the Currency

For sponsorship and giving opportunities for IIEL, please contact the Office of Development at 202.662.9500

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Who should tax international income?

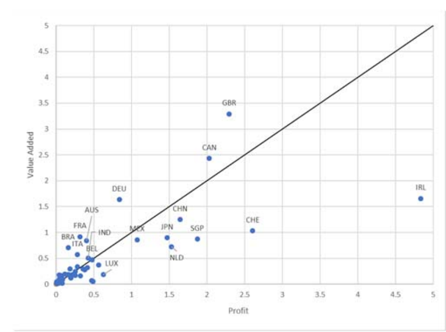
Expanding Source, Destination and User Taxation

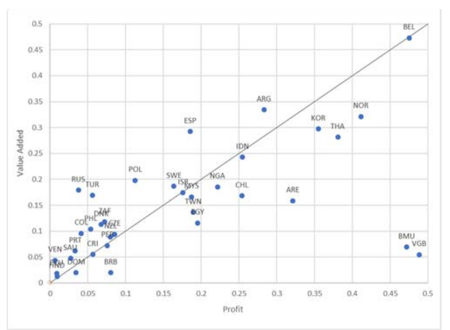
Ruud de Mooij
Fisical Affairs Department

ITPF/Georgetown Conference

February 1, 2019

Misalignment of taxable profit and value creation





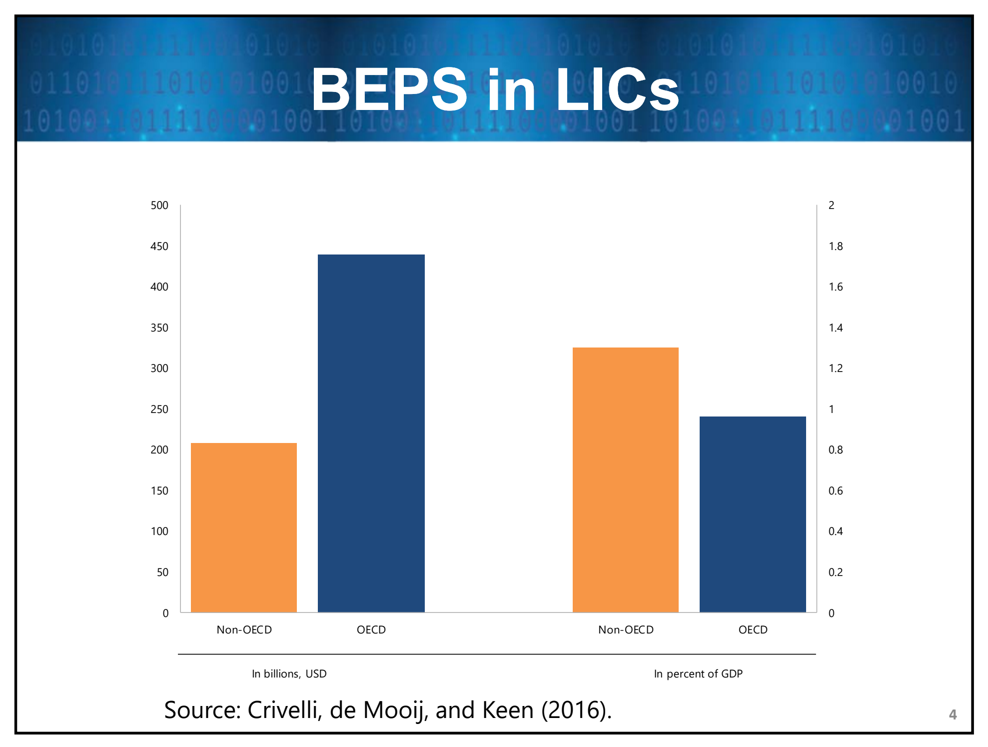
Source: IMF staff calculations using BEA data on US MNCs

The current debate for LICs

	G20/OECD	LICs
Century-old system …	Long seems to have performed well	DTAs restricted 'source'
… gradually got 'broken'	- Spillovers BEPS & tax competition - Complexity - Fairness concerns (digital)	- Spillovers are larger for them (Fig) - Complexity an even bigger concern
BEPS addressed some …	- … forms of avoidance - Yet, complexity grew - Did not address 'allocation' - Did not address tax competition	- Distinct BEPS concerns (OIT, DTA) - Distinct remedies (simplified) - Distinct interest on taxing rights - Different form of tax competition
Current debate goes beyond	- Source (BEAT-like minimum) - Residence (GILTI-like minimum) - Destination (DST, RPA)	- Simplified source measures alike - Formulary apportionment? (Fig)
Multilateralism	Avoiding double taxation / mitigating distortions	

3

BEPS in LICs



Source: Crivelli, de Mooij, and Keen (2016).

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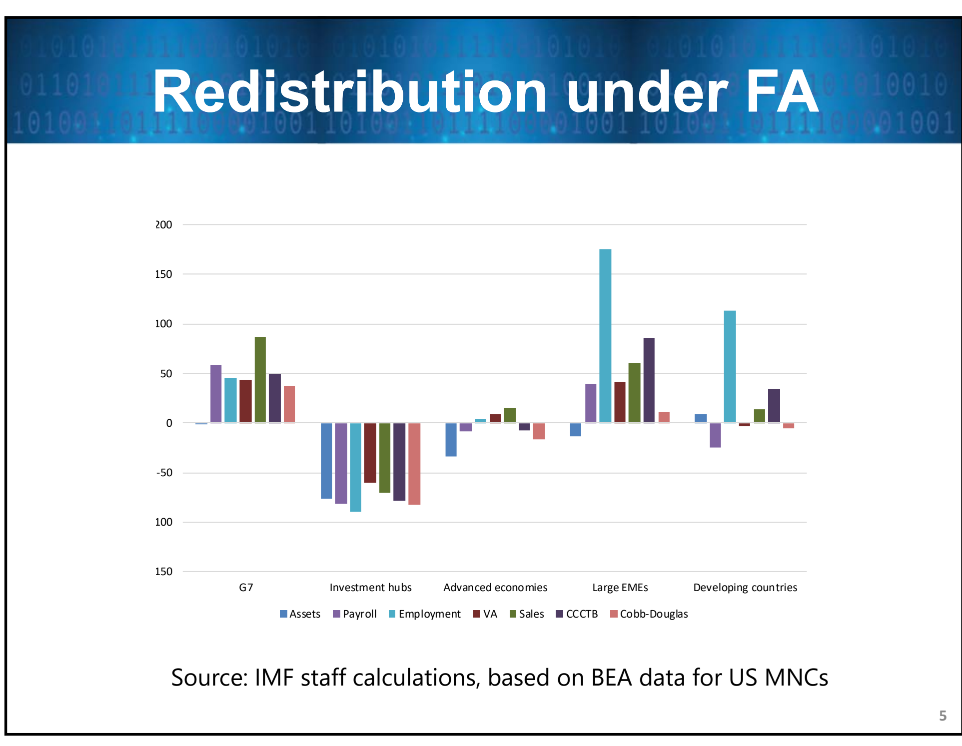
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CCCTB
Cobb-Douglas
Source: IMF staff calculations, based on BEA data for US MNCs
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BEPS, ATAP and the New Tax Dialogue: A Transatlantic Competition?

Reuven Avi-Yonah,
Irwin I. Cohn Professor of Law
University of Michigan Law School

Introduction

- General view: following the conclusion of the BEPS negotiations and the change of Administration, the United States is stepping back from the BEPS process.
- Indicia:
  - did not join the CRS to further automatic exchange of information;
  - decided not to sign the MLI.
- This view is partially wrong.

Introduction

- Tax Cuts and Jobs Act (TCJA) signed into law by President Trump on 22 December 2017 contains multiple provisions that incorporate the principles of the OECD/G20 BEPS into domestic US tax law.
- On 17 February 2016 Treasury announced release of 2016 US Model Income Tax Treaty.
- United States is following the European Union in implementing BEPS and its underlying principle, the *single tax principle*.
- TCJA should not be considered as a 'tax war': it is a long-overdue response to the BEPS by US and a correct application of the *single tax principle* to prevent double non-taxation.

Newly revised US Model Income Tax Convention

- Several measures consistent with the single tax principle:
  - Art. 1(8) revised version of the so-called '*triangular permanent establishment*' rule that has been included in some of the US income treaties since the 1990s
  - New language added to Artt. 10(5); 11(2)(d); 12(2)(b) and 21(2)(b): dividends, interest, royalties and other income paid by an 'expatriated entity' can be subject to 30% WHT for a period of 10 years after the inversion that created it
  - Newly defined term '*special tax regime*' used in Artt. 11(2)(c); 12(2)(a) and 21(2)(a) that would prevent reduction of withholding taxes for deductible related-party payments when the beneficial owner of the payment pays little or no tax on the related income
  - Significant revisions to Art. 22 in order to make treaty access more difficult.

Rev. Proc. 2015-40

- Procedures for Requesting Competent Authority Assistance under Tax Treaties.
- The U.S. competent authority typically will not exercise its discretion to grant benefits where:
  - (i) the applicant or any of its affiliates is subject to a *special tax regime* in its country of residence with respect to the class of income for which benefits are sought. An example of such a regime for interest income is one that allows a notional interest deduction with respect to equity in the residence country;
  - (ii) no or minimal tax would be imposed on the item of income in both the country of residence of the applicant and the country of source, taking into account both domestic law and the treaty provision (‘*double non-taxation*’). For example, double non-taxation would occur if a payment under a *hybrid instrument* was exempt from withholding and generated a deduction in the country of source, while being treated as income exempt from tax in the country of residence of the applicant.

Three BEPS provisions included in TCJA

- § 965: one-time ‘transition tax’ on untaxed accumulated earnings and profits of certain non-US corporations.
- § 951A: foreign minimum tax on 10% US shareholders of controlled foreign corporations to the extent the CFCs are treated as having ‘global intangible low-taxed income’.
- § 59A: base erosion and anti-abuse tax (BEAT) that will be imposed in relation to deductible payments made by certain corporations to their non-US affiliates.

Past accumulations

- These earnings currently exceed $2.6 trillion, are located in just 7 low-tax jurisdictions and are highly concentrated: Apple, Microsoft, Pfizer and GE hold approximately 24% of the offshore profits.
- One-time deemed repatriation on previously untaxed accumulated foreign earnings: 15.5% (cash amounts) and 8% (illiquid assets).
- Taxpayer may elect to pay this tax over an eight-year period.
- If a US shareholder becomes an expatriated entity at any point within the ten-year period following enactment of TCJA, the benefits of the reduced rates would be recaptured.

Future Accumulations – the stick

- § 951(A) a US shareholder of any CFC must include in gross income for a taxable year its GILTI in a manner generally similar to inclusions of Subpart F income.
- GILTI means the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return.
  - GILTI = Net CFC Tested Income – [(10% x QBAI) - Interest Expense)]
- Tax rate of future GILTI 10.5% (21% corporate tax rate and allowing a deduction of 50%).
- Creates incentive to move jobs (not just profits) offshore.

Future Accumulations – the carrot

- § 250(a)(1)(A) provides a 37.5% foreign-derived intangible income deduction (FDII).
- Result: portion of a US corporation's intangible income derived from serving foreign markets is effectively taxed at 13.125%.
- Intent: encourage US multinationals to remain in the country and keep their assets, earnings, jobs and functions there.
- Issues:
  1) Roundtripping transactions / level of further processing required to qualify as foreign use.
  2) Modified nexus approach adopted by the OECD: provision does not require that anything be manufactured in the U.S. Formula is based only on profits from exports. Taxpayers can get the lower rate by importing goods and immediately exporting them.
  3) WTO: FDII regime is a subsidy contingent upon export performance, explicitly prohibited by Art. 3.1(a) of SCM.

Base Erosion

- § 59A(a) an 'applicable taxpayer' is required to pay a tax equal to the 'base erosion minimum tax amount' for the taxable year.
- Generally applies to corporations that over a three-year period have average annual gross receipts of at least $500 million and a 'base erosion percentage' for the taxable year of at least 3%.
- Issues:
  1) Ambiguous and confounding purpose behind BEAT: protection of the US tax base or lack of confidence in policing transfer pricing?
  2) Tax planning opportunities
  3) Can the BEAT be seen as violating non-discrimination provision of Art. 24?

Key BEPS Actions that generated the most controversy in the United States

- Action 1: The Digital Economy
- Disagreement btw US and EU where value is created
- US view: profits originate and taxes are due where R&D is conducted
- Some EU MS: profits should be taxed where the sale of final products is made
- US view is inconsistent with the TP dispute involving *Glaxo* (settled on 11 September 2006) – value of marketing efforts prevails over the value of patents and technical know-how

Digital Taxation in the United States

- Different context, same question: U.S. Supreme Court agreed to hear South Dakota's contention that *Quill Corp v. North Dakota* is obsolete in the e-commerce era and should be overturned.
- *Quill Corp. v. North Dakota* 504 U.S. 98 (1992): an out-of-state business with no physical presence ('*nexus*') in a state could not be required to collect and remit use tax on goods purchased by resident of that state. Requiring collection would violate the Commerce Clause of the U.S. Constitution.
- GAO estimated that state and local governments could gain from about $8 billion to about $13 billion in 2017 if states were given authority to require sales tax collection from all remote sellers.
- Case will also affect Amazon. When selling its own inventory, Amazon collects sales taxes in all states that impose one, but it does not require third-party sellers on its Marketplace platform to collect state sales taxes. For those sales that make up to about half of the company's volume, Amazon says the third-party vendors bears the collecting responsibility.
- However, Amazon collects and remit sales tax on third-party sales into Washington state since November '17 and into Pennsylvania since April '18.

Digital Taxation in the United States

- What can the United States and the European Union learn from each other?
- What happens for direct taxes if the *Quill* physical presence standard is gutted in favor of an economic presence standard?
- Meanwhile, States have enacted three basic approaches:
  - *Click through nexus* (New York State, 2008): if a seller enters into a commission agreement with a NYS resident for referring customers to the remote seller via link on the resident's website, the seller has created a taxable presence in NY and is required to collect and remit sales taxes.
  - *Affiliate nexus* (Louisiana, 2016): dealer includes any person who sells similar products as a Louisiana retailer under a similar name and similar intellectual property, solicits business through an agent with a Louisiana nexus, holds a substantial ownership (over 5 percent) in a Louisiana retailer, or is more than 5 percent owned by a Louisiana retailer.
  - *Economic nexus*: (South Dakota, 2016): an online retailer with a sales threshold of more than $100,000 per year or over 200 transactions essentially created an economic nexus even if there is no physical presence.

Action 2 – Neutralising the Effects of Hybrid Mismatch Arrangements

- § 245A(e) disallows the participation exemption for hybrid dividends that are treated as deductible payments at source.
- § 267A limits the deductibility of payments on hybrid instruments or to hybrid entities.
- The United States will tax at residence if there is no tax at source and will tax at source if there is no tax at residence.
- Is all of this consistent with the spirit of BEPS?
- What about the case where both source and residence are foreign?
- TCJA does not have any material impact on foreign-to-foreign hybrid planning.
- Neither § 245A(e) nor § 267A(a) will significantly impact foreign reverse hybrid entities, i.e. entities that are treated as opaque by its foreign investor and transparent under the jurisdiction where they are established, such as CV-BV and SCS-Sarl.
- Obama Administration's proposal: §§ 954(c)(3) and 954(c)(6) would not have been applied to payments made to a foreign reverse hybrid held by one or more US persons when such amounts were treated as deductible payments received from foreign related persons.

Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

- The United States did not join the MLI primarily due to the inclusion of a general anti-abuse rule based on the principal purposes of transactions.
- In 1999, the US Senate refused to approve the ratification of negotiated treaties with Italy and Slovenia that originally contained a main purpose clause.
- Italian negotiators wanted to include a very broad anti-abuse provision, similar to Art. 30 of the '95 treaty with Israel:
  - 'The competent authorities of the Contracting States, upon their mutual agreement may deny the benefits of this Convention to any person, or with respect to any transaction, if in their opinion the receipt of those benefits, under the circumstances, would constitute an abuse of the Convention according to its purposes.'
- West declared that this broad, subjective anti-abuse rule was rejected for several reasons:
  - Provided less certain standard against which a taxpayer could meaningfully evaluate its transaction;
  - Main purpose test appears in a significant number of treaties around the world and it is more consistent with international norms and will likely be the subject of more interpretive law than the other standards.

Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances

- They gravitated toward the main purpose standard because it corresponds to the U.S. a principal purpose standard which is applied in almost 30 provisions of the IRC, e.g., § 269A; § 877 etc.
- The main purpose test was apparently modelled on similar provisions found in many modern treaties of the United Kingdom.
- Lindy Paull (JCT): '… the main purpose tests … inject considerable uncertainty into the treaty provisions because such tests are subjective and vague.'
- US Senate Committee: '… the inclusion of such tests represents a fundamental shift in US treaty policy, which is based on clear, bright-line objective tests.'
- Should the term 'a principal purpose' be interpreted according to *Santa Fe* or according to settled case law involving IRC provisions, such as §§ 367 and 877, e.g. *Furstenberg*, *Dittler Brothers*, etc.?

Shareholder Residence: The Other Residence Tax Base

Alan D. Viard
American Enterprise Institute
February 1, 2019

"Worldwide"-territorial debate

- Debate often misleading – "keeping jobs in United States" versus "competiveness," "bring home profits trapped abroad"
- Jobs are not the right metric – no country can have competitive advantage in all sectors – repatriation penalty can be avoided under either system

"Worldwide" misnomer

- Truly worldwide system would be great for United States – tax everyone everywhere
- Impossible because U.S. can't tax foreign parents' overseas income
- "Worldwide" system combines territorial system (all firms taxed on U.S. income) and charter-based system (U.S.-chartered parents also taxed on overseas income)

Pure territorial system

- Regardless of charter, all corporations taxed only on U.S. income
- No penalty on investing through U.S.-chartered corporations
- But, high penalty on investing (and booking profits) in Unites States for all corporations

Pure “worldwide” system

- *For U.S.-chartered parents*, no penalty on investing (and booking profits) in United States
- But, penalty still fully applicable for foreign-chartered parents
- And, high penalty on investing through U.S.-chartered parents

Shareholder taxation

- Tax capital gains and dividends of American shareholders, regardless of where corporation is chartered and invests (or books profits)
- Eliminates penalties on investing through U.S.-chartered parents *and* on investing (and booking profits) in United States
- But, doesn’t tax economic rents foreigners earn from U.S. operations

Toder-Viard 2016 plan (1)

- Reduce corporate tax rate from 35 to 15 percent
- Tax dividends and capital gains as ordinary income, with imputation credit
- Mark-to-market taxation of capital gains and losses (with smoothing provision) to negate lock-in effect

Toder-Viard 2016 plan (2)

- Lowers, but does not eliminate, penalty on investing (and booking profits) in United States
- Lowers, but does not eliminate, penalty on investing through U.S.-chartered parents
- Still taxes foreigners' economic rents, but not to the same extent

Toder-Viard 2016 plan (3)

- Revenue neutral in long run, with revenue gain during transition
- Slight increase in progressivity

Update (1)

- May still be beneficial to lower corporate rate to 15 percent – raising capital gain and dividend taxes could still offset revenue and distributional effects
- Smaller capital gain tax increase needed for revenue neutrality – could probably maintain realization basis, but maybe tax gains at death

Update (2)

- If policymakers desire to raise more revenue from taxation of corporate income, tax increases should be focused at shareholder level

Speaker Biographies

John Samuels

John M. Samuels is a Senior Managing Director and the Chairman of Global Tax at Blackstone. Before joining the firm, Mr. Samuels worked at General Electric as the Vice President and Senior Counsel for Tax Policy and Planning for almost 30 years and was responsible for the company's global tax policy, tax planning and tax compliance operations. Mr. Samuels is a Chairman of the Alliance for Competitive Taxation (ACT), Chairman of the International Tax Policy Forum, and is the George W. and Sadella D. Crawford Visiting Lecturer at Yale Law School, where he teaches U.S. taxation of international transactions. Prior to joining GE, Mr. Samuels was a partner in the law firm of Dewey, Ballantine and served in the administrations of Presidents Jimmy Carter and Ronald Reagan as the Deputy Tax Legislative Counsel and Tax Legislative Counsel of the U.S. Department of Treasury. Mr. Samuels is a Fellow of the American College of Tax Counsel, a Trustee of the American Tax Policy Institute, and received the Tax Foundation's Distinguished Service Award for his contributions to tax policy. Mr. Samuels is a graduate of Vanderbilt University and the University of Chicago Law School, and received an LLM in Taxation from NYU Law School.

William M. Treanor

In 2010, Dean Treanor joined the Law Center from Fordham Law School, where he had been dean of the law school since 2002 and Paul Fuller Professor. He had been on the Fordham faculty since 1991. He has also been a visiting professor at the Sorbonne.
From 1998-2001, Dean Treanor served as Deputy Assistant Attorney General in the Office of Legal Counsel, U.S. Department of Justice. From 1987-1990, he was associate counsel, Office of Independent Counsel, during the Iran/Contra investigation, and in 1990 he served as a special assistant U.S. attorney, Misdemeanor Trial Unit, Office of the U.S. Attorney for the District of Columbia. Dean Treanor was law clerk to the Honorable James L. Oakes, U.S. Court of Appeals for the Second Circuit, Brattleboro, Vermont. He has published widely, with a focus on constitutional law and legal history.

James R. Hines Jr.

James Hines teaches at the University of Michigan, where he is Richard A. Musgrave Collegiate Professor of Economics in the department of economics, L. Hart Wright Collegiate Professor of Law in the law school, and Research Director of the Office of Tax Policy Research. His research concerns various aspects of taxation. He holds a B.A. and M.A. from Yale University and a Ph.D. from Harvard, all in economics. He taught at Princeton and Harvard prior to Michigan, and has held visiting appointments at Columbia University, the London School of Economics, the University of California-Berkeley, and Harvard Law School. He is a research associate of the National Bureau of Economic Research, research director of the International Tax Policy Forum, former co-editor of the *Journal of Economic Perspectives*, and once, long ago, was an economist in the United States Department of Commerce.

William H. Morris

William H. Morris was appointed Chair of the BIAC Tax Committee (Business and Industry Advisory Committee to the OECD) in Paris in November 2012. As Tax Committee Chair, Will has been closely involved in all aspects of the BEPS project, including follow-up and implementation, participating in public OECD consultations, coordinating and filing comments on behalf of business, and meeting with many formal and informal OECD groupings as well as national governments.

He is Chair of the AmCham EU Tax Committee in Brussels and was Chair of the Confederation of British Industry (CBI) Tax Committee in London from 2010-16, and. He is also chair of the European Tax Policy Forum, a registered UK charity that since 2005 has commissioned over 40 papers from leading academic economists on business tax issues.

Will is currently Deputy Global Tax Policy Leader at PricewaterhouseCoopers, having recently moved to PWC from GE after 17 years. From 1995-97 Will worked at the IRS, and from 1997-2000 worked in the Office of Tax Policy at the U.S. Treasury. At Treasury his areas of responsibility included subpart F, foreign partnerships and other fiscally-transparent entities, as well as entity classification issues ("check-the-box").

Will has degrees in history, law, and theology from Trinity College Cambridge, the University of Virginia, and St Mellitus College, respectively. He is qualified as a U.S. attorney and an English solicitor.

Mihir A. Desai

Mihir A. Desai is the Mizuho Financial Group Professor of Finance at Harvard Business School and a Professor of Law at Harvard Law School. Professor Desai's areas of expertise include tax policy, international finance, and corporate finance. His academic publications have appeared in leading economics, finance, and law journals. His work has emphasized the appropriate design of tax policy in a globalized setting, the links between corporate governance and taxation, and the internal capital markets of multinational firms.

He received his Ph.D. in political economy from Harvard University; his MBA as a Baker Scholar from Harvard Business School; and a bachelor's degree in history and economics from Brown University. In 1994, he was a Fulbright Scholar to India.

Michael Devereux

Professor Michael Devereux is Director of the Oxford University Centre for Business Taxation, Professor of Business Taxation and Associate Dean for Faculty at Saïd Business School, Professorial Fellow at Oriel College, Oxford, and Co-Director of the MSc in Taxation in the Oxford Law Faculty. He is Honorary President of the International Institute for Public Finance, Research Director of the European Tax Policy Forum, and a member of the Board of Academic Advisers of the International Tax Policy Forum. He is Research Fellow of CESifo and the Centre for Economic Policy Research. He is a member of the editorial boards of the *British Tax Review* and the *World Tax Journal* and was previously Editor in Chief of *International Tax and Public Finance* and Managing Editor of *Fiscal Studies*. He has published widely in academic journals. He has also made contributions to the tax policy-making debate in the UK and internationally, especially through the OECD, the IMF, and the EU Commission where he was a member of the European Commission High Level Expert Group on Taxation of the Digital Economy. He acted as Specialist Adviser to the Economic Affairs Committee of the House of Lords on its enquiry into corporation tax in 2013. Prior to his appointment at CBT, he obtained his PhD in Economics at University College London and was Professor and Chair of the Economics departments at the Universities of Warwick and Keele.

Lilian V. Faulhaber

Lilian V. Faulhaber is an Associate Professor at Georgetown University Law Center. Before joining the Georgetown faculty in 2015, she was an Advisor to the Base Erosion and Profit Shifting (BEPS) Project at the Organisation for Economic Co-operation and Development. Prior to working at the OECD, she was an Associate Professor at Boston University School of Law. Professor Faulhaber was an associate at Cleary Gottlieb Steen & Hamilton LLP in New York and clerked for the U.S. District Court for the District of Massachusetts. She is a graduate of Harvard College, Cambridge University, and Harvard Law School, where she was editor-in-chief of the Harvard International Law Journal. Professor Faulhaber teaches courses on federal income taxation, international business transactions, and taxation in the European Union, and she has published articles on international taxation, tax competition, tax avoidance, charitable giving, and European Union law.

Ruud de Mooij

Ruud de Mooij is Division Chief for the Tax Policy Division of IMF's Fiscal Affairs Department. The Division delivers technical assistance in tax policy to IMF member countries; performs analytical work on topical tax policy issues; and supports IMF country teams on tax-related matters. Before joining the IMF, Mr. De Mooij was Professor of Public Economics at Erasmus University Rotterdam and Economist at CPB in the Netherlands. He is currently also a Research Fellow at the University of Oxford, the University of Bergen, ZEW in Mannheim and member of the CESifo network in Munich. His main research interests are in public finance. He has extensively published on tax issues, including in the *American Economic Review* and the *Journal of Public Economics*.

Michelle Hanlon

Michelle Hanlon is the Howard W. Johnson Professor at Massachusetts Institute of Technology Sloan School of Management. She earned her Ph.D. at the University of Washington. She teaches both financial accounting and the M.B.A. tax course, Taxes and Business Strategy. She is the winner of the 2013 Jamieson Prize for Excellence in Teaching at Massachusetts Institute of Technology Sloan School of Management.

Professor Hanlon's research focuses primarily on the intersection of taxation and financial accounting. She has published research studies in the *Journal of Accounting & Economics*, the *Journal of Accounting Research, The Accounting Review*, the *Review of Accounting Studies*, *The Journal of Finance*, the *Journal of Financial Economics*, the *Journal of Public Economics*, and others. She has won several awards for her research and has presented her work at numerous universities, conferences, and policy forums. Professor Hanlon has served on several editorial boards and currently serves as an editor at the *Journal of Accounting & Economics*.

Professor Hanlon has served as the chair of the accounting group at MIT Sloan, the chair of the undergraduate programs at MIT Sloan, and a member of the Committee on Curricula for MIT. She is a co-author on two textbooks: (1) *Taxes and Business Strategy* (published by Pearson), and (2) *Financial Accounting* (published by Cambridge Business Publishers). She has testified in front of the U.S. Senate Committee on Finance and the U.S. House of Representatives Committee on Ways and Means. She served as a U.S. delegate to the American-Swiss Young Leaders Conference in 2010 and worked as an Academic Fellow at the U.S. House Ways and Means Committee in 2015.

Reuven S. Avi-Yonah

Reuven S. Avi-Yonah, the Irwin I. Cohn Professor of Law and director of the International Tax LLM Program, specializes in corporate and international taxation. He has served as a consultant to the U.S. Department of the Treasury and the Organisation for Economic Co-operation and Development (OECD) on tax competition, and is a member of the steering group for OECD's International Network for Tax Research. He also is a member of the American Law Institute, a fellow of the American Bar Foundation and the American College of Tax Counsel, and an international research fellow at Oxford University's Centre for Business Taxation. In addition to prior teaching appointments at Harvard University (law) and Boston College (history), he practiced law with Milbank, Tweed, Hadley & McCloy in New York; with Wachtell, Lipton, Rosen & Katz in New York; and with Ropes & Gray in Boston. After receiving his BA, *summa cum laude*, from Hebrew University, he earned three additional degrees from Harvard University: an AM in history, a PhD in history, and a JD, *magna cum laude*, from Harvard Law School. He has published more than 150 books and articles, including *Advanced Introduction to International Tax* (Elgar, 2015), *Global Perspectives on Income Taxation Law* (Oxford University Press, 2011), and *International Tax as International Law* (Cambridge University Press, 2007).

Itai Grinberg

Itai Grinberg is a Professor of Law at Georgetown University Law Center and a member of the Institute of International Economic Law at Georgetown.

Prof. Grinberg has provided expert testimony before the US Congress and the German Bundestag, and has acted as an outside academic tax expert for the Organisation for Economic Co-operation and Development. He also consults to governments, multilateral institutions, and corporations, all on a selective basis.

Prior to joining the Georgetown law faculty, Prof. Grinberg served in the Office of International Tax Counsel at the United States Department of the Treasury. At Treasury, he represented the United States on tax matters in multilateral settings, negotiated tax treaties with foreign sovereigns, had responsibility for a wide-ranging group of cross-border tax regulations, and was involved in international tax legislative efforts. Among other matters, he worked on every aspect of FATCA beginning with the original budget proposal, and was the U.S. official charged with reinvigorating the OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes.

Earlier in his career, Prof. Grinberg practiced law as an attorney in the tax group at Skadden, Arps, Slate, Meagher & Flom LLP, where he focused on a wide range of international tax planning and controversy matters. In 2005, he served as Counsel to the President's Advisory Panel on Federal Tax Reform, a bipartisan advisory commission appointed by President Bush that proposed fundamental tax reforms for the United States.

Mr. Grinberg holds degrees from Amherst College and Yale Law School. He is a Term Member of the Council on Foreign Relations, and serves on the editorial board of the Journal of International Economic Law.

Alan D. Viard

Alan D, Viard is a resident scholar at the American Enterprise Institute (AEI), where he studies federal tax and budget policy.

Prior to joining AEI, Viard was a senior economist at the Federal Reserve Bank of Dallas and an assistant professor of economics at Ohio State University. He has also been a visiting scholar at the US Department of the Treasury's Office of Tax Analysis, a senior economist at the White House's Council of Economic Advisers, and a staff economist at the Joint Committee on Taxation of the US Congress. While at AEI, Viard has taught public finance at Georgetown University's Public Policy Institute. He also cohosted the New York University Law School tax policy colloquium in the spring 2015 semester. Earlier in his career, Viard spent time in Japan as a visiting scholar at Osaka University's Institute of Social and Economic Research.

A prolific writer, Viard is a frequent contributor to AEI's "On the Margin" column in Tax Notes and was nominated for Tax Notes's 2009 Tax Person of the Year. He has also testified before Congress, and his work has been featured in a wide range of publications, including Room for Debate in The New York Times, TheAtlantic.com, Bloomberg, NPR's Planet Money, and The Hill. Viard is the coauthor of "Progressive Consumption Taxation: The X Tax Revisited" (2012) and "The Real Tax Burden: Beyond Dollars and Cents" (2011), and the editor of "Tax Policy Lessons from the 2000s" (2009).

Viard received his Ph.D. in economics from Harvard University and a B.A. in economics from Yale University. He also completed the first year of the J.D. program at the University of Chicago Law School, where he qualified for law review and was awarded the Joseph Henry Beale prize for legal research and writing.

Michael Graetz

Michael J. Graetz is the Columbia Alumni Professor of Tax Law at Columbia Law School. Before coming to Columbia in 2009, he was the Justus S. Hotchkiss Professor of Law at Yale University, where he had taught since 1983. His most recent books are *The Burger Court and the Rise of the Judicial Right*, forthcoming from Simon & Schuster, and *Follow the Money: Essays on International Taxation*. Previous books include *The End of Energy: The Unmaking of America's Environment, Security and Independence* (MIT Press 2011); *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States,*(Yale University Press 2008); *Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth* (Princeton University Press 2005); *True Security: Rethinking Social Insurance* (Yale University Press 1999); *The U.S. Income Tax: What It Is, How It Got That Way and Where We go From Here* (W.W. Norton & Co, 1999) (a paperback edition of the book originally published as *The Decline (and Fall?) of the Income Tax*); and *Foundations of International Income Taxation* (Foundation Press 2003). He is also the co-author of a leading law school coursebook, *Federal Income Taxation: Principles and Policies*, and has published more than 80 articles on a wide range of federal tax, international tax, health policy, and social insurance issues.

During January-June 1992, Michael Graetz served as Assistant to the Secretary and Special Counsel at the Treasury Department. In 1990 and 1991, he served as Treasury Deputy Assistant Secretary for Tax Policy. In 2013, Professor Graetz was awarded the Daniel M. Holland Medal by the National Tax Association for outstanding contributions to the study and practice of public finance. He has been a John Simon Guggenheim Memorial Fellow, and he received an award from Esquire Magazine for courses and work in connection with provision of shelter for the homeless. He served on the Commissioner's Advisory Group of the Internal Revenue Service. During 1969-1972, he served in the Treasury Department in the Office of Tax Legislative Counsel. He is a fellow of the American Academy of Arts and Sciences.

Professor Graetz is a graduate of Emory University (B.B.A. 1966) and the University of Virginia Law School (J.D. 1969). A native of Atlanta, Georgia, Michael Graetz is married to Brett Dignam and has five children.

Giorgia Maffini

Giorgia Maffini is a Special Advisor on Tax Policy and Transfer Pricing with PwC (London).

Before joining PwC, she was the Deputy Head of the Tax Policy and Statistics Division at the OECD Centre for Tax Policy and Administration (2016-2018). There she has led an important part of the work and drafting of the recent 2018 OECD/G20 Interim Report on Tax Challenges Arising from Digitalisation. Before that, she was a senior economist at the Oxford University Centre for Business Taxation (2006-2016). Among others, Giorgia has published on the American Economic Journal: Economic Policy, the Journal of Banking and Finance, the Oxford Review of Economic Policy, the Oxford Bulletin of Economics and Statistics and the European Economic Review. She holds a PhD in Economics from the University of Warwick (UK).

Paul Oosterhuis

Mr. Oosterhuis has extensive experience in mergers and acquisitions, post-acquisition integration, spin-offs, internal restructurings and joint ventures. He also represents multinational companies in nontransactional international tax planning and assists clients in resolving high-stakes, complex tax controversies.

Mr. Oosterhuis has been ranked in the top tier of *Chambers USA* each year since the guide was first released in 2003. He also has been ranked in the top tier of *Chambers Global* each year since 2002. In addition, he repeatedly has been selected for inclusion in *Tax Directors Handbook*, *The Legal 500 U.S.*, *Who's Who Legal: Corporate Tax*, *IFLR1000* and *The Best Lawyers in America*. He also was named as a 2017 BTI Client Service All-Star.

Having worked for decades in complex and high-profile cross-border tax matters, he also frequently testifies on international tax policy matters before congressional committees, including the U.S. House Committee on Ways and Means at its 2013 hearing on "Tax Reform: Tax Havens, Base Erosions and Profit Shifting."

Mr. Oosterhuis is a frequent speaker and author on international tax law developments. In addition to regularly authoring Skadden's publications, he is author (or co-author) of several articles.

Ruth Mason

Ruth Mason is a Professor of Law at the University Of Virginia School Of Law. Her work focusing on international and comparative taxation has appeared in both student- and peer-edited journals and has been cited by the U.S. Supreme Court. She was a Fulbright Senior Scholar at WU Vienna and has been a visiting professor at Johannes Kepler University, Leiden University, and Panthéon Sorbonne, and Yale Law School. From 2018 to 2019, she will be the professor-in-residence at the International Bureau of Fiscal Documentation. Mason has served as National Reporter for the United States to both the International Fiscal Association (IFA) and European Association of Tax Law Professors (EATLP) annual congresses.

Jeff VanderWolk

Jeff VanderWolk helps organizations, businesses and individuals understand and respond to global developments in cross-border taxation. Drawing on both technical expertise and commercial savvy, he helps clients make sense of complex, emerging areas of tax law such as the taxation of the digital economy, transfer pricing and treaty-based structuring.

Jeff has extensive experience in private practice and government and agency work, most recently as head of the Tax Treaty, Transfer Pricing and Financial Transactions Division at the Organization for Economic Co-operation and Development's (OECD) Centre for Tax Policy and Administration in Paris. There, he was at the forefront of shaping international tax policies and responsible for the rollout of the multilateral instrument currently being implemented in several countries around the world. He has also worked at the heart of US tax policymaking, gaining deep knowledge of tax reform and its practical applications. He has advised clients in Asia Pacific, Europe and the US on tax planning, structuring and compliance across numerous industry sectors.

Earlier in his career, Jeff served as executive director at the Washington DC office of an international accounting firm (2013-16), where he advised on international tax legislative and policy developments. He also served as International Tax Counsel to the US Senate Committee on Finance (2011-13) and as a Special Counsel in the Office of the Chief Counsel at the Internal Revenue Service (2005-06). In private practice, Jeff worked extensively on tax policy matters and advised clients globally on significant transactions as an international tax adviser – serving as partner both at international law and accountancy firms, in London and Hong Kong, for more than a decade until 2005, and as managing director and head of Tax for Asia Pacific at a major US financial institution for three years (2006-09).

Lafayette "Chip" Harter

Chip Harter is the Deputy Assistant Secretary for International Tax Affairs in the Office of Tax Policy at the US Department of the Treasury. In this capacity, he is responsible, on behalf of the Assistant Secretary, for the conduct of legal and economic aspects of tax policy relative to the representation of the United States in bilateral and multilateral relations with other countries, as well as advising the legal and economic staffs within the Office of Tax Policy, other offices of the Treasury Department and other government agencies as to policy analysis and interpretation for domestic legislation and administrative guidance in all matters involving cross border taxation. Mr. Harter serves as the U.S. delegate to the Committee on Fiscal Affairs (CFA) in the Organization for Economic Cooperation and Development (the OECD).

Prior to joining Treasury, Mr. Harter was a principal in the Washington National Tax Practice of PricewaterhouseCoopers LLP. During his 18 years with PwC, he engaged in a broad international tax practice advising a numerous clients on a range of issues, including structuring both inbound and outbound ventures, the establishment of efficient international structures, the formation of joint ventures and private equity funds and international mergers and acquisitions. He served as a national technical resource of PwC on tax issues relating to international financial transactions. During the 18 years prior to his joining PwC, Mr. Harter was first an associate and then a partner with the law firm of Baker & McKenzie, practicing first in its Chicago and then in its Washington D.C. office. His practice with Baker & McKenzie included both tax litigation and a broad international transactional practice.

He is a member of the American Bar Association Tax Section, the District of Columbia Bar Association Tax Section, and the International Fiscal Association. Mr. Harter has published numerous articles on international tax topics and has regularly spoken on panels on international tax issues at leading tax conferences. He graduated from Harvard College in 1977 and the University of Chicago Law School in 1980, where he was comments and articles editor on the managing board of The University of Chicago Law Review. After graduating, he clerked for the Honorable Thomas McMillen of the United States District Court for the Northern District of Illinois.

Transfer Pricing After BEPS: Where Are We and Where Should We Be Going

By Joe Andrus and Paul Oosterhuis

Joe Andrus and Paul Oosterhuis analyze transfer pricing developments, their impact on multinational tax planning and the likelihood for increased tax disputes. Included in the article is a review of fundamental alternatives to the arm's-length standard, including various proposals that allocate income to the jurisdiction where a product is sold or a service provided.

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In October 2015, the G20 and the OECD approved and issued a series of reports in their project on Base Erosion and Profit Shifting.[1] Transfer pricing issues formed a significant portion of the subject matter of those reports. The final report on BEPS Actions 8–10: *Aligning Transfer Pricing Outcomes and Value Creation*[2] contained nearly 200 pages of revisions to the OECD Transfer Pricing Guidelines.[3] The final report on BEPS Action 13: *Transfer Pricing Documentation and Country-by-Country Reporting*[4] rewrote Chapter V of the OECD Guidelines, setting out a new coordinated approach to transfer pricing documentation and reporting, including a requirement that large multinational enterprises prepare and submit annually a country-by-country report of their income, taxes paid and certain indicators of economic activity.

The BEPS transfer pricing reports address a number of topics. However, they are directed toward one overarching objective: the alignment of the place where income is reported for tax purposes with the place of value creation. The first paragraph of the explanatory statement to the October 2015 BEPS reports suggests that the collective BEPS outputs constitute "a bold move by policy makers to … ensure that profits are taxed where economic activities take place and value

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is created."[5] The transfer pricing elements of the project are especially important parts of the G20/OECD effort to meet this objective.

In the 2013 Action Plan that initiated the BEPS Project,[6] the G20 and OECD countries committed to focus attention on three transfer pricing problems that country representatives believed allow a separation of income from relevant economic activity under pre-BEPS interpretations of the arm's-length principle. These are: (i) the transfer of intangibles and other mobile assets for less than full value; (ii) the over-capitalization of low-taxed group companies; and (iii) contractual allocations of risk to low tax environments in transactions that would be unlikely to occur between unrelated parties. To address these problems, the G20 and OECD countries committed themselves in the Action Plan to the following work:

- Developing rules to prevent profit shifting by ensuring that inappropriate returns do not accrue to an entity solely because of its contractual assumption of risk.[7]
- Developing rules ensuring that inappropriate returns do not accrue to an entity merely because it has provided capital.[8]
- Developing rules ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation. This work was to include updates to the provisions of the OECD Guidelines on hard to value intangibles and cost contribution arrangements.[9]
- Clarifying the circumstances under which transactions can be recharacterized or disregarded by tax administrations.[10]
- Clarifying transfer pricing rules related to profit splits and other transfer pricing methods in the context of global value chains.[11]

The Action Plan underscored the OECD's strong desire to find solutions to the perceived transfer pricing problems by inviting delegates to address those issues either under the arm's-length principle or through special measures going beyond the arm's-length principle.[12] While the various workstreams listed in the Action Plan were obviously interrelated, the work on risk, provision of capital or funding and transfers of intangibles were the foundational elements of the BEPS transfer pricing work.

Separation of Risk from Business Functions

The OECD Guidelines have long recognized that a party assuming a greater risk in its business dealings will tend to expect a higher return as compensation for assuming the risk.[13] This means that in transactions between associated enterprises, a member of an MNE group that assumes risk can expect a return that correlates with the level of risk it assumes, unless the risk factor plays out in a way that reduces or eliminates the return anticipated. While this correlation between risk and reward is a well-established transfer pricing principle, there was little general guidance in the pre-BEPS OECD Guidelines on how one determines which entities in an MNE group in fact bear specific risks. 2010 changes to the OECD Guidelines had provided some guidance on the allocation and transfer of risk in business restructuring transactions,[14] but there was little comprehensive treatment of risk in the general provisions of the OECD Guidelines. The BEPS work sought to rectify this perceived lack of clear guidance.

The Final BEPS Transfer Pricing Report begins by discussing how, as a general matter, one determines the actual terms and conditions of a related party transaction to be analyzed under the transfer pricing rules. The report suggests that one should begin with the terms, conditions and allocations of risk contained in contracts and other written terms of the transaction in question.[15] However, if written terms are ambiguous or missing, or if the conduct of the parties differs from the transactional terms contained in the contracts, one must "accurately delineate" the transaction based on the conduct of the parties.[16] This delineation of the transaction requires a careful, detailed, facts and circumstances-based functional analysis.[17]

One of the important factual circumstances to be considered in delineating the transaction relates to risk. The Final BEPS Transfer Pricing Report suggests that the allocation of risk follows the general conduct related rule on delineation of transactions. That is, a particular risk will be allocated to the party or parties in the MNE group that contractually assumes the risk, provided the relevant parties also conduct their affairs in a manner consistent with what the contracts say about the allocation of risk. At the heart of the factual investigation of how the parties' conduct affects the determination of which entity or entities in the MNE group actually bear risk are two questions: (i) which party or parties control the risk, and (ii) which party or parties have the financial wherewithal to assume the risk.[18] The report suggests that unless a party controls the risk in question, and has the financial wherewithal to assume the risk, its conduct will not support an allocation of the risk to that party, even if contracts clearly assign the risk to that party. If these requirements are not satisfied, the risk will be deemed to be borne for transfer pricing purposes by entities within the MNE group which do control the risk and which have financial wherewithal to assume the risk.[19]

The Final BEPS Transfer Pricing Report defines what it means to control risk for this purpose. It suggests that there are three elements critical to the efforts of an independent business to manage its risks. These elements are: (i) making decisions to take on risk, lay off risk or to decline to undertake a risk bearing opportunity; (ii) making decisions regarding how to respond to the risks arising in connection with a business opportunity, and (iii) making decisions regarding the mitigation of risk by taking actions that affect risk outcomes. The first two of these the BEPS report defines as being the functions that control risk. Risk mitigation, however, is not a required element of control according to the BEPS Report.[20]

This categorization of risk-related functions and the definition of control is quite arbitrary and is not always clear. Under these rules, however, a party must have the capacity to make, and must actually make, some of the risk controlling decisions of the MNE group in order to claim that it bears that risk in the accurately delineated transaction. If there is no capacity to control risk, that is if all decisions related to risk are made elsewhere in the group, the entity will not be treated as having assumed the risk and will not be entitled to any risk-related premium return from the business transactions that are the subject of the transfer pricing analysis. Thus, consistent with the income alignment objectives of BEPS, risk and risk premiums will go to the entities performing the income producing activity of controlling risk; a low-function entity, with no capacity to control risk or make risk-related decisions, will not be treated as bearing risk and will not be able to claim returns based on mere contractual allocations of risk.[21]

Tax planning strategies related to risk have involved allocating risk to low tax environments in order to claim that tax-advantaged entities in the group are entitled to significant income as compensation for bearing risk. While in the past some have thought that such allocations of risk could be achieved merely by adopting contracts specifying where the risk is allocated, following BEPS the critical question will be how much and what type of decision making capacity must be present in a particular entity in order to support the contractual risk allocation and establish that the entity controls its risks.

A careful reading of the BEPS changes to the Guidelines on risk suggests that the required level of activity to support a finding of control may not be terribly significant. While paragraphs 1.65 and 1.66 of the BEPS Report make it clear that some actual participation in decision making is required, paragraph 1.94 makes it clear that this decision making function can be shared with other entities. That paragraph also suggests that where the decision making responsibility is shared, as long as some decisions are taken by the entity contractually assigned the risk, no further inquiry is required to confirm that that party will be treated as bearing risk for transfer pricing purposes.

While in the past some have thought that such allocations of risk could be achieved merely by adopting contracts specifying where the risk is allocated, following BEPS the critical question will be how much and what type of decision making capacity must be present in a particular entity in order to support the contractual risk allocation and establish that the entity controls its risks.

Thus, to assign risk to a tax-advantaged jurisdiction, there must be some decision making in that jurisdiction. However, not all risk control decisions must be allocated to the party contractually assigned the risk.[22] Other entities may assist in controlling risk by performing even important control functions. It is not even necessary that a majority of the control function be in the tax-advantaged entity.[23] The OECD Guidelines as revised by the BEPS Report do indicate that parties other than the one contractually assigned a risk must be compensated for any control functions they undertake, and that if those functions are important they may entitle the party performing the control function to a share of the risk-related profits of the enterprise.[24] But apart from this obligation to compensate other entities assisting with control, the BEPS Report seems to require only that the tax-advantaged entity be contractually assigned a risk and perform some modest portion of the control function related to that risk.[25]

Two questions come to mind in connection with this treatment of risk. The first is whether the control requirement as described in the Final BEPS Transfer Pricing Report will actually be effective in encouraging alignment of income and value creation. It seems that the control test as it has been framed is quite a tame anti-abuse measure and that a standard based on the performance of only some control functions will be quite easy for taxpayers to satisfy if they are determined to allocate risk-based

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profits to tax advantaged environments. The threat to require profits based compensation to entities that are not contractually assigned risks, but that perform control functions on behalf of the risk-bearing entity, may limit the distortions that can be generated. But the standard for the level of risk control activity that must migrate to a low-tax environment in order to assign at least some risk premium to the low-tax entity seems quite modest and a requirement that should be easy to satisfy.

The other question is whether the control requirement, even in the modest form described in the BEPS Report, will be enforceable. The new rules are implicitly based on an assumption that parties only assume risks if they actually control those risks. Business commentators on the new rules argued in the public consultation process that in dealings between independent enterprises it is common for one entity to assume and bear risks that they do not control, or do not fully control.[26] If the business commentators are correct and if examples can be brought forward showing that independent entities sometimes assume risks they do not control, then the control requirement fashioned by the OECD may impose a burden not fully consistent with the arm's-length principle.[27] Whether courts, and particularly U.S. courts, will be willing to sustain a government transfer pricing adjustment based on a reallocation of risk because of lack of control over the risk may become a contentious question.[28]

Separating Intangibles from the Creation of Intangible Value

The OECD was well advanced in a long overdue project to rewrite the provisions of Chapter VI of the OECD Guidelines on intangibles when the BEPS exercise began. The intangibles project was rolled into the BEPS work, the primary objective being to update the existing guidance in order to better prevent below value transfers of intangibles that result in the separation of intangible value from the economic activities creating that value.[29]

The new chapter of the Guidelines on intangibles covers a wide range of topics. It sets out definitions that seek to fill gaps that exist in some countries' laws whereby items can fall outside a definition of intangibles, and therefore arguably be transferred with little or no compensation under transfer pricing rules, and yet give rise to significant income in the hands of the transferee.[30] The intangibles rules also clarify how business synergies and features of local markets are to be treated in transfer pricing analyses,[31] and overtly approve the use of common valuation techniques in a transfer pricing analysis in an effort to provide some way forward when it is impossible to identify reliable comparables because of the unique nature of the intangibles in question.[32]

While these elements of the new intangibles chapter of the OECD Guidelines may prove to be important, the most contentious portion of the new intangibles guidance relates to the treatment of intangible ownership and the entitlement of various members of the group to returns derived by the MNE group from the exploitation of intangibles. It is in this section of the report that the OECD seeks to achieve greater alignment between intangible returns and the contributions of various group members to intangible value. As with risk, the new provisions on intangible ownership suggest that a transfer pricing analysis where intangibles are present should begin with the relevant contracts and agreements. A party treated as the owner of the intangible under such contracts will be treated as the owner of the intangible for transfer pricing purposes.[33] However, the determination of contractual or legal ownership of the intangible is not treated as being particularly important to the question of how intangible related income should be allocated.[34]

The new BEPS guidance provides that associated enterprises contributing to the value of the intangibles must be rewarded by the intangible owner for those contributions. Contributions to intangible value can come in the form of the performance of functions, the provision of assets including, importantly, funding for intangible development, or the assumption of risks. The rewards to entities providing such contributions may be substantial and, particularly for important management and control functions, may justify compensation based on a share of the profits derived from the exploitation of the intangible.[35] In this way, the report seeks to reverse a perception that the owner of a key intangible can claim all of the residual profit of the business after rewarding certain low-risk or routine functions. Instead the parties performing critical functions related to the development and exploitation of the intangibles may be entitled to substantial rewards for their contributions.[36]

The focus on important contributions, including the so-called DEMPE functions, is reflected in several examples in the Appendix to the new Chapter VI. One important example, Example 6 in the Appendix, describes a situation where two associated enterprises embark on a joint intangible development project. One party owns the intangible and provides the funding for the development. It is assumed to perform the functions necessary to control its financing risk. The other party manages the

development project, performs all the relevant research activities, controls the development risks and is responsible for exploiting the intangible once the development is complete. Hence, it performs most, if not all, of the DEMPE functions. Under these circumstances, the largest share of the anticipated returns from exploiting the intangible is allocated to the "doing" participant, rather than to the "owning" participant.[37]

The guidance on the rewards to be provided to entities contributing to the development and exploitation of intangibles is underscored by new provisions on cost contribution (cost sharing) arrangements (CCAs) and hard to value intangibles. The changes to the provisions of Chapter VIII of the OECD Guidelines on CCAs seek to impose the same rules on arm's-length compensation for control of risk, reward of contributions and compensation for services as apply to non-CCA transfer and use of intangibles under Chapter VI. The ability of an entity to claim high returns for what is essentially a cash only contribution to a CCA is thereby severely restricted, and the importance of functions that control risk and contribute directly to intangible value is emphasized.[38]

Similarly, rules on hard to value intangibles allow governments under some circumstances to rely on post-transfer financial results of the transferee of an intangible to value the intangible at the date of the transfer. The rules are pitched as being necessary to rectify situations of information asymmetry and can usually be avoided by adequate information disclosure. However, the rules will likely have the effect of bringing other countries more closely into line with practice under the U.S. commensurate with income principle.[39]

As with the new rules on risk, the new provisions of the OECD Guidelines on intangibles have a tendency to push at the boundaries of the arm's-length principle. The rules on hard to value intangibles permit tax authorities to refer to information that an independent enterprise would not have had in order to determine arm's-length prices. The rules on CCAs arguably overlook situations where independent parties do in fact adopt arrangements in which development costs are shared while one of the parties is primarily a cash contributor. In some situations, it may be argued that the approach to compensating DEMPE functions may create variable arm's length values for contributions in very similar factual contexts. The rules on accurate delineation of transactions may give tax administrations added authority to disregard taxpayers' intangible development or transfer transactions in situations where unrelated parties would not have such flexibility.[40]

Income Shifting Through Funding Arrangements Involving Overcapitalized Entities

A further transfer pricing problem noted in the BEPS Action Plan involves the overcapitalization of low-tax, low-function entities and the use of that excess capital by such cash-box entities to provide financing or funding to other group entities, resulting in the shifting of income. For example, an MNE group could overcapitalize a low-tax entity and have it lend money to more highly taxed group members, shifting income out of high tax locations and into low tax locations through interest payments. Such entities might also invest their excess capital in valuable income producing assets or, of particular concern in the BEPS work, use that capital to fund the development of high value intangibles.

The term "overcapitalization" is not defined or described in the Action Plan and is largely ignored in the final BEPS Report. In particular, no effort is made in the BEPS Report to articulate standards for determining an arm's-length level of capital for a single entity in an MNE group[41] or to regulate contributions of capital or capital assets between members of the group.[42] To address the overcapitalization issue raised in the Action Plan, the BEPS Report turns its attention exclusively to determining the appropriate arm's-length return to an entity providing funding. In doing so, the BEPS Report returns to its analysis of risk as the primary consideration in determining the proper reward for funding.[43]

The new guidance establishes three categories to describe the levels of risk undertaken by a funding entity and the resulting returns to which the funding entity is entitled. The first of these categories is described as an entity that does not have the capacity to and does not in fact evaluate and make decisions regarding its own funding arrangements. Such a classic, low-function cash-box entity is described as an entity that does not bear any risk for transfer pricing purposes because it fails the control requirement described above. Since it does not actually bear risk, such an entity is entitled to no more than a risk-free rate of return from its funding.[44] While the report does not define what is meant by a risk-free rate of return, that term should likely be interpreted as being the return an independent investor would receive for an investment in which it runs no or virtually no risk of losing its invested capital. The return anticipated from an investment in a high-grade bond issued by a strong government creditor would likely be the type of return the report appears to have in mind for such a funding arrangement.

The second category of risk and return involves an entity that has the independent capacity to make decisions about its funding arrangements (*i.e.,* whether to take on, lay off or decline to accept the risks associated with the funding) but which lacks the ability to control the underlying activities it is funding. Such an entity is described as "controlling its financing risk" but as not controlling the underlying development risk.[45] Such an entity is entitled, under the calculus of the BEPS Report, to earn a risk-adjusted rate of return. While the determination of such a risk-adjusted rate of return is not fully clear under the BEPS Report, it is indicated that reference to the entity's cost of capital and reference to other reasonably available alternative investments provide a guide to the determination of such a return.[46]

Nor is it clear at all what decision making capacity and independence is required to reach the threshold of controlling investment risk. In the context of a multinational enterprise, it will not be likely that officers of a subsidiary will have the ability to defy either the corporate management or the group's Board of Directors when the subsidiary is asked (or told) to make its accumulated capital available for corporate investment purposes, such as funding research and development. Declining an opportunity to fund a risky research and development project favored by management, and to instead invest in CDs or a casino in Macau, would not seem to represent a solid career move for the Treasurer of a subsidiary. But if such independence does not exist, does that mean that risk-free returns are the best that can be expected for related party funding arrangements?

The final category of risk bearing involves an entity which both controls its financing risk and controls the underlying activity for which the financing is used. Thus, an entity funding research and development could enter this higher level of risk and return only if it could both make independent decisions about whether the funding should be provided and give informed direction to the course of research for which the funding is used. If it has the capacity to contribute to the control of both types of risk, it will potentially be entitled to a return higher than a "risk adjusted rate." Its anticipated return will presumably include a participation in the future earnings derived from the investment.

The Final BEPS Transfer Pricing Report repeatedly notes that the funding returns it is describing are anticipated returns at the time of the investment, not the actual returns derived from the development activities.[47] It is suggested that differences between anticipated and actual returns are often present, and that a separate analysis is required to determine which of the entities is entitled to enjoy unanticipated benefits or bear unanticipated burdens associated with the difference between projected and actual returns. The Report says almost nothing about how an analysis of which entity is entitled to unanticipated returns is to be carried out. The answer presumably has something to do with which entity bears and controls the risks associated with either not meeting or exceeding the projections. But since the potential reasons for falling short of projections or for exceeding projections are likely numerous, and may lie entirely outside the control of any of the parties to the funding arrangement, the allocation of the difference between *ex ante* and *ex post* returns remains a near total mystery, one to which the Working Party apparently intends to turn its attention in the coming year.

Potential Consequences of the BEPS Transfer Pricing Guidance

The practical consequences of these changes in the OECD Guidelines for U.S.-based multinationals are challenging to evaluate. A number of factors need to be taken into account.

First, it does seem fairly obvious that to the extent countries around the world adopt and enforce these new principles in their local law, companies will have to deal with much greater complexity in their transfer pricing analyses and compliance. The new OECD guidance requires detailed factual understanding of the nature of the risks faced by the business, how decisions related to those risks are made within the business and which entities within a group are involved in making those decisions. That analysis of the mechanisms for managing and controlling risk has to be undertaken on a material risk by material risk basis. Not only is it necessary to understand how the parties to a controlled transaction manage and control the risks of doing business, it will also be necessary to consider how independent companies engaged in potentially comparable transactions address risks. The new OECD Guidelines make it highly relevant to determine whether such comparables bear the same risks as the parties in the tested transaction, and whether they control risks in the same way. Information needs regarding potential comparables will increase.

The same type of factual complexity will be required in matters involving intangibles. Careful factual attention will need to be paid to the contributions made by various associated enterprises to the creation of intangible value. While identification of which entities bear development risks related to intangible development presents one important line of now required factual investigation, it

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will also be necessary to consider which entities perform important development functions, including management and decision making regarding intangible development undertakings.

With greater factual investigation being demanded, the likelihood of controversy is virtually certain to increase. Where the rules require very close factual examination of all parties to a tested transaction and to all potential comparables, the possibilities for factual disagreements and disagreements over the meaning of the facts identified are likely to expand.

Second, the new rules may have important impacts on the structures adopted by taxpayers for intangible development and ownership. These consequences are still difficult to predict. If one associated enterprise is the legal owner of an intangible, has the financial capability to develop and exploit the intangible, provides the relevant funding, bears and controls the risks associated with the development and use of the intangible and has employees that perform the DEMPE functions, that affiliate is entitled to the returns from exploiting the intangible. If such an associated enterprise owns an intangible, has the financial capability to develop and exploit the intangibles and provides the relevant funding, but does not control the risks associated with its financing arrangement or with the intangible development project, and does not perform DEMPE functions, that enterprise will likely be entitled to no more than a risk-free rate of return on its funding.[48]

What outcomes arise between these two fairly clear endpoints are quite uncertain. For example, where an associated enterprise performs DEMPE functions but lacks capacity to develop and exploit the intangible, or where one associated enterprise controls some but not all risks related to development, or where DEMPE functions are split among multiple affiliates each having financial capacity, or each bearing and controlling some risk, the intended outcomes are rather unclear. Through some combination of accurate delineation of transactions and providing compensation for important development functions or risk controlling functions, the intent seems to be that members of the group will arrive at an equitable sharing of the fruits of exploiting developed intangibles. Exactly how that outcome will occur, however, is difficult to describe. Indeed, it is notable that the recently released discussion draft on profit split methods[49] somewhat surprisingly does not necessarily recommend that profit splits be used in such circumstances. Indeed, in its current form that draft seems to narrow the circumstances in which profit split methods can be applied rather than encouraging greater reliance on profit splits. One is left to a not insignificant amount of head scratching to understand what exactly companies or tax administrations should do to administer these rules.

Third, the uncertainty created by the new rules is compounded by the suspicions, described above, that the direct correlation between control of risk and bearing of risk upon which the new rules seem to be premised may not always exist in transactions between independent entities. Some will certainly contend that the BEPS guidance does not, despite its protestations to the contrary, strictly conform to the arm's-length principle. There may in fact be transactions between independent enterprises where a more or less passive investor funds intangible development costs and earns part or all of the return from the exploitation of the intangible after compensating those entities performing DEMPE functions. There may also be transactions where such passive, nonrisk controlling enterprises lose their investment in a failed development exercise. If that is the case, particularly given recent movements in U.S. case law,[50] a serious question may arise as to whether courts will enforce the imposition of a government transfer pricing adjustment premised exclusively on a lack of control over risk.

If the new rules are challenged in the courts as being inconsistent with the arm's-length principle, the status of the OECD Guidelines will become a topic of intense debate. The Guidelines do not constitute part of U.S. domestic law. They are referred to occasionally by the courts but do not constitute authority for interpreting Code Sec. 482. The United States, however, is a member of the OECD and is bound to follow its authoritative formal recommendations, at least in interpreting its treaties in dealings with other OECD countries. While most U.S. treaties do not explicitly refer to the OECD Guidelines as a basis for dispute resolution,[51] it can be expected that the U.S. Treasury will not affirmatively concede that there is a difference between the arm's-length principle as interpreted under domestic law and the same principle as interpreted in the OECD Guidelines. The IRS will, therefore, likely seek to follow the OECD Guidelines in resolving international tax disputes under treaties. Other countries likewise will follow the OECD Guidelines and may formally incorporate the principles of the Guidelines in their domestic law.

As a result, many companies will seek to conform their practices to the demands of the Guidelines on control of risk and performance of DEMPE functions. Knowing precisely how to do so may be more challenging, however. Obviously, some companies will shift functions to low-tax environments in an effort to establish a sufficient level of control. The fact that the new rules do not require all of

the control of risk, or all of the DEMPE functions, to be in a low-tax entity in order to establish in such an entity a claim to much of the returns derived from intangibles or much of the risk premium will lead to uncertainty over what functions will need to move. One can anticipate the export of some jobs in response to BEPS, but how many and which jobs companies will feel compelled to move remains uncertain.

The uncertainty and the complexity of the place the transfer pricing rules have landed after BEPS is unsatisfactory. The rules almost certainly will be hard to administer, hard to comply with and will lead to increased controversy. That being the case, the current stopping point in the evolution of the arm's-length principle is likely unstable and there may be a reason to consider in the near term whether a better alternative exists. The next section of this paper turns to some possibilities.

Alternatives to Transfer Pricing Methodologies

The highly uncertain and often contentious nature of today's arm's length pricing regime post-BEPs should be compared to other alternative methods of allocating multinational income among taxing jurisdictions. In this country, these alternatives have historically focused on three-factor combined unitary formulary apportionment similar to the approach used in many states of the United States.[52] In the European Union, the primary focus has been the European Commission's development of the Common Consolidated Corporate Tax Base, which also applies a multi-factor formula apportionment.[53] The problems of adapting the U.S. state alternatives have been well documented.[54] Walter Hellerstein, among others, has described many of the distortions inherent in the CCCTB.[55] These problems and distortions have led more recent commentators to focus on a sales-based apportionment or allocation of residual profits.[56] Nonetheless a brief review of the problems of multi-factor formulary apportionment proposals is useful followed by a more detailed discussion of the issues related to residual profit apportionment or allocation proposals. The latter two proposals, each of which substantially alter the amount of income attributable to any specific affiliate in a multi-national group, should then be compared to the current regime of transfer pricing after BEPS, including any improvements that can be made to that regime.

The discussion below ignores two important sectoral issues: the treatment of financial institutions and the treatment of the exploitation of natural resources. Both can be reasonably resolved, but the nature of that resolution depends in large part on the broader system for allocating income. Thus, a discussion of these sectoral issues is left for another day.

Combined Unitary Multi-Factor Formulary Apportionment

Much academic study has been devoted to applying a variant of the combined, unitary formulary apportionment regimes adopted by many U.S. states (and by Canadian provinces) to global income of multinationals.[57] The paradigm for these regimes is determining a single tax base by combining the income of multiple-related legal entities operating a unitary business and then apportioning that tax base according to three factors: payroll or another measure of employment, property and sales. The 2011 European Commission Proposal for a Common Consolidated Corporate Tax Base (CCCTB) was proposed to be optional for EU resident corporations.[58] The proposal would combine the income of all related entities resident in EU countries and apportion that income among EU resident entities based on an apportionment fraction weighted one-third to sales, one-third to assets (generally using tax-book value), one-sixth to payroll and one-sixth to employee headcount. The proposal attracted relatively little interest beyond academia. It was revived by the European Commission in the wake of BEPS in 2015.[59] The Commission now proposes that it be considered as a mandatory proposal, but implemented in steps, the first of which is achieving a common tax base, which was released in proposed directive form on October 25, 2016.[60]

As the history of the CCCTB indicates, the difficulties of adapting an apportionment regime in a regional much less a global context should not be underestimated. Establishing such a regime requires a multilateral consensus on three basic design issues: what is the set of business income to which an apportionment formula should be applied, how is the income subject to the formula measured and what factors should be included in the formula. Each of these design issues is discussed separately below.

Identifying Business Income Subject to Separate Apportionment

While many states apply formulary apportionment only to the income of a single separate legal entity, in the international context apportionment only makes sense if the various legal entities in the controlled group of companies are combined; since most legal entities in multinational

groups do not operate in multiple countries, formulary apportionment as applied to a single legal entity would accomplish little because it would leave today's transfer pricing regime as the mechanism that divides up group income among legal entities.

Given combined reporting of multiple affiliates, the question then arises should the income of the entire multinational group be combined and subject to a single apportionment or should separate apportionment be undertaken for each so-called unitary business of the group. Either way losses would, of course, be taken into account, which apparently was one of the reasons some multinationals supported the 2011 CCCTB.[61] One study estimates losses would reduce the global tax base by as much as 12 percent.[62]

Applying the formula to groupwide income would be simpler and perhaps for that reason more likely to achieve uniformity among implementing jurisdictions. The 2011 CCCTB adopts that approach.[63] However, applying the formula separately to each unitary business, as is done by many states,[64] would more accurately allocate income to the functions and activities that create it: pharma companies, for example, have quite different margins for their prescription pharmaceutical businesses than for their generics or consumer products businesses. But the experience of U.S. states illustrates that what constitutes a unitary business can be very subjective and thus give rise to disputes.[65] Technology companies, for example, are often a combination of hardware, software and services that are sometimes bundled but other times sold separately. Getting multilateral agreement on how to divide multinational groups along the lines of separate unitary businesses is likely to be a daunting task; different countries are likely to take different approaches depending on what yields them the most revenues.

Measuring Income Subject to Apportionment

Once the business unit subject to apportionment is determined, the relevant combined income of the legal entities must be measured. Particularly if the apportionment is determined on a groupwide basis, it is tempting to suggest that financial statement income be used as the base for apportionment. However, financial statement income, whether conforming to IFRS, Japanese GAAP, U.S. GAAP or some other financial accounting system, provides considerable flexibility for multinational groups to choose methods of booking revenues and expenses in ways that may not be acceptable to tax authorities.[66] Revenue recognition policies, reserve policies, amortization and depreciation policies can vary from one multinational group to another as long as they are fully disclosed and consistently applied over time.[67] It would seem unlikely that legislatures and tax authorities would be willing to have their corporate tax base determined by such flexible policies. And of course, notwithstanding considerable efforts over the past several years, the efforts to conform IFRS with U.S. GAAP and similar systems in Japan and other countries show no sign of succeeding, creating dissimilar treatment for many multinationals headquartered or trading in different jurisdictions.

One conclusion readily drawn from the foregoing discussion of potential alternatives to the existing arm's-length transfer pricing rules is that there are no easy fixes. It may well be that one or another of those alternatives could be an improvement over the existing approach.

If financial statement income is rejected as the best measure of income to be apportioned, then some common measurement of taxable income would need to be developed. Today, the measurement of taxable income differs enormously from one country to another: revenue recognition, methods of inventorying costs, schedules for depreciation or amortization of tangible and intangible property, use of mark-to-market accounting, treatment of original issue discount, circumstances in which the sale or other transfer of business assets or subsidiary stock trigger income—all today differ substantially from one country to another.[68] Under today's arm's-length pricing regime, taxpayers can be expected to cope with these differences because they only apply to the income of an entity doing business in that country. But consolidated reporting applies to all entities engaged in the same unitary business. That means global consolidated income for each unitary business would need to be separately calculated taking into account the measure of taxable income as determined by each country to which the unitary business must report its income. If countries do not agree to a common tax base, an enormous effort would be required to apply the formula apportionment regime in various countries.[69] The 2016 CCCTB common tax base proposal does

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not comprehensively deal with many timing issues but contains a number of provisions that are not likely to be adopted consistently by other countries, including a participation exemption for affiliate dividends and gains from the sale of affiliate stock, a super deduction for R & D expenditures, a limitation on interest deductions in excess of 30 percent of EBITDA and a notional interest deduction against book equity capital.[70]

Besides the measurement of taxable income, each country would need to develop rules on how to treat intercompany transactions within the combined reporting group. Should each entity calculate its income and then that income be aggregated to determine group income or should a true consolidation that ignores, for example, intercompany transactions, be adopted? If the former, how should losses be treated? The 2011 CCCTB proposes a true consolidation, ignoring intercompany transactions.[71] These issues must be consistently resolved by various countries if formulary apportionment is to be a practical alternative to today's transfer pricing regime.

As mentioned above, the European Commission is now focusing its efforts on the issue of developing a common tax base. Reflecting on this approach, some recent commentators have suggested that regional agreements or treaties might provide a path of agreement for a common tax base to implement formula apportionment.[72]

Apportionment Factors

If adopting consistent concepts of what businesses should be combined and how their income should be calculated seems difficult in the multilateral context, adopting apportionment factors in at least a somewhat consistent manner could be even more daunting. As described above, the 2011 CCCTB, similar to many U.S. states historically, proposed three equally weighted factors: employees (under the CCCTB determined half by headcount and half by payroll), property and sales.[73] Each creates incentives for both the manipulation of factors and the migration of activities and functions that must be understood.

Employee Headcount and/or Payroll Factor. Each of these potential factors requires grappling with employee versus independent contractor issues. The 2011 CCCTB leaves it to the laws of each country to define what constitutes employment but does include a provision dealing with secondments of employees between related entities and an anti-abuse rule applicable to individuals that perform "tasks similar to those performed by employees."[74] In the United States, we see how difficult these issues can be, how much flexibility businesses have in choosing alternative business models and how technology is increasing that flexibility in today's economy. The judicious use of independent contractors in high tax rate countries and a similar use of employees in lower tax rate countries could conceivably yield tax reductions significantly in excess of any cost differentials.[75] The employee/payroll factor can also influence decisions whether to outsource back office and other routine functions versus bringing them in house. Even more important functions such as lower level software development, pharmaceutical clinical testing and routine manufacturing can efficiently be outsourced if tax considerations are taken into account. These problems are perhaps more prominent if headcount rather than payroll is the measure of employment because outsourcing and the use of independent contractors is most feasible for relatively low paying employee activities.

But using payroll as a measure raises the issues of how to deal with stock-based compensation. The exclusion of such compensation seems inappropriate; yet its inclusion creates serious measurement issues and can create substantial distortions of the factor in specific years. Given different concepts of the tax treatment of stock-based compensation in different countries, it is very difficult to see how any consensus on its treatment would be achieved; the 2011 CCCTB, for example, measures stock-based compensation by the amount that is deductible under the laws of the member state applying the formula.[76]

There is really no good way to minimize the ability of taxpayers to manipulate the employee/payroll factor through outsourcing and independent contractors: somewhere the line between what is counted and what is not counted must be drawn and multinational groups are inevitably in a position to tailor their business structures at least around the edges to minimize income in higher tax rate jurisdictions and maximize their income in tax-favored jurisdictions.

Property Factor. The 2011 CCCTB defines this factor as fixed, tangible personal property.[77] It essentially includes factories, office buildings, warehouses and the like plus the equipment and furnishings that are used at these locations. The amounts taken into account are measured by historical cost less allowable depreciation; rents are capitalized to minimize distortions from decisions to rent versus own.[78]

Under the 2011 CCCTB, the factor does not include inventories, accounts receivable or intangibles generally; U.S. states typically include all tangible property, including inventories, but not intangibles.[79] The reasons the 2011 CCCTB excluded each of these assets are apparent. Inventories and accounts receivable are highly mobile and thus easily manipulable. Self-developed intangibles raise serious valuation issues comparable to today's most serious transfer pricing issues; including purchased intangibles

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while excluding self-developed intangibles would seemingly distort the factor in an irrational manner.

Yet the fact is that high margin companies typically have a relatively small portion of their value invested in fixed tangible assets. Moreover, what value they have in these assets can to a considerable extent be manipulated; third-party contract manufacturing, for example, is common in both the electronics and pharma industries. Moreover, the same outsourcing alternatives described above for manipulating the employee/payroll factor can be applied to alter the property factor. And, of course, those functions and activities that must be conducted directly by the multinational group can in many circumstances be moved to relatively low-tax rate jurisdictions, in the same way that companies are today moving their DEMPE functions into those jurisdictions.

Because of these simple ways taxpayers can manipulate the employment/payroll and property factors for their benefit, and because the existence of these factors in a high tax jurisdiction can lead to a migration of functions and activities from that jurisdiction, most U.S. states have moved away from three-factor apportionment. According to a recent study, in 1986, 80 percent of the states used a variant three-factor apportionment. By 2012, only 17 percent of the states did so.[80] All of the other states moved closer to a single sales factor, presumably based on the premise that sales were less subject to manipulation and less likely to encourage the migration of functions and activities from that particular state.

Sales Factor. The sales factor raises several particularly difficult issues,[81] including: the treatment of remote sales, the treatment of sales through intermediaries, the treatment of sales of raw materials, components and intermediate goods, the treatment of capital goods sales and the treatment of services. These issues may be novel in the income tax context, but not in the value-added tax context; the evolving thinking on these issues in the latter context can thus be a useful guide.

Sales made directly from a seller located in a different jurisdiction than the buyer raise serious issues. In the U.S. states, partly for Constitutional reasons, these sales cannot be taxed in the buyer's jurisdiction unless the seller has some physical nexus to that jurisdiction. Sales in states with no physical nexus are either "thrown out" of the apportionment fraction or are "thrown back" to all other jurisdictions where the seller has both sales and nexus.[82] In the multilateral context, these results could be unacceptable to countries with substantial remote sales (although the 2011 CCCTB proposal does include a variant of a throwback rule).[83] If so, the concept of a permanent establishment must be expanded substantially beyond anything contemplated by OECD or implemented by any country to date. Most broadly a seller would be determined to have a permanent establishment in a country if its sales to purchasers in that country exceed a certain minimum threshold without any other element of nexus.[84] That raises significant enforcement issues.[85] The enforcement issues can be reduced for remote sales to businesses, where a deduction disallowance or withholding tax mechanism can aid enforcement. But for remote consumer transactions, the enforcement problem is significant. No doubt it can be expected that substantial multinational enterprises would comply with broadened PE rules independent of their nexus. Thus, the problem principally involves consumer purchases from relatively small- and medium-sized businesses. Perhaps, if the minimum thresholds for establishing a permanent establishment are set judiciously, enforcement issues could be reduced. Nonetheless, extension of the permanent establishment concept to apply to remote sales would require more extensive information exchange and ultimately cooperation on collection assistance from other governments.

Sales through third-party intermediaries also raise significant issues. As an example, most pharmaceutical companies sell to many U.S. customers through third-party distributors, such as Cardinal Health or McKesson. These distributors at times today buy from manufacturers outside the United States and with proper tax incentives could probably structure operations to acquire even more of their inventory outside the United States. The same could be said for major retailers and major distributors in other industries. To avoid this potential for manipulation, sales to third-party distributors should be included on a basis that looks through to the ultimate retailer or consumer depending on the pattern of trade.[86] Accomplishing this requires reporting by the distributing purchaser to its sellers and to the relevant tax authorities; the system would likely require financial penalties, such as the loss of deductions for purchases or a withholding tax on payments for purchases, to incentivize the purchaser to maintain and report the necessary information. A look-through rule also requires that a seller to a third-party distributor be treated as being subject to tax in the jurisdiction of ultimate sale. In effect buy-sell arrangements with third-party distributors would be put on an equal footing with agency distribution arrangements for that purpose. Like with remote sales, such rules would expand the notion of permanent establishment substantially beyond anything currently contemplated by OECD or most countries. And as with remote sales, perhaps the rules should apply only for sales in excess of some floor to reduce the burden on taxpayers with relatively small sales.

Another difficult problem is the treatment of franchising and other licensing arrangements.[87] The decision to own hotels, restaurants or stores directly or to franchise them to third-parties, or to license a product to a local manufacturer versus contract manufacturing and selling the product directly, could clearly be influenced by a sales apportionment factor. Even if royalties are "sourced" to the jurisdiction of the franchisee's or licensee's activities, the difference in the magnitude of royalties earned versus the underlying sales revenues can be substantial. Given the lack of control exercised over third-party franchisees and other licensees, it is not clear that multinational businesses would change their business model for the sake of altering their apportionment factors in high tax jurisdictions, but the potential for such manipulation should be acknowledged.

Sales of raw materials, components or other intermediate goods to third-party manufacturers also raise the question of whether they should be treated on a look-through basis or whether the location of the sale should be the place where the goods are incorporated into products of the purchaser.[88] Here, however, the considerations are clearly different than sales to third-party distributors. Tracking the place of ultimate consumption of raw material, component or intermediate goods may be substantially more difficult compared to a distributor tracking the sale of its products, particularly where the purchased goods are transformed. In addition, the purchaser of the goods may have valid competitive reasons for not informing its seller of the location of its sales even if it could practically track them. It is difficult to see why distributors would have an equally valid concern. Indeed, in many situations, sellers expressly limit a distributor's ability to sell into various markets to control its channels of distribution, thus having an explicit agreement regarding the location of sales.

For these reasons, the location of sales of raw materials, components and other intermediate goods should be the location of their use by purchasing third-party manufacturers. Such a rule would provide purchasers of these goods an incentive to locate their manufacturing facilities in relatively low-tax jurisdictions if the benefit to the seller is sufficient to pass a portion of the tax savings on to the purchaser in the form of lower prices.[89] How widespread a phenomenon that would be is difficult to ascertain. Presumably because the tax rates are relatively low, studies of the migration of activities in the context of U.S. state taxes have not indicated that a particular problem exists. But at a minimum it would seem that any incentives for locating manufacturing facilities in a tax-favored jurisdiction to obtain better pricing from raw material, component and intermediate good suppliers would be substantially less than the incentive today to locate in such jurisdictions under the current arm's-length pricing regime.

If a look-through rule is applied to sales to third-party distributors but no look-through is applied to sales to purchasers of raw materials, components and intermediate goods, a rule that distinguishes between distribution and manufacturing would be required. The location, for example, of the final packaging or labeling of products can too easily be migrated if a significant tax advantage results. Perhaps, the current Subpart F definition of manufacturing[90] is a good starting point in crafting such a distinction, although that definition has generated its share of controversy over the years.[91]

The sale of capital goods raises many of the same issues as the sale of intermediate goods, except that it seems even more apparent there is no practical way to look-through the purchase of capital goods to the location of sales of the products produced by those goods. If nothing else, given that the capital goods sale is taxable in the year of sale, any look through would seemingly be based on projections of future sales that would inevitably be subjective and subject to substantial controversy. Thus, the sale of capital goods should be treated as located where the purchaser uses those goods. Again, such a rule could provide the purchaser with an incentive to locate its facilities in tax-favored jurisdictions where the seller of the good might be willing to offer a lower price. This incentive effect should be acknowledged. But it is likely to be a smaller incentive than that provided today under arm's-length pricing.

The determination of the location of services raises even more difficult issues.[92] For U.S. state income tax purposes services are typically sourced in the location where the services are performed, not the location of the customer's use of those services. The 2011 CCCTB follows a similar path.[93] Presumably, this sourcing is attributable to the difficulties in determining the location of the use of services by recipients of those services; indeed, in many cases, service recipients utilize the services of a provider in multiple jurisdictions. Today's transfer pricing regime provides one potential mechanism to deal with these situations by requiring that service recipients charge out the services costs to various affiliates benefitting from those costs. In these circumstances, the service providers' income could conceivably be apportioned to the various jurisdictions based on the service recipient's charge out of that amount. That would require the service recipient to provide information to the service provider at a minimum and could result in a negotiation of the allocation of service fees, in much the same way

as today buyers and sellers negotiate the relative value of specific assets in a business asset acquisition. Given the frequency of services transactions where the service recipient benefits in multiple jurisdictions, this regime could be quite burdensome.

These difficulties could lead to the conclusion that at least for personal services where capital is not a material factor in producing income, the place of performance may be the best factor to utilize even if it does leave an incentive for those services to be located in tax-favored jurisdictions. Most personal services that involve minimal capital investment are not high margin activities. But some exceptions would no doubt be needed. One exception could be financial investment advisors. For that type of business, perhaps the global trading model developed by the United States and the OECD could be adapted to determine the location of the relevant services.[94]

Other services, such as Internet and transportation services, require relatively little employee activity and substantial capital investment. It is possible that for Internet services generally the location of users can be tracked and business earnings sourced accordingly. That would require treating an internet service provider as having a permanent establishment in the jurisdiction of its users, a fundamental departure from the law today. For transportation services, the jurisdictions in which the transportation is used by customers could be included in the sales factor, presumably with travel over the oceans being allocated on some basis.[95] These services create significant problems of sourcing and income allocation under today's arm's-length pricing regime; the fact that they also cause similar problems under a sales factor should not be particularly disturbing.

Single Factor Sales Apportionment. The problems described above with the employment/payroll and property factors have led some commentators[96] to recommend that if formulary apportionment is to be adopted multilaterally, a single sales factor be utilized. That may be an improvement over three-factor apportionment, but the problems with the sales factor described above would be substantially accentuated under a single factor apportionment. The potential incentive effects to purchase raw materials, components and intermediate and capital goods in facilities located in tax-favored jurisdictions would be substantially larger, as would the incentives to provide personal services from such locations. Moreover, such a proposal would result in countries with substantial business production activity, but relatively small sales, collecting insignificant income tax revenues from those businesses. While countries attempting to attract business activity may be satisfied with that result, it seems in some sense an inappropriate result under an income tax. Moreover, it would cause a very large shift in corporate tax revenues among various countries compared to today's arm's-length pricing regime, thus making multilateral acceptance unlikely.

Residual Profit Sales Apportionment Proposal

The above issues with various proposals to apportion total profits led Durst, Avi-Yonah and Clausing[97] to propose that a formulary apportionment regime differentiate between "routine" profits and "residual" profits. In their proposal, "routine" profits would be determined on a cost plus 7.5 percent mark-up basis and taxed where the costs are incurred.[98] That means the jurisdiction where activities and functions take place would be allocated out of the global income of a unitary business an amount of profit equal to 7.5 percent of the costs incurred in that jurisdiction (presumably proportionately less where the group earns less than a 7.5-percent markup on its costs). The remaining profit would be considered "residual" and would be allocated to the various jurisdictions on the basis of a sales factor.

This residual profit sales apportionment proposal has several advantages over the apportionment of all multinational income. First, the markup on costs could be set at a level such that the incentives to move that cost to a low-tax jurisdiction based on earning a routine return are minimized. For example, with a 7.5-percent markup on costs, moving 100 of costs from a 35 percent to a 10-percent jurisdiction would only save about 1.9 of taxes; a tax saving equal to less than two percent of operating costs is unlikely to influence location decisions given other variables that are inevitably involved.

Even such a relatively modest mark-up on costs would mean that many businesses with low or even moderate margins would pay most if not all of their income tax to the jurisdictions where their activities and functions take place. For enterprises with high margins, the tax in the jurisdictions of function and activities would be relatively modest but not insignificant. Residual profits would be allocated based on sales, leading to all the problems described above relating to the location and measurement of sales. But at least those problems would largely be limited to multinationals with relatively high margins. And, given the unpredictability of future profitability, the incentive effects should be lessened because location decisions are often made before the existence of high margins is predictable with certainty.

Of course, the above proposal starts with the combined income of affiliates constituting a unitary business. Thus, the problems described above in determining what constitutes a unitary business and how its combined income should be measured remain.

Residual Profit Sales Allocation Proposal

In contrast to the above formulary apportionment proposals, Michael Devereux and others working as an informal group have been considering a proposal[99] that uses transfer pricing methodologies in a manner that allocates residual profits to the jurisdiction of sale. The proposal starts with the "entrepreneurial" model under today's transfer pricing regime, under which a typical multinational group identifies one "entrepreneur" affiliate to bear most of the risks (*e.g.,* marketing and R & D funding risk) inherent in the group business and treats all other affiliates in the supply chain as engaged in routine activities and functions. The affiliates treated as engaged in routine functions earn returns on a cost plus or return on assets basis under transfer pricing methodologies based on third parties that bear little if any entrepreneurial risk. The residual profit then falls to the entrepreneur, which is typically resident in a tax-favored jurisdiction.

The residual profit sales allocation proposal essentially turns this transfer pricing model on its head and deems the country in which customer sales take place as the entrepreneurial affiliate. It ascribes routine profits to all jurisdictions in the supply chain except the market jurisdiction. The Devereux et al. proposal provides that routine profits be determined under traditional transfer pricing cost-plus or return on asset methodologies, but if preferable routine profits could alternatively be determined based on a fixed mark-up in a manner similar to the Durst et al. apportionment proposal described above. The proposal thus overrides intercompany contractual arrangements by imposing deemed arrangements to which transfer pricing methods are applied.

The Devereux et al. proposal would essentially build up a transfer price through the supply chain based on actual legal entity costs and the allocation of a routine return to those costs. For example, an affiliate manufacturer would charge a price based on that manufacturer's activities and functions plus a mark-up, similar to a contract manufacturer. Any intermediate purchasing affiliate in the supply chain would also earn a routine return on its functions and activities which would then be reflected in its transfer price. The affiliate operating in the market jurisdiction would treat the amount determined above from its supply chain as its purchase price, to which it would add its costs in selling the product. It would measure its taxable income by the difference between actual revenues earned on the sale of that product and the sum of these costs. Thus, product revenues and product-related costs would be determined on a separate accounting basis (*i.e.,* tracing revenues and costs to specific products) rather than on any type of apportionment basis, but imputed contractual arrangements would deem the affiliate operating in the market jurisdiction as the group entrepreneur.

The Devereux et al. proposal recognizes the need to "charge out" indirect costs, including R & D, G & A and potentially certain marketing costs and suggests charging those costs to deemed entrepreneur market country affiliates on a *pro rata* basis, similar to cost-sharing arrangements in the U.S. today (*e.g.,* on the basis of relative sales revenues, gross income or some other similar metric). The charge out would include a services-type markup on the charged-out costs so that the affiliates performing these functions earn significant profits. Interest expense could then be allocated to all affiliates based on relative EBITDA or assets.

This separate accounting of revenues and direct costs, plus an apportionment of indirect costs, forces market country affiliates to bear the risks and rewards of the business related to the products they sell and earn any residual profits from those sales. All other affiliates, including affiliates performing R & D or G & A, earn a cost-plus or similar routine return.

Comparison of Durst et al. Residual Profit Sales Apportionment and Devereux et al. Residual Profit Sales Allocation Proposals

The two residual profit proposals share a number of advantages and disadvantages. Both would substantially reduce the incentives for manipulation compared to other apportionment proposals and both reduce the incentives for the migration of functions and activities to tax favored jurisdictions compared to post-BEPS transfer pricing. Both create a more level playing field between resident and nonresident multinationals. Both require facing up to the issues of remote sellers, seller of raw materials, intermediate and capital goods, sellers through third-party distributors and the location of services activities. Both present issues in dealing with losses and with profit levels that fall short of routine returns. All of these problems require more thorough and detailed thinking than has been undertaken to date.[100]

From a U.S. perspective, the revenue impact of each proposal is uncertain. Durst et al. project that their proposal would raise substantial revenues based on an assumption that U.S. profits would be approximately proportionate to U.S. revenues overall.[101] Grubert disagrees, pointing to the fact that royalties paid by U.S. multinationals today are twice the amount that R & D cost sharing payments would generate.[102] The mark-up on R & D under the Devereux et al. proposal does not nearly make up that difference. However, Grubert does not take into account the fact that a portion of royalties earned by U.S. multinationals today relate to U.S. sales; those royalties would effectively continue to be taxed in the United States under either sales-based proposal. He also does not consider the revenue impact of charging out G & A (plus earning a mark-up under the Devereux et al. proposal) attributable to non-U.S. sales. Finally, he does not take into account the fact that the United States would be taxing residual profits for the inbound transactions of foreign multinationals, which no doubt are substantial. Thus, on balance, it seems most likely the Durst et al. analysis is closer to being correct.

The Devereux et al. proposal differs from the Durst et al. apportionment proposal is a few key respects. It is a "bottoms up" rather than a "top down" proposal; by building up a transfer price based on the costs of and routine returns on functions and activities throughout the supply chain, the proposal avoids the issues discussed above in determining what businesses are treated as unitary, what is the measure of combined income subject to apportionment and what revenues are included in a sales factor. Under the Devereux et al. proposal, unitary business issues would apply but only in the determination of the allocation of R & D, G & A and other indirect expenses.

More importantly, by determining profit based on actual revenues and related direct expenses under separate accounting, the Devereux et al. proposal results in sales jurisdictions with higher margins receiving a larger tax base and those with lower margins a lower tax base, compared to averaging of margins across all jurisdictions under the Durst et al. proposal. In that way, for example, jurisdictions that permit higher prices for pharmaceutical products (like the United States) will receive higher than average tax revenues from their local sales. Similarly, jurisdictions in which lower margins are realized, for example, because the local government does not vigorously enforce patent, trademark or other legal protections, would see a lower than average tax base. Further, when a multinational introduces a product into a new market incurring substantial start-up expense, the market country will only get incremental tax base as its local margin grows taking into account start-up costs.

Equally importantly, the Devereux et al. proposal could conceivably be adopted unilaterally as opposed to requiring a multinational agreement. Other countries continuing today's post-BEPS transfer pricing regime would still ascribe residual profits largely based on the multinationals' decisions where to place functions and risk. To the extent those functions and risks are in tax-favored jurisdictions, any resulting double taxation may not be a serious concern. For multinationals who do not undertake such planning, the taxation of residual profits would lead to double taxation with high tax jurisdictions with respect to imported products and less than full taxation with respect to exported products. It is not clear that a jurisdiction adopting the residual profit allocation proposal would see that as such a bad result. Moreover, over time multinationals concerned about such results could adapt their transfer pricing methodologies to minimize any double taxation.

Destination-Based Cash Flow Tax

The final alternative that should be discussed is the Destination-Based Cash Flow Tax (awkwardly referred to as the DBCFT). The tax has been discussed in academic circles for many years,[103] including most recently as an alternative proposal by the informal Devereux group.[104] It was proposed in 2005 by President Bush's Tax Reform Advisory Panel.[105] Most recently, it has been proposed by House Republicans as part of their 2016 Blueprint.[106]

In the end, the need to consider these more far-reaching proposals further depends on the tax rate imposed by the United States under its corporate tax compared to that of relevant alternative jurisdictions.

The proposal is essentially a subtraction-method VAT with a deduction for domestic wages. It is a destination-based tax,[107] meaning that imports are not deductible to purchasers and exports are exempt from tax. Domestic wages are deductible without regard to whether they relate to imports, domestically produced goods or exports.

From an economist's perspective, the proposal is efficient because the incidence of the tax does not fall on labor or basic returns to capital but is imposed on "rents" or excess returns on investment. It thus does not distort investment decisions. Because it is destination based,

no transfer pricing is required. The problems with the apportionment and residual allocation proposals above related to sales to distributors and sales of raw materials, components and intermediate and capital goods disappear because the purchaser of all such goods is a business and will only get a deduction where the seller is subject to tax in the same jurisdiction on its sale. That eliminates any incentives to locate functions and activities in tax-favored jurisdictions. It thus completely levels the playing field between resident and nonresident multinationals. The same issues as discussed above with respect to sales-based residual profit proposals exist under the DBCFT for remote sales to consumers (since they are not deducting their purchases), but these issues are no worse than under the alternative proposals.

One principal issue with a DBCFT proposal is that it is potentially inconsistent with GATT agreements as interpreted by the WTO.[108] The deduction for domestic but not foreign wages attributable to imports is potentially an impermissible discrimination against imports; similarly, the deduction for wages attributable to exports can be viewed as an export subsidy. While arguments regarding WTO legality can be made based on the underlying economics of the tax, they may be difficult to sustain; economists make clear that the tax in principle is trade-neutral once currency exchange rates are taken into account.[109] But, unfortunately, the legal analysis under existing trade agreements may not be consistent with that standard. Thus, a renegotiation of those agreements could be required.

A second issue with a DBCFT proposal stems from the fact that, in replacing the corporate income tax, it eliminates any production-based tax on business functions and activities and instead taxes consumption. If adopted unilaterally to replace the current business income tax, the proposal would make the adopting country one of the few jurisdictions in the world not imposing that kind of tax on business income; nonadopting countries would understandably view that country as a tax haven. Thus, while adopting a DBCFT as a partial replacement for a more traditional production-based corporate income tax may well be an efficient way to allow for a substantial reduction in the rate of the production-based tax, complete replacement of that tax with a DBCFT may be less than ideal unless done on a multilateral basis.[110]

Where Should We Go From Here?

From a Tax Administration Perspective. One conclusion readily drawn from the foregoing discussion of potential alternatives to the existing arm's-length transfer pricing rules is that there are no easy fixes. It may well be that one or another of those alternatives could be an improvement over the existing approach. However, none of the alternatives would be easy to develop, easy to apply or problem free. All have their own complications and none (other than a pure DBCFT) would easily banish transfer pricing controversy or put an end to tax planning.

Moreover, any attempt to discard the arm's-length principle for another approach would involve heavy transaction costs. Current treaties require adherence to the arm's-length principle and arguably would have to be abandoned or modified if another approach were to be adopted. A unilateral move by one or a few countries to a new approach would necessarily give rise to double taxation until such time as a global consensus could be reconstituted. But the challenge of finding a new global consensus would be daunting. The years of efforts on the CCCTB with no agreement, and the 13 years to develop guidance on attribution of profits to permanent establishments under Article 7 with very little international agreement as to the ultimate outcome, both provide some warning as to what would be involved in resetting the standards in an increasingly complex global environment.

But standing still does not seem a particularly attractive option either. The BEPS transfer pricing rules are too complicated, too prone to controversy and leave too many questions unanswered to allow countries to simply walk away and say the task has been accomplished. If the arm's-length principle is to be retained, more effort will be required. That effort would need to focus urgently on the questions of clearer definitions regarding the returns to funding activities and capital, clearer descriptions of how the normal cases where functions and risks are spread throughout the group can be dealt with, and importantly, how one can determine which entities bear the risks of actual returns departing from projected returns and how those differences can be allocated in the group. The very challenging questions raised in Action 1 of the BEPS Reports relating to the digital economy also cannot be ignored for long.

A further urgent need is to recognize that all of these new rules on returns to funding, allocation of risk and attribution of ex ante and ex post differences cannot be addressed in every case. The questions are too hard for any but the most difficult cases and other, simplified approaches will have to be found to resolve more routine matters. The recent OECD work on safe harbors has largely been ignored by country tax administrations, but simplified, safe harbor approaches are going to have to be a large part of any stable solution to the transfer pricing problem.

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From a Broader U.S. Tax Reform Perspective. Many in the United States have voiced concern over what is seen as the loss of revenues—and jobs—from the transfer price planning of U.S. and inbound multinationals.[111] Given the high U.S. corporate tax rate, and the continued availability of planning opportunities to move business activities and income to tax-favored jurisdictions, these concerns will continue post-BEPS and if anything could be heightened as multinationals migrate more functions and activities to align with income in those jurisdictions. Improvements to the transfer pricing rules will not alter this fundamental reality.

One solution proposed by some academics is to tax U.S. multinationals currently on their world-wide income, potentially at a rate lower than the full corporate tax rate.[112] That is a very risky solution because the United States cannot similarly tax non-U.S. based multinationals; the resulting disparity of treatment risks a long-run migration of asset ownership that is unlikely to be in the U.S. interests.

To avoid this result, any solution should move in the direction of treating U.S. and non-U.S. multinationals similarly. The DBCFT clearly does that by being destination based. That is one of the principal reasons it appealed to Ways & Means Republicans—and should appeal to many Democrats as well. If, however, something less challenging to international tax norms is more feasible, the two residual profit proposals discussed above should be studied in more serious detail. Each would treat the residual profits of U.S. and non-U.S. multinationals similarly. And each could, subject to further study, substantially reduce the incentives to move functions and activities to tax-favored jurisdictions.

In the end, the need to consider these more far-reaching proposals further depends on the tax rate imposed by the United States under its corporate tax compared to that of relevant alternative jurisdictions. In part because of BEPS, and increasingly because of pressures from the European Union, the ability of multinationals to achieve stateless income or even single digit local effective tax rates is rapidly diminishing. We may well be moving to a world where paying an effective rate in a tax favored jurisdiction in the low to middle teens is the best tax planners can do. The question then is what tax rate will the United States be imposing. If, for example, by adopting some variant of a DBCFT, value added tax or other consumption tax, the United States could reduce the rate of its production-based corporate tax to 20 percent or less, as some have proposed,[113] a solution of working with OECD and other countries to improve the post-BEPs transfer pricing regime as described above makes eminent sense. But if U.S. corporate tax rates are to stay at or near current levels, the residual profit allocation and residual profit apportionment proposals discussed above should be seriously considered.

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ENDNOTES

1. *See* OECD (2015), *Explanatory Statement*, OECD/G20 Base Erosion and Profit Shifting Project, OECD. *www.oecd.org/tax/beps-explanatory-statement-2015.pdf* (hereafter the "Expanatory Statement").
2. OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Action 8 -10 – 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241244-en* (hereafter the "Final BEPS Transfer Pricing Report").
3. OECD (2010), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* OECD Publishing, Paris (hereafter the "OECD Guidelines").
4. OECD (2015), *Transfer Pricing Documentation and Country-By-Country Reporting, Action 13 – Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264241480-en.*
5. Explanatory Statement, para. 1.
6. OECD (2013), *Action Plan on Base Erosion and Profit Shifting,* OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264202719-en* (hereafter the "Action Plan").
7. Action Plan, Action 9, at 20.
8. *Id.*
9. Action Plan, Action 8, at 20.
10. Action Plan, Action 10, at 20–21.
11. *Id.*
12. Action Plan, Actions 9 and 10, at 20–21.
13. OECD Guidelines at para. 1.45.
14. OECD Guidelines at paras. 9.17–9.46.
15. Final BEPS Transfer Pricing Report, para. 1.60.
16. Final BEPS Transfer Pricing Report, paras. 1.43, 1.60.
17. Final BEPS Transfer Pricing Report, para. 1.82 *et. seq.*
18. Final BEPS Transfer Pricing Report, para. 1.86.
19. Final BEPS Transfer Pricing Report, paras. 1.98–1.99.
20. Final BEPS Transfer Pricing Report, para. 1.65.
21. Final BEPS Transfer Pricing Report, paras. 1.98–2.06.
22. Final BEPS Transfer Pricing Report, paras. 1.93–1.94.
23. *Id.*
24. Final BEPS Transfer Pricing Report, para. 1.105.
25. Final BEPS Transfer Pricing Report, para. 1.94.
26. *See also* J. Gregory Ballantine, *Ownership, Control, and the Arm's Length Standard*, TAX NOTES INTERNATIONAL (June 6, 2015).
27. *See Altera Corp.,* 145 TC No. 3, Dec. 60,354 (July 27, 2015), *Xilinx Inc.,* 125 TC 37, Dec. 56,129 (2005) *aff'd,* CA-9, 2009-1 USTC ¶50,405, 567 F3d 482.
28. *See* Michael L. Schler, *The Arm's Length Standard After Altera and BEPS*, TAX NOTES (Nov. 30, 2016).
29. Action Plan, Action 8, at 20.
30. Final BEPS Transfer Pricing Report, paras. 6.2, 6.5 and 6.6.
31. Final BEPS Transfer Pricing Report, paras. 1.157–1.163.
32. Final BEPS Transfer Pricing Report, paras. 1.153–1.180.
33. Final BEPS Transfer Pricing Report, para. 6.40.
34. Final BEPS Transfer Pricing Report, paras. 6.42–6.46.
35. Final BEPS Transfer Pricing Report, paras. 6.50–6.58.
36. In the wake of the BEPS Report and its focus on functions, these critical functions have been referred to by some as DEMPE functions. While that term is not used in the BEPS Report, the report does refer repeatedly to functions related to the *D*evelopment, *E*nhancement, *M*aintenance, *P*rotection and *E*xploitation of intangibles, hence DEMPE.
37. Final BEPS Transfer Pricing Report, Chapter VI Appendix, paras. 14–15.
38. Final BEPS Transfer Pricing Report, para. 8.1 *et. seq.*
39. Final BEPS Transfer Pricing Report, paras. 6.186–6.195.

[40] *See, e.g.*, Example 16, Final BEPS Transfer Pricing Report, Chapter VI Appendix, paras. 54–58, recharacterizing a purchase of an intangible as a financing transaction because the buyer lacks the capacity to make decisions regarding future development of the intangibles. Notably this recharacterization does not seem to require a finding that the transfer documented by the taxpayer was commercially irrational. It requires merely a finding that the transferee does not control its contractual risks.

[41] Several countries, including Australia and the United Kingdom, have sought to use transfer pricing rules to help regulate thin capitalization and excessive interest payments. The United States has generally not sought to use transfer pricing rules for this purpose and tends to believe that the definition of an arm's-length level of capital through analysis of comparables is not likely to be a workable solution.

[42] The United States has, at times, sought to use transfer pricing rules to modify the consequences of capital contributions of income producing assets, with mixed results. *See, e.g., Eli Lilly & Co.,* 84 TC 996, Dec. 42,113 (1985) *aff'd in part, rev'd in part and remanded,* CA-7, 88-2 USTC ¶9502, 856 F2d 855; *G.D. Searle & Co.,* 88 TC 252, Dec. 43,685 (1987); *Northwest Securities Corp.,* CA-3, 43-2 USTC ¶9560, 137 F2d 600, *cert. denied* SCt, 320 US 794, 64 SCt 262; *Central Cuba Sugar Co.,* CA-2, 52-2 USTC ¶9390, 198 F2d 214.

[43] Some countries objected to this funding return only approach and therefore insisted that the rules on disregard or recharacterization of transactions remain applicable to funding arrangements. *See* Final BEPS Transfer Pricing Report, para. 1.105.

[44] Final BEPS Transfer Pricing Report, paras. 1.85, 1.103.

[45] *See, e.g.,* Example 6, Chapter VI Appendix, paras. 14–15.

[46] Final BEPS Transfer Pricing Report, para. 6.62.

[47] Final BEPS Transfer Pricing Report, paras. 6.69–6.70.

[48] *See, e.g.,* Final BEPS Transfer Pricing Report, Chapter VI Appendix, Example 16.

[49] *Discussion Draft on the Revised Guidance on Profit Splits,* July 4, 2016, OECD.

[50] *Altera Corp.,* 145 TC No. 3, Dec. 60,354 (July 27, 2015), *Xilinx Inc.,* 125 TC 37, Dec. 56,129 (2005) *aff'd,* CA-9, 2009-1 USTC ¶50,405, 567 F3d 482.

[51] The treaty with Japan is an exception to this general statement.

[52] *See, e.g.,* Walter Hellerstein, STATE TAXATION (3d ed. Warren, Gorham & Lamont 2013 rev).

[53] European Commission Proposal for a Council Directive on a Common Consolidated Corporate Tax Base 2011/0058 (CNS), March 16, 2011 (hereinafter referred to as "2011 CCCTB").

[54] Julie Roin, *Can the Income Tax Be Saved? The Promised Pitfalls of Adopting Unitary Formulary Apportionment*, 61 TAX LAW REVIEW 169 (2008).

[55] Walter Hellerstein, *Formulary Apportionment in the EU and the US: A Comparative Perspective,* TAX MOBILITY (A. Dourdo ed.) International Bureau of Fiscal Documentation, September 2013.

[56] Proposals by Durst et al. and Devereux et al., both focus on residual profits. *See* Reuven S. Avi-Yonk, Kimberly A. Clausing and Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLORIDA TAX REVIEW 5 (hereinafter "Durst et al."); and Michael Devereux et al., *www.taxpolicycenter.org/event/corporate-tax-21st-century*.

[57] *See, e.g.,* Joann Martens-Weiner, *Company Tax Reform in the European Union: Guidance for the United States and Canada on Implementing Formulary Apportionment* (2006).

[58] 2011 CCCTB, Note 53.

[59] European Commission, Communication to the European Parliament and The Council: A Fair and Efficient Corporate Tax System in the European, Union Com (2015) 302, June 17, 2015.

[60] European Commission, Proposal for a Council Directive on a Common Corporate Tax Base, COM (2016) 685 final, October 25, 2016 (hereinafter "2016 CCCTB").

[61] *See* Sol Picciotto, *Taxing Multinational Enterprises as Unitary Entities*, 82 TAX NOTES 895 (May 30, 2016), at 912.

[62] Alex Cobham & Simon Loretz, *International Distribution of the Corporate Tax Base: Implications of Different Apportionment Factors* ICTD Working Paper 27 (2014).

[63] 2011, CCCTB, Articles 54–58.

[64] *See* Hellerstein, note 52.

[65] *See, e.g.,* Charles E. McLure, Jr., *Operational Interdependence Is Not the Appropriate 'Bright Line Test' of a Unitary Business – At Least Not Now*, 18 TAX NOTES 107 (Jan. 10, 1983).

[66] Roland Murphy & Prev Sikka, *Unitary Tax Base and the Role of Accounting*, ICTD Working Paper 34 (2014).

[67] *Id.*

[68] *Id.*

[69] Roin, note 54, at 200.

[70] 2016 CCCTB, note 60.

[71] 2011 CCCTB, note 53, Article 59.

[72] Picciotto, note 61, at 913.

[73] 2011 CCCTB, note 53, Article 86.

[74] 2011 CCCTB, note 53, Article 90.

[75] Roin, note 54, at 205–206.

[76] 2011 CCCTB, note 53, Articles 90 and 91.

[77] CCCTB note 51, Articles 92–94.

[78] *Id.*

[79] Hellerstein, note 52.

[80] Kim Clausing, *Lessons for International Tax Reform From the U.S. State Experience Under Formulary Apportionment*, ICTD Research Report 2 (2014).

[81] Other less difficult issues include what revenues are included as sales, including financial transactions, and when do transactions such as hedging transactions affect revenues as opposed to adjusting expenses. *See* Hellerstein, note 55, at 7–8, 13–15.

[82] Hellerstein, note 55, at 10–121. The states are prohibited from imposing tax where an out of state seller only solicits orders locally for approval in another state. 15 USC §381(a).

[83] The 2011 CCCTB throws remote sales—and sales to jurisdictions outside the EU—back to EU states where the multinational group has a presence, based on the groups relative employment and property factors. 2011 CCCTB, Article 96.

[84] Picciotto, note 61, at 911.

[85] *Id.*

[86] Clausing and Avi-Yonah proposed a look-through rule for unrelated distributors in their single sales factor formulary apportionment proposal. Kim Clausing & Reuven Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary apportionment* (Brookings Inst. 2007).

[87] These difficulties are discussed in Harry Grubert, *Destination-Based Income Taxes: A Mismatch Made in Heaven*, 69 TAX LAW REVIEW 57 (2015).

[88] *See* Grubert, note 88, at 55–56.

[89] *Id.* Grubert points out that in 2012, 66 percent of U.S. exports were either "Industrial Supplies or Materials" or "Capital Goods." Consumer Goods accounted for less than 12 percent.

[90] *See* Reg. 1.954-3(a)(4).

[91] *See, e.g., Electronic Arts, Inc.*, 118 TC 226, Dec. 54,680 (2002) and *Bausch & Lamb Inc.*, 71 TCM 2031, Dec. 51,160(M), TC Memo. 1996-57.

[92] *See* Roin, note 54, at 208–209 and Hellerstein, note 55, at 9–12, for a discussion of these issues.

[93] 2011 CCCTB, note 53, Article 98.

[94] IRS Notice 94-40, Proposed Reg. 1.482-8.

[95] *See, e.g.,* Code Secs. 861(d), 863 (c) and (d).

[96] Clausing and Avi-Yonah, note 87, provided such a proposal as part of the Hamilton Project.

[97] Durst et al., note 56.

[98] *Id.*

[99] Devereux et al, note 56.

[100] Grubert, note 88, provides a critical review of all these issues.

[101] Durst et al., note 56 at 44.

[102] Grubert, note 88, at 60.

[103] *See, e.g.,* David Bradford, *The XTax in the World Economy*, Griswold Center for Economic Policies working paper No. 93 (August 2003).

[104] Devereux and Alan Auerbach, a participant in the Devereux Group, have published prior papers describing the tax. *See,* for example, Alan Auerbach, *Center for American Progress*, A Modern Corporate Tax (2010).

[105] The President's Advisory Panel on Federal Tax Reform (2005).

[106] Ways and Means Committee. A Better Way: Our Vision for a Confident America: Tax, June 24, 2016.

[107] The Advisory Panel report also described an origin-based cash flow tax. *See* Advisory Panel, note 106, at 108.

[108] Wolfgang Schon, another participant in the Devereux group, has written extensively on this subject. *See* Wolfgang Schon, *Destination-Based Income Taxation and WTO Law*, Max Plank Institute for Tax Law and Public Finance working paper 2016-03.

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[109] The best exposition of this perspective is provided by Alan Aurbach and Douglas Holtz-Eakin in "The Role of Border Adjustments in International Taxation" American Action Forum, November 30, 2016.

[110] Devereux and Auerbach argue that if one or more major countries—like the United States—adopt the tax as a replacement for its origin-based tax, it will force other countries to follow suit. *See* Auerbach and Devereux, *Consumption and Cash-Flow Taxes in the International Setting*, National Bureau of Economic Research working paper No. 19579 (Oct. 2013).

[111] *See, e.g.*, Edward Kleinbard, *The Lessons of Stateless Income*, 65 Tax Law Review 99 (2011).

[112] *See, e.g.*, Fleming, Peroni & Shay, *Getting Serious About Curtailing Deferral on Foreign Source Income*, 52 Southern Methodist University Law Review 2 (1999).

[113] *See, e.g.*, Graetz, Michael, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States*, Yale University Press (2008).

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Chapter 1

BEPS, ATAP and the New Tax Dialogue: A Transatlantic Competition?

Reuven Avi-Yonah and Gianluca Mazzoni

The Tax Cuts and Jobs Act (TRA17) signed into law by President Trump on 22 December 2017 contains multiple provisions that incorporate the principles of the OECD/G20 Base Erosion and Profit Shifting (BEPS) into domestic US tax law. Together with the changes in the 2016 US Model Tax Treaty,[1] these provisions mean that the United States is following the European Union in implementing BEPS and particularly its underlying principle, the *single tax principle* (all income should be subject to tax once at the rate derived from *the benefits principle*, i.e. active income at a minimum source tax rate and passive at the residence state rate). This represents a triumph for the G20/OECD and is incongruent with the generally held view that the United States will never adopt BEPS.

1.1. Introduction: The US and BEPS

Since its launch in 2013, the United States has actively participated in all aspects of the BEPS Project. However, until recently, the general view was that following the conclusion of the BEPS negotiations and the change of Administration,[2] the United States was stepping back from the BEPS process. While the European Union was charging ahead with implementing BEPS through the Anti-Tax Avoidance Directive (ATAD), the United States stated that it was already in compliance with all BEPS minimum standards and therefore other than country-by-country reporting (CbCR) it had no further BEPS obligations. The United States decided not to sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) , which would have obliged it to implement BEPS into tax treaties[3] and did not join the Common

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1. On 17 February 2016 the Treasury Department issued a newly revised US Model Income Tax Convention, which includes several measures consistent with the single tax principle, e.g. Art. 1(8), a revised version of the so-called 'triangular permanent establishment' rule that has been included in some of the US income treaties since the 1990s, such as those with Austria Art. 16(4), Belgium Art. 21(6), Denmark Art. 22(6), Finland Art. 16(5), France Art. 30(5), Germany Art. 28(5), Iceland Art. 21(5), Ireland Art. 23(7), Luxembourg Art. 24(5), Malta Art. 22(5), the Netherlands Arts 1 and 2 of 1993 Protocol, South Africa Art. 22(6), Sweden Art. 17(5), and Switzerland Art. 22(4); new language added to Arts 10(5), 11(2)(d), 12(2)(b) and 21(2)(b) to the effect that dividends, interest, royalties and other income paid by an 'expatriated entity' can be subject to 30% withholding tax for a period of ten years after the inversion that created it; a newly defined term 'special tax regime' used in Arts 11(2)(c), 12(2)(a) and 21(2)(a) that would prevent reduction of withholding taxes for deductible related-party payments when the beneficial owner of the payment pays little or no tax on the related income; significant changes to Art. 22 in order to make treaty access more difficult than under the 2006 Convention. On BEPS and the US Model, *see* R.S. Avi-Yonah, *Full Circle? The Single Tax Principle, BEPS, and the New US Model* (13 Oct. 2015), U of Michigan Public Law Research Paper No. 480, 1 Global Tax'n 12 (2016); U of Michigan Public Law Research Paper No. 480; U of Michigan Law & Econ Research Paper No. 15-019. Available at SSRN: https://ssrn.com/abstract=2673463 or http://dx.doi.org/10.2139/ssrn.2673463 (accessed 5 Apr. 2018). *See also* M. Herzfeld, *US Perspectives on the Multilateral Instrument*, 46 Intertax 1, p. 80 et seq. (2018).
2. Early commentators argued that the OECD has good reason to be pessimistic about the BEPS Project's success under the new US administration, primarily due to the lack of? enthusiasm showed by previous Republican administrations in prioritizing the fight against international tax avoidance and evasion, such as the Bush Administration's position on the OECD harmful tax practices project and Trump's ideological roots. *See* T. Fensby, *Will the BEPS Project Survive the Trump Administration?* (DOC 2017-50984) 86 Tax Notes Int'l, (15 May 2017), p. 617. That view has been recently upheld by a panel of experts, during the EU-US Tax Relationship Forum: Contest or Dialogue seminar organized by Ludovici & Partners, according to which the path taken by the US Congress last December is inconsistent with the BEPS Project, which the United States declined to sign last June, because, as Ludovici stated, 'the BEPS project has an anti-avoidance function, while BEAT is entirely designed and focused on the US.' Unofficial authors' translation of A. Galimberti, *Con Beat e Gilti il fisco Usa torna indietro di 17 anni*, Il Sole 24 ORE, 14 Mar. 2018.
3. According to Henry Louie, Deputy International Tax Counsel at the US Treasury Department, the United States did not sign the MLI because its tax treaty network has a low degree of exposure to BEPS issues and many of the MLI provisions are consistent with the Treasury Department's long-standing policy, i.e. rules that determine when treaty benefits should be available for payments through fiscally transparent entities, Art. 1(6) of the 2016 Model; robust bright-line objective limitation on benefits (LOB) rules that prevent third-country investors from routing their investment into the United States through a company resident in a treaty partner to get treaty benefits. Louie has also pointed to the challenges involved with obtaining consideration by the Senate Foreign Relations Committee (first) and ratification by the Senate (after) in explaining the United States' refusal to sign on to the

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Reporting Standard (CRS) to further automatic exchange of information,[4] leading the European Union to call it a tax haven.[5] The United States has adopted BEPS provisions in its model tax treaty[6] but they have not been implemented in any actual US treaty.[7] Thus, most observers believe that the United States has abandoned the BEPS effort.

This view is not wholly correct. The current tax reform legislation clearly relies on BEPS principles and particularly on the single tax principle. This represents a triumph for the G20/OECD and challenges the generally held view that the United States will never adopt BEPS.

This chapter proceeds in four parts. Sections 1.2., 1.3. and 1.4. analyse the three BEPS provisions included in TRA17: a one-time 'transition tax' on untaxed accumulated earnings and profits (E&P) of certain non-US corporations (new § 965) and two anti-base erosion and income shifting provisions, namely a foreign minimum tax on 10% US shareholders of controlled foreign corporations (CFCs) to the extent the CFCs are treated as having 'global intangible low-taxed income' (GILTI) (new § 951A) and a base erosion and anti-abuse tax (BEAT) that will be imposed in relation to deductible payments made by certain corporations to their non-US affiliates (new § 59A). Section 1.5. discusses one of the key BEPS Action items that caused the most concern in the United States, i.e. Action 6 on the prevention of treaty abuse through inclusion of *a principal purpose test* (PPT). In section 1.6., the authors argue that Congress could have done more, especially with regard to the anti-hybrid rules for certain related-party amounts of the new § 267A since it does not have any significant impact on foreign-to-foreign hybrid planning. To this extent, it should be noted that in order to limit the application of Subpart F exceptions to transactions that use reverse hybrids to create *stateless income*, the Obama Administration proposed a rule that would provide that §§ 954(c) and 954(c)(6) do not apply to payments made to a foreign reverse hybrid held directly by a US owner when those amounts are treated as deductible payments received from foreign related persons. Section 1.7. provides some conclusions.

1.2. Past Accumulations

Section 965 of TRA17 provides for a one-time deemed repatriation tax on previously untaxed accumulated foreign earnings. TRA17 splits E&P between cash and illiquid assets with cash amounts taxed at a 15.5%

MLI. *See* K. Bell, *Treasury Official Explains Why U.S. Didn't Sign OECD Super-Treaty*, BNA Transfer Pricing Report (8 June 2017) available at https://www.bna.com/treasury-official-explains-n73014453413/ (accessed 5 Apr. 2018).

4. Because it has signed a host of bilateral intergovernmental agreements (IGAs), the United States sees no need to join the CRS. *See* The Economist, *The biggest loophole of all* (20 Feb. 2016), https://www.economist.com/news/international/21693219-having-launched-and-led-battle-against-offshore-tax-evasion-america-now-part (accessed 5 Apr. 2018).

5. K. Scannell & V. Houlder, *US tax havens: The new Switzerland*, *Financial Times* (8 May 2016), https://www.ft.com/content/cc46c644-12dd-11e6-839f-2922947098f0 (accessed 5 Apr. 2018). For a general comment on the topic of automatic exchange of information (AEoI) *see* G. Marino, *International and European Measures for De-offshoring: Global Ambitions and Local Hypocrisies*, 45 Intertax 8/9 (2017), p. 527 et seq. However, it should be noted that on 13 Dec. 2016 the US Treasury Department and Internal Revenue Service (IRS) have issued final regulations that treat a domestic disregarded entity wholly owned by a foreign person as a domestic corporation separate from its owner for the limited purposes of the reporting, record maintenance and associated compliance requirements that apply to 25% foreign-owned domestic corporations under section 6038A of the Internal Revenue Code (IRC). In the authors' opinion re AEoI, this should give the United States something to exchange.

6. *Supra* n. 1. In addition to these new provisions, the 2016 Model incorporates certain other BEPS recommendations for the first time: (i) a new preamble language that makes clear that the parties' common intention with the treaty is to eliminate double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements; (ii) a rule intended to prevent contract-splitting to circumvent the twelve-month threshold for building sites or construction or installation projects (Art. 5(3)) and (iii) a twelve-month ownership and residence requirement for the 5% withholding rate for direct dividends (Art. 10(2)). Finally, the 2016 Model has not adopted the Final Report on Action 7 proposed amendments to Art. 5(5) and (6) of the OECD Model Tax Convention that address the application of the so-called 'dependent agent PE' provisions to commissionaire arrangements and similar strategies, as well as those to Art. 5(4) that would have narrowed the specific activity exceptions. The reason is that the United States has not seen promised guidance on attribution of profits to permanent establishments (PEs) and is not confident about how its treaty partners intend to apply those rules. *See* M. Herzfeld, *New Analysis: The Multilateral Instrument and Permanent Establishments*, 86 Tax Notes Int'l (19 June 2017), p. 1029 et seq.

7. However, *see* the Statement regarding bilateral tax treaty negotiations between the United States and Luxembourg and the Treatment of Certain Permanent Establishments (22 June 2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Luxembourg-Statement-06222016.pdf. For a comment *see* E. Tanenbaum, *The 2016 U.S. Model Income Tax Treaty in Action: U.S.-Luxembourg Protocol*, BNA Int'l Tax (9 Sept. 2016), https://www.bna.com/2016-us-model-n73014447419/ (accessed 5 Apr. 2018).

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effective rate[8] and illiquid assets taxed at an 8% effective rate.[9] The taxpayer may elect to pay this tax over an eight-year period.[10] However, if a US shareholder becomes an '*expatriated entity*' within the meaning of § 7874(a)(2)[11] at any point within the ten-year period following enactment of TRA17, the benefits of the reduced rates would be recaptured. In that event, the US shareholder would be subject to an additional tax equal to 35% of the amount of the deduction allowed in respect of the transition tax. No foreign tax credits are permitted to offset this additional tax.[12]

The accumulation of offshore profits by US multinationals in low-tax jurisdictions has been the focus of significant concern and a primary driver of the BEPS effort. The EU ATAD and State aid as well as the UK diverted profits tax (DPT) and current discussion on the digital economy all reflect these concerns.[13] Indeed, these earnings, accumulated since the 2004–5 tax amnesty and currently exceeding USD 2.6 trillion, are located in just seven low-tax jurisdictions[14] and they are highly concentrated: just four companies (Apple,[15] Microsoft,[16] Pfizer[17] and GE)[18] hold approximately one quarter (24%) of the offshore profits. Ten companies have 38% of the profits and fiftycompanies hold three quarters of the earnings.

8. 14% in the House bill § 4004 and 14.5% in the Senate amendment § 14103.

9. 7% in the House bill § 4004 and 7.5% in the Senate amendment § 14103.

10. Sec. 965(h)(1).

11. A foreign corporation or publicly traded foreign partnership (foreign acquirer) acquires a US corporation (domestic target) and former shareholders of the US corporation hold at least 60% (by vote or value) but less than 80% of the stock of the combined entity. *See* O. Marian, *Home Country Effects of Corporate Inversions*, 90 Wash. L. Rev. 1, 7–9 (2015).

12. § 965(l)(1).

13. OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (OECD 2018), http://dx.doi.org/10.1787/9789264293083-en (accessed 5 Apr. 2018).

14. Clausing suggests that 82% of the US profit shifting problem is with just seven tax havens with extremely low effective tax rates: the Netherlands, Ireland, Luxembourg, Bermuda, Switzerland, Singapore and the UK Caribbean Islands. These countries alone account for 50% of all foreign income earned by affiliates of US multinational firms but only account for 5% of all foreign employment of such firms. *See* K.A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond* (17 June 2016), at pp. 7–8, available at SSRN: http://ssrn.com/abstract=2685442 (accessed 5 Apr. 2018). *See also* M.P. Keightley & J.M. Stupak, *Corporate Tax Base Erosion and Profit Shifting (BEPS): An Examination of the Data*, CRS report R44013 (30 Apr. 2015), at p. 6; G. Zucman, *Taxing across Borders: Tracking Personal Wealth and Corporate Profits*, 28 Journal of Economic Perspectives 4, (2014), at p. 128.

15. Apple Inc. I 2017 Form 10-K at p. 30: 'As of September 30, 2017 and September 24, 2016, the Company's cash, cash equivalents and marketable securities held by foreign subsidiaries were $252.3 billion and $216.0 billion, respectively, and generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S.', http://files.shareholder.com/downloads/AAPL/6134806168x0xS320193-17-70/320193/filing.pdf (accessed 5 Apr. 2018).

16. Microsoft Corp I 2017 Form 10-K: 'Of the cash, cash equivalents, and short-term investments as of June 30, 2017, $127.9 billion was held by our foreign subsidiaries and would be subject to material repatriation tax effects. The amount of cash, cash equivalents, and short-term investments held by foreign subsidiaries subject to other restrictions on the free flow of funds (primarily currency and other local regulatory) was $2.4 billion. As of June 30, 2017, approximately 87% of the cash equivalents and short-term investments held by our foreign subsidiaries were in U.S. government and agency securities, approximately 3% were invested in U.S. mortgage- and asset-backed securities, and approximately 2% were invested in corporate notes and bonds of U.S. companies, all of which are denominated in U.S. dollars. The remaining cash equivalents and short-term investments held by our foreign subsidiaries were primarily invested in foreign securities', https://www.microsoft.com/investor/reports/ar17/index.html# (accessed 5 Apr. 2018).

17. Pfizer Inc. I 2016 Form 10-K at p. 95: 'As of December 31, 2016, we have not made a U.S. tax provision on approximately $86.0 billion of unremitted earnings of our international subsidiaries. As these earnings are intended to be indefinitely reinvested overseas, the determination of a hypothetical unrecognized deferred tax liability as of December 31, 2016 is not practicable', http://d18rn0p25nwr6d.cloudfront.net/CIK-0000078003/3e486f49-627a-4c2c-b133-0e7d714465a4.pdf (accessed 5 Apr. 2018). In its 2017 Financial Report, Pfizer stated that, 'Given the recent changes in tax law under the TCJA, which includes transitioning U.S. international taxation from a worldwide tax system to a territorial tax system, we have recorded a repatriation tax [$15.2 billion tax liability] on deemed repatriated accumulated post-1986 earnings of foreign subsidiaries for which we plan to elect payment over eight years through 2026 [first installment due in April 2019].' See 2017 Financial Report at p. 57, https://s21.q4cdn.com/317678438/files/doc_financials/Annual/2017/Financial-Report-2017.pdf (accessed 5 Apr. 2018).

18. GE 2016 FORM 10-K at p. 93: 'At December 31, 2016 and 2015, approximately $82 and $104 billion of earnings, respectively, have been indefinitely reinvested outside the United States. Most of these earnings have been reinvested in active non-US business operations, and we do not intend to repatriate these earnings to fund U.S. operations. Because of the availability of U.S. foreign tax credits, it is not practicable to determine the U.S. federal income tax liability that would be payable if such earnings were not reinvested indefinitely outside the United States', https://www.ge.com/ar2016/assets/pdf/GE_AR16.pdf (accessed 5 Apr. 2018). In its 2017 FORM 10-K, GE stated that, 'On December 22, 2017, the U.S. enacted the Tax Cuts and Jobs Act (U.S. tax reform) that lowers the statutory tax rate on U.S. earnings, taxes historic foreign earnings at a reduced rate of tax, establishes a territorial tax system and enacts new taxes associated with global operations. As a result of the enactment of U.S. tax reform, we have recorded tax expense of $3.3 billion in 2017 to reflect our provisional estimate of both the transition tax on historic foreign earnings ($1.2 billion) and the revaluation of deferred taxes ($2.2 billion)', https://www.sec.gov/Archives/edgar/data/40545/000004054518000014/ge10-k2017.htm at p. 21 (accessed 5 Apr. 2018).

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In the authors' opinion, there are four arguments for why such low rates are inappropriate for past earnings. Firstly, as a policy matter, there is no justification for not taxing these profits in full, because they do not raise competitiveness issues (since they have been earned) or behavioural response issues (since the behaviour has already happened) and because they mostly represent earnings on intellectual property developed in the United States with hefty taxpayer support.[19]

Secondly, there are a few outstanding issues with dual rates, including: (i) what may be considered a 'cash or cash equivalent' for the purposes of this tax and (ii) whether there would be a look-back rule for 'cash or cash equivalent' assets recently invested to take advantage of the lower rate, or a more general anti-abuse rule targeting transactions carried out to achieve the lower rate. The reason is simple: taxpayers are incentivized to manipulate their foreign cash positions by converting cash to more illiquid investments and by legitimately distributing some of their cash through dividend payments or other means.[20] The new law includes both a look-back rule and a subjective intent-based anti-abuse test, the PPT. Indeed, § 965(c)(3)(A) provides a formula for calculating how much E&P should be attributed to cash assets and therefore subject to the higher 15.5% rate. The benchmark is the '*aggregate foreign cash position*' calculated as the greater of either 'the pro rata share of the cash position of all specified foreign corporations as of the last day of the last taxable year beginning before January 1, 2018, or the average of the cash position determined on the last day of each of the two taxable years ending immediately before November 2, 2017.' In addition, § 965(c)(3)(F) states that, 'If the Secretary determines that *a principal purpose* of any transaction was to reduce the aggregate foreign cash position taken into account under this subsection, such transaction shall be disregarded for purposes of this subsection [emphasis added].' The Conference Report accompanying TRA17, states that, 'The provision also authorizes the Secretary to disregard transactions that are determined to have *the principal purpose* of reducing the aggregate foreign cash position [emphasis added],' thus, viewing those two formulations as having the same meaning. But if '*a principal purpose*' shall be defined as being one of its '*first-in importance*' purposes, the authors believe that the effectiveness of § 965(c)(3)(F) would be substantially undermined. In this regard, the extensive report prepared by the Tax Section of the New York State Bar Association (NYSBA) on the 1994 proposed partnership anti-abuse regulation stated,

> If a transaction were subject to attack only if 'the' principal purpose were tax avoidance, the result would be a substantially increased willingness on the part of taxpayers to engage in aggressive transactions. In our experience, a taxpayer usually is able to assert some nontax purpose for a transaction, even if that purpose is on its face borderline. *Any such claim would have to satisfy a much lower threshold of* '*believability'* if the test were whether 'the' principal purpose of the transaction is tax avoidance … The history of § 269, the corporate anti-abuse rule that applies only when 'the' principal purpose of a transaction is tax avoidance, demonstrates the weakness of such a test. The Service has been unable to successfully apply $ 269 with any regularity, as indicated by the dearth of judicial decisions under that section as well as our experience that agents in the field rarely attempt to apply the section. We believe those results may be attributable to § 269's requirement that 'the' principal purpose of a transaction be tax avoidance, which *often allows the taxpayer to prevail by asserting a relatively weak business purpose* [emphasis added].[21]

Thirdly, studies have highlighted that repatriated earnings in 2004 were used to send cash back to shareholders, either in the form of dividends or stock buybacks,[22] instead of being invested in new US jobs and infrastructure

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19. According to the Permanent Subcommittee on Investigations (PSI) report on Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.), in 2011, almost all of Apple's research activity was conducted by Apple Inc. employees in California. The vast majority of Apple's engineers, product design specialists and technical experts were physically located in California.
20. S.E. Shay, *Directions for International Tax Reform, Testimony before the U.S. Senate Committee on Finance, Hearing on International Tax Reform* (3 Oct. 2017), https://www.finance.senate.gov/imo/media/doc/Shay%2010-3-17%20SFC%20Testimony%20final%209-30.pdf (accessed 5 Apr. 2018). S.E. Shay, *Tax Reform – Process Failures, Loopholes and Wealth Windfalls* (21 Nov. 2017), https://ssrn.com/abstract=3076151 or http://dx.doi.org/10.219/ssrn.3076151 (accessed 5 Apr. 2018). D. Morgan, *Corporations may dodge billions in U.S. taxes through new loophole – experts*, Reuters Market News (12 Jan. 2018), https://www.reuters.com/article/usa-tax-repatriation/rpt-corporations-may-dodge-billions-in-u-s-taxes-through-new-loophole-experts-idUSL1N1P701I (accessed 5 Apr. 2018).
21. 94 TNT 130-34, *NYSBA Submits Report on Partnership Antiabuse Regulation* (1 July 1994 (Doc 94-6234).
22. K.A. Clausing, *Profit shifting and U.S. corporate tax policy reform*, Washington Center for Equitable Growth (May 2016), at p. 10: 'As part of the American Jobs Creation Act of 2004, the U.S. government gave U.S. multinational firms a temporary holiday for repatriating income at a low rate of 5.25 percent. This holiday dramatically increased repatriations, *but the inflow of funds was largely used for share repurchases and dividend issues*, *and did not boost employment or investment despite the hopeful title of the legislation* [emphasis added]', http://cdn.equitablegrowth.org/wp-content/uploads/2016/05/05115111/051016-clausing-profit-shifting.pdf (accessed 5 Apr. 2018).

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as President Trump sold TRA17 on the promise that, '*the plan is going to bring trillions of dollars back into the United States*, *money that's offshore* … But you look at the great companies – Apple and so many others. They have billions of dollars overseas that they want to bring back. Now they're going to be able to bring it back, and we'll [sic] spending that money, and they'll be spending that money right here. *And it will be jobs and lots of other good things* [emphasis added].'[23] Thus, it is highly likely that repatriated funds will be used for already planned projects, such as pay down [sic] existing borrowings,[24] set off a new wave of M&A,[25] rather than being invested in expansion. For example, Cisco expects to spend much of the newly repatriated cash on share buybacks and dividends over the next two years.[26] On the other hand, Apple announced in January that it would invest USD 30 billion in capital spending in the United States; over five years that would create more than 20,000 jobs. However, analysts questioned whether Apple's commitments were new and impacted in any way by the tax reform since the company would have been able to make this investment with existing cash flow – without needing to tap into cash holdings.[27]

Last but not least, this money is not trapped offshore. Under the previous § 956(c)(2)(A) and (F), a foreign subsidiary's untaxed earnings might have been invested without triggering the deemed dividend rules regarding stock of a domestic corporation, a debt obligation of a US person or a US bank deposit, as long as the issuer was not a US shareholder or did not have a 25% or other proscribed relationship with the foreign subsidiary.[28] The US Senate Permanent Subcommittee on Investigations on the 2004 tax holiday has showed that at the end of FY2010, of the USD 538 billion in undistributed accumulated foreign earnings of 20 US multinational corporations, nearly half (46%) of the funds that the corporations had identified as offshore and for which US taxes had been deferred were actually deposited in the names of CFCs in accounts at US financial institutions.[29] Recent data compiled by Bloomberg shows that the top 10 US multinationals have boosted their investments in government bonds to USD 113 billion from USD 67 billion and have received at least USD 1.4 billion in interest payments over the past five years.[30]

1.3. Future Accumulations

In TRA17, the shift from a worldwide system of taxation to a quasi-territorial one is accompanied by some sort of a foreign minimum tax, the so-called *global intangible low-taxed income* (GILTI) provision, the stick. The intent is to discourage erosion of the US base by moving or holding intangible assets outside the United States. Under the new § 951A(a), a US shareholder of any CFC must include in its gross income for a taxable year its GILTI in a manner generally similar to inclusion of Subpart F income. GILTI means, with respect to any US shareholder for the shareholder's taxable year, the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return.[31] Net deemed tangible income return is, with respect to any US shareholder for a taxable year, the excess (if any) of 10% of the aggregate of its pro rata share of the qualified business asset investment (QBAI) of each CFC with respect to which it is a US shareholder over the amount of interest expense taken into account in determining its net CFC tested income for the taxable year to

23. *Remarks by President Trump at Lunch with Bicameral Tax Conferees*, Budget & Spending (13 Dec. 2017), https://www.whitehouse.gov/briefings-statements/remarks-president-trump-lunch-bicameral-tax-conferees/ (accessed 5 Apr. 2018).
24. R. Waters, *US tax holiday will benefit tech shareholders not workers*, Financial Times (17 Apr. 2017), https://www.ft.com/content/1ede0082-2b5d-11e7-bc4b-5528796fe35c (accessed5 Apr. 2018).
25. C. Nao, *Trump's Corporate Tax Reform Poised to Fuel More M&A*, Law 360 (28 Apr. 2017): 'We would expect to see an increase in domestic acquisitions by U.S. multinationals. They would have access to their cash that has been trapped overseas, so repatriation tax or deemed repatriation tax at a rate that is below 35 percent would allow companies, instead of having to borrow, to access that cash to make domestic acquisitions …', https://www.law360.com/tax/articles/918368/trump-s-corporate-tax-reform-poised-to-fuel-more-m-a (accessed 5 Apr. 2018).
26. A. Hufford & J. Greene, *Cisco to Bring $67 Billion to U.S. After New Tax Law*, The Wall Street Journal (14 Feb. 2018), https://www.wsj.com/articles/cisco-returns-to-growth-after-two-year-sales-slump-1518645580?mod=searchresults&page=1&pos=2 (accessed 5 Apr. 2018).
27. T. Mickle, *Apple to Pay $38 Billion in Taxes on Cash Overseas, Build New U.S. Campus*, The Wall Street Journal (17 Jan. 2018), https://www.wsj.com/articles/apple-to-pay-38-billion-in-repatriation-tax-plans-new-u-s-campus-1516215419 (accessed 5 Apr. 2018).
28. S.E. Shay, *The Truthiness of 'Lockout': A Review of What We Know*, 146 Tax Notes 9 (16 Mar. 2015), at p. 1394 n. 8.
29. Senator Carl Levin (D-MI) & Senator John McCain (R-AZ), *Memorandum RE Offshore Profit Shifting and the U.S. Tax Code – Part 2* (Apple Inc.), at p. 7 n. 14.
30. A. Wong, *Americans Are Paying Apple Millions to Shelter Overseas Profits*, Bloomberg Technology (7 Dec. 2016), https://www.bloomberg.com/graphics/2016-apple-profits/#methodology (accessed 5 Apr. 2018).
31. § 951A(b)(1).

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the extent that the interest expense exceeds the interest income properly allocable to the interest expense that is taken into account in determining its net CFC tested income.[32] Net CFC tested income means, with respect to any US shareholder, the excess of the aggregate of the shareholder's pro rata share of the tested income of each CFC with respect to which it is a US shareholder over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a US shareholder.[33] The tested income of a CFC means the excess (if any) of the gross income of the corporation – determined without regard to certain exceptions to tested income – over deductions (including taxes) properly allocable to such gross income.[34] QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is generally allowable under § 167.[35] To put it simply, the formula for GILTI can be expressed as:

GILTI = Net CFC Tested Income – [(10% x QBAI) – Interest Expense]

As a result, the formula generally exempts from inclusion a deemed return on tangible assets and assumes the residual income to be intangible income that is subject to current US tax.[36]

The tax rate for future GILTI is determined by taking the 21% corporate tax rate and allowing a deduction of 50%,[37] to give? a net rate of 10.5%.[38] This rate can be partially offset by foreign tax credits[39] but in a separate basket[40] (but with cross-averaging within the basket).[41] The provision is effective for taxable years of foreign corporations beginning after 31 December 2017.

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32. § 951A(b)(2).
33. § 951A(c)(1).
34. § 951A(c)(2).
35. § 951A(d)(1).
36. M.A. Sullivan, *Economic Analysis: More Gilti Than You Thought*, 89 Tax Notes Int'l (12 Feb. 2018), p. 587: 'GILTI is an arbitrary measure of high profitability. *High profits* (relative to tangible assets) *could be related to the presence of intangibles*, as economists often assume, or may have nothing to do with intangibles at all. Drafters did the public no favors with the GILTI acronym. The "I" in GILTI is understandably confusing to many because *there is otherwise no direct reference to intangible assets in the statutory text*, *and these assets play no direct role in the calculation of tax liability under sections 951A and 250*. And, as we shall see, the "LI" is also misleading because in certain circumstances, GILTI can be subject to U.S. tax even when the average worldwide foreign tax rate of a U.S. taxpayer is not low;' C.H. Lowell, M.P. Thomas & K.L. Novak, *The International Provisions of the TCJA*, Corporate Taxation (WG&L) (Mar./Apr. 2018): 'The Final BEPS Actions 8-10 recommendations focused on establishing an appropriate balance in the allocation of income between routine and non-routine functions of affiliates. The U.S. approach embraces this model to (1) coordinate its new territorial regime with the former worldwide regime, including prior tax base protection mechanisms in the CFC and related FTC provisions of the U.S. Code; and (2) encourage economic activity within the United States. *For these purposes*, *such non-routine income is derived by defining "intangible income" as the margin in excess of a normative return of 10% on tangible assets*;' L.D. Yoder, D.G. Noren & E.R. Chao, *Tax Reform: Taxation of Income of Controlled Foreign Corporations*, BNA Daily Tax Report (22 Jan. 2018): 'In general, the new GILTI provision is designed to impose a minimum residual U.S. tax on above-routine CFC earnings, with the exempt routine return being defined generally as a 10% return on the CFC's tangible property ("qualified business asset investment," or "QBAI").'
37. § 250(a)(1)(B) For taxable years beginning after December 31, 2025, the deduction for GILTI is lowered to 37.5 percent, *see* § 250(a)(3)(B). It should be noted that the conference agreement followed § 14202 of the Senate amendment, clarifying that the deduction for GILTI is only available to domestic corporations, i.e. C corporations that are not RICs or REITs. US shareholders that are not domestic corporations are subject to full US tax on their GILTI. An S corporation's taxable income is computed in the same manner as individual (sec. 1363(b)) so that deductions allowable only to corporations, such as FDII and GILTI, do not apply. *See* Conference Report to TRA17, n. 1524. For a comment, *see* L. Browning, *'Orwellian' Offshore Tax Will Hit Some Firms Harder Than Others*, Tax Management Weekly Report (1 Jan. 2018): 'But those low rates are available only for corporations. Partnerships and other so-called pass-through entities would face much higher rates on some of their foreign income – they wouldn't get the deduction, experts say … global private equity partnerships that aren't publicly traded wouldn't be eligible for the GILTI deduction.'
38. The Conference Report to TRA17 illustrates that, 'If the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 10.5 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125. At foreign tax rates greater than or equal to 13.125 percent, there is no residual U.S. tax owed on GILTI, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.'
39. § 960(d)(1).
40. § 904(d)(1)(A).
41. Yoder, Noren & Chao, *supra* n. 36: 'A foreign tax credit is permitted for 80% of the foreign taxes associated with GILTI … A separate basket is provided for non-passive GILTI taxes, and any excess credits may not be carried forward or back (i.e., the computation is carried out on a purely annual basis). It appears that the U.S. tax consequences are calculated by treating all non-passive GILTI the same. This allows for cross-crediting between non-passive GILTI that is subject to tax at different rates, but taxes associated with non-passive GILTI may not be used to offset income in other baskets.'

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What this means in plain English is that Amazon, Apple, Facebook, Google, Netflix and their ilk will have to pay tax at 10.5% on future GILTI because they have CFCs that produce 'tested income' (and no loss) in excess of 10% over their basis in offshore tangible assets, which will be zero or close to it (since they derive almost all of their income from intangibles). Other MNEs (e.g. GE or Intel) will pay less because they have more tangible assets offshore. This creates an obvious incentive to move jobs (not just profits) offshore. In this regard, a Baker McKenzie Client Alert observed that, 'the GILTI rules create a surprising and unexpected incentive for U.S. multinationals to increase the amount of tangible assets held by their CFCs, which in most circumstances will be presumably be situated outside the United States. Assuming a more or less steady amount of overall income potentially subject to Section 951A (and deductible under Section 250), increasing QBAI held by CFCs may be one of the most effective ways to manage or reduce GILTI.'[42]

To address these issues, TRA17 proposes two solutions. Firstly, § 951A(d)(4) includes a very broad anti-abuse provision which reads as follows: '[f]or purposes of determining QBAI, the Secretary is authorized to issue anti-avoidance regulations or other guidance as the Secretary determines appropriate, including regulations or other guidance that provide for the treatment of property if the property is transferred or held temporarily, or *if avoidance was a factor* in the transfer or holding of the property [emphasis added].' Secondly, § 250(a)(1)(A) provides a 37.5% foreign-derived intangible income deduction (FDII),[43] the *carrot*, with the result that the portion of a US corporation's intangible income derived from serving foreign markets is effectively taxed at 13.125%. The intent is to encourage US multinationals to remain in the country and keep their assets, earnings, jobs and functions there.

Section 250(b)(1) defines the FDII of any domestic corporation as the amount which bears the same ratio to the corporation's 'deemed intangible income' as its 'foreign-derived deduction eligible' income bears to its 'deduction eligible income'. In other words, a domestic corporation's FDII is its deemed intangible income multiplied by the percentage of its deduction eligible income that is foreign derived.

Deemed intangible income is the excess of a domestic corporation's deduction eligible income[44] over its deemed tangible income return.[45]

The 'foreign-derived deduction eligible income' is defined as income derived in connection with (1) property that is sold by the taxpayer to any foreign person for a foreign use or (2) services provided to any foreign person, or with respect to foreign property.[46] Foreign use means any use, consumption or disposition which is not within the United States.[47] For purposes of the provision, the terms 'sold,' 'sells,' and 'sale' include any lease, exchange or other disposition. Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or related parties. Section 250(b)(5)(B) and (b)(5)(C) operate- to make sure that property is ultimately sold to a foreign person for use or consumption abroad or services are provided to a person, or with respect to property, located outside the United States. If property is sold to a related foreign party, the sale is not treated as for a foreign use unless the property is sold by the related foreign party to another person who is unrelated and is not a US person and the taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use.[48] Transactions implicating this rule might arise where, for example, a US corporate taxpayer who owns intellectual property (IP) rights domestically in film or television programming licenses those rights to a wholly owned foreign subsidiary, which, in turn, sub-

42. Baker McKenzie, *Tax News and Developments – Client Alert* (20 Dec. 2017), at p. 21, https://www.bakermckenzie.com/-/media/files/insight/publications/2017/12/client-alert--us-tax-reform--the-tax-cuts-and-jobs-act-congress-passe.pdf?la=en (accessed 5 Apr. 2018).
43. § 250(a)(3)(A) For taxable years beginning after December 31, 2025, the deduction for FDII is reduced to 21.875 percent.
44. § 250(b)(3)(A) Gross income without regard to certain exceptions - (1) subpart F income; (2) GILTI; (3) financial services income; (4) dividends received from a related person; (5) domestic oil and gas extraction income; and (6) foreign branch income – over deductions (including taxes) properly allocable to such gross income.
45. § 250(b)(2)(B) 10 percent of the corporation's QBAI; Baker McKenzie, *supra* n. 42, at p. 20: 'Second, as a planning matter, we note that the key components of the formula – specifically, those over which the taxpayer might be able to exercise some degree of control, – are "deemed intangible income" and "foreign derived deduction eligible income". Broadly speaking, *any increase in such amounts will result in an increase in the deduction under Section 250 … Consequently a reduction in a domestic corporation's QBAI will tend to increase deemed intangible income and*, *accordingly*, *FDII* [emphasis added].'
46. § 250(b)(4).
47. § 250(b)(5)(A).
48. § 250(b)(5)(C)(i).

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licenses the content in its local market to third parties.[49]A similar restriction also exists with services provided to a related party located outside the United States. Income derived from such a transaction does not qualify as foreign-derived deduction eligible income unless the taxpayer establishes to the satisfaction of the Secretary that the service is not substantially similar to services provided by the related party to persons located within the United States.[50]

There are three obvious problems with the FDII deduction.

According to a group of thirteen tax law professors, taxpayers may be able to take advantage of the reduced rate on export income through 'resale' transactions where goods are sold to independent foreign distributors who subsequently resell back into the United States. In their opinion, Treasury should address such 'roundtripping' transactions in regulations with rules similar to those under Treas. Reg. 1.954-3(a)(3)(ii),[51] which determine the place of use, consumption or disposition of property for foreign base company sales income purposes. In particular, Treasury should require US manufacturers to conduct a real investigation of how much the independent foreign party will sell back into the United States.[52] Another major issue that Treasury should focus on is the level of further processing required to qualify as foreign use. Assuming that roundtripping transactions are permitted to the extent that the property sold is somewhat further processed abroad,[53] what would be the minimum amount of further processing necessary to allow reimportation into the United States? In the authors' opinion, Treasury should apply standards similar to the '*substantial transformation*' and/or '*substantial contribution*' tests provided by Treas. Reg. 1.954-3(a)(4)(ii) and 1.954-3(a)(4)(iv). If substantial transformation and/or contribution may sound like high standards, the authors believe that property should be, at least, significantly or materially modified before being reimported into the United States. Additional guidance will be needed for computer software transactions where software is licensed to be merely imprinted in physical CDs and then sold back into the United States. In the authors' opinion, income derived from such a transaction should not qualify as foreign-derived deduction eligible income since the software is merely imprinted in physical form and not significantly modified.

Secondly, the authors believe that the FDII regime is clearly inconsistent with the modified nexus approach adopted by the OECD in the BEPS because it does not require any activity to be carried out in the United States other than exporting. Taxpayers can get the lower rate by importing goods and immediately exporting them.[54] As stated by Schler, 'the provision does not require that anything be manufactured in the U.S. The formula is based only on profits from exports. A U.S. corporation could buy goods from a related or unrelated foreign

49. Portfolio 599-2nd: Film and TV Production: Tax Accounting Considerations and Federal Tax Incentives, Detailed Analysis, F. 2017 Tax Act Changes that Affect Cross-Border Operations or Multinational Groups.
50. § 250(b)(5)(C)(ii).
51. Treas. Reg. § 1.954-3(a)(ii): 'As a general rule, personal property which is sold to an unrelated person will be presumed for purposes of this subparagraph to have been sold for use, consumption, or disposition in the country of destination of the property sold; for such purpose, the occurrence in a country of a temporary interruption in shipment of goods shall not constitute such country the country of destination. However, if at the time of a sale of personal property to an unrelated person *the controlled foreign corporation knew*, *or should have known from the facts and circumstances surrounding the transaction*, *that the property probably* would not be used, consumed, or disposed of in the country of destination, the controlled foreign corporation must determine the country of ultimate use, consumption, or disposition of the property or the property will be presumed to have been used, consumed, or disposed of outside the country under the laws of which the controlled foreign corporation is created or organized [emphasis added].'
52. D. Kamin et al., *The Games They Will Play: An Update of the Conference Committee Tax Bill* (18 Dec. 2017), https://ssrn.com/abstract=3089423 (accessed 5 Apr. 2018).
53. Conference Report to TRA17: 'If property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use', n. 1522 at p. 625. For a comment, *see* Kamin et al., *supra* n. 52, at p. 20: 'This presumably allows for roundtripping so long as there is some degree of foreign processing since otherwise this rule would not be necessary. It is possible that, by negative implication, the conferees aimed to imply that a sale for reimportation would not be for foreign use in the absence of further foreign processing.'
54. In addition, in their letter sent to Treasury Secretary Mnuchin, the Finance Ministers of France, Germany, Italy, Spain and the United Kingdom noted that: '[t]he design of the regime is notably different from accepted IP regimes by *providing a deduction for income derived from intangible assets other than patents and copyright software*, *such as branding*, *market power*, *and market-related intangibles*. It would not be compatible with the BEPS consensus that has been approved by more than 100 states and jurisdictions worldwide. Furthermore, in deviation of the agreed nexus approach, *the proposal will provide benefits to income from IP assets that are in no direct connection with R & D activity* [emphasis added].'

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supplier, resell them around the world, and have FDII for its profits on foreign sales. Not a single employee need be in the United States.'[55]

Thirdly, the FDII regime has a blatant and obvious WTO problem:[56] it is a subsidy contingent upon export performance, which is explicitly prohibited by Art. 3.1(a) of the Subsidies and Countervailing Measures Agreement (SCM). This was precisely the type of export subsidy struck down in the 'Domestic International Sales Corporation,' 'Foreign Sales Corporation' and 'Extraterritorial Income' cases, resulting in massive potential sanctions and forcing the United States to repeal the subsidy and enact a domestic manufacturing provision (§ 199) that did not violate the SCM because it was not contingent upon export performance. The FDII has a very low chance of surviving a WTO dispute not only because it clearly satisfies the definition of a 'prohibited subsidy' under the SCM agreement, but also because it is inconsistent with the main arguments advanced by the United States during the US-FSC litigation. The authors would expect that this provision will be struck down by the WTO and the United States will be left with only the GILTI provision. As stated above, the GILTI provision is inadequate but this can be fixed by a future Democratic administration by the setting of the GILTI rate as the same as the domestic rate (21%).[57]

1.4. Base Erosion

The Conference Agreement followed the Senate's BEAT with some changes,[58] an alternative to the House excise tax proposal.[59] Under the new § 59A(a), an 'applicable taxpayer' is required to pay a tax equal to the 'base erosion minimum tax amount' for the taxable year. The BEAT generally applies to corporations (other than RICs, REITs or S corporations) that over a three-year period have average annual gross receipts of at least USD 500 million and a 'base erosion percentage' for the taxable year of at least 3%.[60] The 'base erosion minimum tax amount' is the excess of 10% of the taxpayer's 'modified taxable income' over the taxpayer's 'regular tax liability' (defined in § 26(b)) reduced (but not below zero) by the excess (if any) of credits allowed against such regular tax liability over the sum of: (1) § 38 credit properly allocable to the § 41(a) research credit; plus (2) the portion of the applicable § 38 credits not in excess of 80% of the lesser of the amount of such credits or the base erosion minimum tax amount.[61] To determine its modified taxable income, a corporation computes its taxable income for the year without regard to any 'base erosion tax benefit' with respect to any 'base erosion payment' or the 'base erosion percentage' of any allowable net operating loss deduction allowed under section 172 for the taxable year.[62] A 'base erosion payment' is defined as any amount paid or accrued to a foreign related person that is a related party of the taxpayer and with respect to which a deduction is allowable,[63] including interest and royalties; amounts paid in connection with an acquisition of property subject to the allowance of depreciation (or amortization in lieu of depreciation);[64] premiums or other consideration paid or accrued for any reinsurance payments[65] and, for inverted corporations only, also the cost of goods sold (COGS).[66] On the other hand, payments for services if such services qualify for the services cost method under

55. M.L. Schler, *Reflections on the Pending Tax Cut and Jobs Act*, Tax Forum 686 (4 Dec. 2017), at p. 41.
56. R. Kysar, *The Senate Tax Plan Has a WTO Problem* (12 Nov. 2017), https://medium.com/whatever-source-derived/the-senate-tax-plan-has-a-wto-problem-guest-post-by-rebecca-kysar-31deee86eb99 (accessed 5 Apr. 2018); Kamin et al., *supra* n. 52, at p. 20; R.S. Avi-Yonah & M. Vallespinos, *The Elephant Always Forgets: U.S. Tax Reform and the WTO* (28 Jan. 2018), U of Michigan Law & Econ Research Paper No. 18-006, https://ssrn.com/abstract=3113059 or http://dx.doi.org/10.2139/ssrn.3113059 (accessed 5 Apr. 2018).
57. In this regard, it should be noted that on 1 March Rep. Rosa L. DeLauro (D-Conn.) has introduced legislation (H.R. 5145) to amend the IRC of 1986 'to eliminate tax preferences for foreign profits by repealing the reduced rate of tax on foreign-derived intangible income and global intangible low-taxed income' *See Rep. DeLauro Introduces Bill to Eliminate Tax Preferences for Foreign Profits*, Targeted News Service (3 Mar. 2018).
58. § 14401 of the Senate amendment.
59. § 4303 of the House bill.
60. § 59A(e)(1). In the case of banks and registered securities dealers, the base erosion percentage is 2%, *see* § 59A(e)(1)(C).
61. § 59A(b)(1).
62. § 59A(c)(1).
63. § 59A(d)(1).
64. § 59A(d)(2).
65. § 59A(d)(3).
66. § 59A(d)(4)(A).

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Treas. Reg. § 1.482-9 and only if they are made for services that have no markup component,[67] as well as any qualified derivative payment, are not treated as base erosion payments.[68]

A couple of preliminary observations are in order. Firstly, the real purpose of BEAT seems to be somehow ambiguous and confounding. If BEAT intends to prevent the erosion of and protect the US tax base, why does it make a distinction between payments to foreign related parties and payments to unrelated ones and include only the former in calculating the new tax? Stevens and Barnes argue that the definition of base erosion payment apparently reflects the US government's lack of confidence in policing transfer pricing.[69] In this regard, it should be noted that § 59A(i) provides that the Secretary of the Treasury is to prescribe such regulations or other guidance necessary or appropriate, including regulations providing for such adjustments to the application of this section necessary to prevent avoidance of the provision, including through: (1) the use of *unrelated persons*, *conduit transactions* or *other intermediaries* or (2) transactions or arrangements designed in whole or in part: (A) to characterize payments otherwise subject to this provision as payments not subject to this provision or (B) to substitute payments not subject to this provision for payments otherwise subject to this provision. In the authors' opinion, principles similar to those under the anti-conduit regulations[70] may be applied to identify whether a foreign related party is the actual beneficial owner of a base erosion payment.

Secondly, it offers tax planning opportunities with unintended consequences. Rather than manufacturing the goods itself and paying the foreign affiliate a royalty for the use of software, trademark or other intellectual property, a US corporation may prefer to purchase the finished products from a foreign affiliate. The fact that a royalty payment is excluded from a US company's COGS but included in the expanded tax base creates incentives to move jobs offshore.[71]

Finally, can the BEAT be seen as violating the non-discrimination provision of Article 24? Article 24 has two relevant provisions: Article 24(4) and (5). Under Article 24(4),

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67. § 59A(d)(5). For a comment, *see* B. Wells, *Get With the BEAT*, 158 Tax Notes 8 (19 Feb. 2018), p. 1027: 'Under the facts in Example 2, the BEAT still does not apply. In this regard, related-party tax deductible payments that reimburse the foreign parent corporation for the actual cost of such related-party services are excluded from the definition of a base erosion payment for purposes of computing modified taxable income under section 59A. If Example 2 involved both a cost reimbursement and a markup as part of the service cost reimbursement, a colloquy between Senate Finance Committee Chair Orrin G. Hatch, R-Utah, and Finance Committee member Rob Portman, R-Ohio, suggests that only the portion of the service fee related to the markup (not the gross amount of the service payment) would be considered a base erosion payment under section 59A(c)(2). However, the language in the Senate bill that was the subject of this colloquy provided that the service cost "constitutes the total service cost with no markup." But, the final bill modified that language to state that the service cost exception applies only if the service cost "constitutes total service cost with no markup component." Thus, if the facts in Example 2 were changed so that a payment representing a markup component were made in any form in addition to the service cost payment, then the total amount of the service payment would be considered a base erosion payment, whereas a recharge of services at cost would not.'

68. § 59A(h)(1).

69. E.J. Stevens & P.A. Barnes, *Insight: BEAT Strikes the Wrong Note*, 53 BNA Daily Tax Report 16 (19 Mar. 2018), at p. 2: 'The only sustainable argument for the BEAT tax is that U.S. transfer pricing enforcement is so wholly ineffectual that it must be backstopped by an automatic penalty on most cross-border related party transactions and a crude proxy for an arm's length price.' http://www.capdale.com/files/22787_insight_beat_strikes_thewrong_note.pdf (accessed 5 Apr. 2018).

70. Treas. Reg. § 1.881-3.

71. Schler, *supra* n. 55, at pp. 39–40: 'The rule does not apply to payments for goods (except for a special rule when the payment to a surrogate foreign corporation following an inversion). As a result, it may be preferable for a U.S. corporation to buy finished goods from a foreign affiliate rather than (1) pay the foreign affiliate to act as a contract manufacturer for the U.S. company (a service payment), or (2) manufacture the goods itself and pay the foreign affiliate a royalty for the use of the trademark.' Kamin et al., *supra* n. 52 at p. 22: 'Royalty payments from a U.S. firm to its foreign affiliate, which holds intellectual property, would be included in the expanded base. If a foreign affiliate incorporates the foreign-held intellectual property into a product and then sells the product back to a U.S. affiliate, this could be considered cost of goods sold that is not captured by the inbound regime.' Stevens & Barnes, *supra* n. 69, at p. 2: 'A U.S. company pays royalties to a foreign affiliate (which may be a foreign parent of the U.S. company, or a foreign subsidiary if the taxpayer is a U.S. headquartered company.) The U.S. company uses the intellectual property to manufacture goods in the U.S. (which, significantly, provides U.S. jobs). *If the U.S. company cannot include the royalty payment in COGS, the payment will be subject to the BEAT tax, but no BEAT tax applies if the foreign affiliate performs the manufacturing and the U.S. company purchases the finished goods. The BEAT tax thus puts enhanced pressure on the tax accounting rules and creates a significant financial incentive to push manufacturing to foreign affiliates* [emphasis added].' However, Koontz and Kadet noted how the base erosion provision in the Senate version would actually miss the bulk of the profit shifting that many companies conduct, arguing that, 'Today, many such companies do not physically manufacture their own products. They may conduct all the "production activities" except the physical manufacture at their headquarters in the United States, but they farm out the physical manufacture of their products by contracting with unrelated foreign manufactures. So when a U.S. group member sources inventory for sales to U.S. customers, it's not buying that inventory from a related foreign party. In those cases, there are no base-eroding payments to related parties and no profit shifting.' *See* D.L. Koontz & J.M. Kadet, *Internet Platform Companies and Base Erosion – Issue and Solution*, 2017 TNT 243-8 (20 Dec. 2017).

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> *Except where the provisions of paragraph 1 of Article 9* (Associated Enterprises), paragraph 8 of Article 11 (Interest), or paragraph 7 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, *for the purpose of determining the taxable profits of such enterprise*, be deductible *under the same conditions* as if they had been paid to a resident of the first-mentioned Contracting State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned Contracting State [emphasis added].

Does the BEAT violate this provision? The first author has already argued elsewhere it does not because the BEAT is not equivalent to the denial of a deduction. Interest, royalties and the other items covered by the BEAT remain fully deductible. Instead, the tax benefit conferred by deducting them is subject to the 10% BEAT. The non-equivalence of the BEAT and denying the deduction can be seen from the fact that denying a deduction would increase the tax on the deductible item by 21%, not by 10%.

In addition, the BEAT can be seen as conceptually similar to a broadly applied thin capitalization rule. In fact, the BEAT replaces the old earnings stripping rule (former IRC § 163(j)).[72] And thin capitalization rules, even though they do frequently involve denying the interest deduction for interest paid to foreign but not domestic related parties, are widely used and generally regarded by the OECD as non-discriminatory.[73]

The other relevant provision of Article 24 is paragraph 5, which states that a country may not apply less favourable treatment to any entity owned or controlled by non-residents in comparison with domestically held entities.[74]

Arguably, this paragraph is violated by the BEAT because a foreign-owned US party will be subject to the BEAT but a US-owned one will not. But there are two counter-arguments. First, the BEAT applies regardless of the ultimate ownership of the US corporation and thus also to payments from a US party to a foreign party that is owned by the US party (e.g. a CFC), which shows that one of the intentions was to protect the US corporate tax base, not to discriminate against foreign-owned US parties.

Secondly, the first author argued that the foreign related party and the US related party are not comparable for applying a non-discrimination analysis. The reason is that the United States knows that a US related party is in fact subject to tax on the relevant deductible items, such as interest, royalties, and in some cases, cost of goods sold. But the United States does not know that the foreign related party is similarly subjected to tax by its country of residence because in many cases these countries will not tax, particularly when it comes to foreign-source interest or royalties. It should be expected that the enactment of the BEAT would lead multinationals to establish related parties that receive deductible payments from US parties precisely in those jurisdictions that exempt such payments because otherwise they would risk double taxation since a credit would normally not be immediately available.

The guiding spirit behind the international provisions of the TCJA is the single tax principle and under that principle it is perfectly appropriate for the United States to deny a deduction for items that it has no reason to believe will be taxed on a residence basis. No violation of Article 24(5) should arise under those circumstances.

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72. § 163(j) was amended in TRA17 to apply a 30% of earnings limit on all business interest, whether paid to domestic or foreign parties.

73. *See* OECD, Committee on Fiscal Affairs, *Report on Thin Capitalisation* (1986). There was some diversity of opinion about whether Art. 9 is held to be 'restrictive' or merely 'illustrative" in its scope. Some considered that Art. 9(1) prohibits an adjustment of the profits of a taxpayer beyond arm's length amounts. Others argued that while Art. 9(1) permits the adjustment of profits up to the arm's length amount, it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances. Note that in the case of interest, comparables always exist, but IRC sec. 163(j) applied to deny the interest deduction regardless of whether the interest rate was excessive based on the comparables. Nevertheless, there was no challenge to sec. 163(j) as discriminatory. *See* H. Ault and J. Sasseville, *Taxation and Non-Discrimination: A Reconsideration*, Boston College Law School Faculty Papers, Paper 286 (2010), http://lawdigitalcommons.bc.edu/lsfp/286 (accessed 5 Apr. 2018).

74. Art. 24(5): 'Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned Contracting State are or may be subjected.'

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Therefore, rather than engaging in retaliatory actions, EU treaty partners should adopt similar measures and apply them to US multinationals.[75]

1.5. BEPS Action 6: Should the US Reconsider the Rejection of the PPT?

One of the key BEPS Actions that generated the most controversy in the United States and eventually led the United States not to join the MLI was Action 6, primarily due to the inclusion of a general anti-abuse rule based on the principal purposes of transactions or arrangements (the PPT rule). Under that rule, if *one of the principal purposes* of transactions or arrangements is to obtain treaty benefits, these benefits will be denied unless it is established to grant them would be in accordance with the object and purpose of the provisions of the treaty. In order to understand why the United States opposed this subjective intention-based test and preferred a more objective detailed LOB provision, which has been part of its treaty policy since 1981, it is necessary to go back to the beginning of the 21st century when the US Senate refused to approve the ratification of negotiated treaties with Italy and Slovenia that originally contained a '*main purpose*' clause.

The Italian negotiators wanted to include a very broad anti-abuse provision which would have denied treaty benefits in situations not covered by the LOB clause. At that time (second half of the 1990s), Italy did not have effective domestic anti-abuse rules, which could have been used to deny treaty benefits in the case of abusive transactions, and was therefore increasingly relying on explicit anti-abuse provisions in its treaties. Indeed, Italian domestic anti-abuse provisions were so weak that, in three cases of the early 2000s, the tax authorities tried unsuccessfully to fight *dividend washing* transactions[76] through the principle of *fraude à la loi* set forth by Article 1344 of the Civil Code. In particular, Italian negotiators wanted to incorporate a provision similar to Article 30 of the 1995 treaty with Israel, which reads as follows: 'The competent authorities of the Contracting States, upon their mutual agreement, may deny the benefits of this Convention to any person, or with respect to any transaction, if in their opinion the receipt of those benefits, under the circumstances, would constitute an abuse of the Convention according to its purposes.[77]

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75. I. Grinberg, *The BEAT is a Pragmatic and Geopolitically Savvy Inbound Base Erosion Rule* (12 Nov. 2017), http://scholarship.law.georgetown.edu/facpub/2009 (accessed 5 Apr. 2018). Wells, *supra* n. 67, at p. 1030: 'Instead of criticizing the BEAT, the appropriate European response would be to adopt their own form of a BEAT to protect their own tax base from excessive BEPS practices … If all European countries adopted their own forms of a BEAT to protect their tax bases against excessive use of base erosion payments by MNEs, the effect would be that the developed nations of Europe would preserve their rights to at least a reasonable split on the combined profits of associated enterprise that conduct operations within those countries.' J. Kirwin, *EU Requests OECD Review of U.S. Tax Law's Harmful Provisions*, BNA International Tax (7 Mar. 2018), https://www.bna.com/eu-requests-oecd-n57982089605/ (accessed 5 Apr. 2018). *Id*., *EU May Blacklist U.S. As a Tax Haven After OECD Review*, BNA International Tax (23 Mar. 2018), https://www.bna.com/eu-may-blacklist-n57982090327/ (accessed 5 Apr. 2018).

76. The Technical Explanation to Art. 10(10) of the 1999 treaty with Italy listed *dividend washing* among those abusive transactions that would have been subject to the main purpose test. A typical example of a cross-border dividend washing transaction is when a shareholder in one country (the 'customer') that does not qualify for treaty benefits sells shares in a US company to a bank resident in Italy (the 'intermediary party') shortly before a dividend is paid on the shares. Once the dividend has been paid, the intermediary party will resell the participation to customer, the original shareholder, at a fixed price. The intermediary party, being an Italian resident, qualifies for reduced withholding on the dividend income under the Italy-US Income Tax Treaty. Otherwise, the dividend income would be subject to a 30% US withholding tax if it were paid to customer. The intermediary party incurs no market risk because it has entered into a repurchase agreement whereby the customer (the third-country resident) is committed to buying the shares back at a later date for a specified price. Presumably, the customer is compensated for its loss of the dividend income through the sales price or other compensation. Thus, the main purpose of the transaction is to reduce the amount of US withholding tax imposed on the dividend income. For a comment, *see* F. Camerlingo, *Supreme Court Decisions on Dividend Washing and Abuse of Rights in Tax Matters*, 8 Derivs. & Fin. Instrums. 4, (2006), pp. 209–212; A. Fantozzi & G. Mameli, *The Italian Abuse of Law Doctrine for Taxation Purposes*, 64 Bull. Intl. Taxn. 8/9 (2010), at p. 446; C. Innamorato, *An Unwritten Anti-Abuse Principle in the Italian Tax System*, 48 Eur. Taxn. 8 (2008), pp. 449–453; R. Cordeiro Guerra & P. Mastellone, *The Judicial Creation of a General Anti-Avoidance Rule Rooted in the Constitution*, 49 Eur. Taxn. 11 (2009), at p. 511 n. 3.

77. Art. 30, Israel-Italy Income and Capital Tax Treaty (1995). Anti-abuse provisions included in certain of Italy's other bilateral treaties appear to be narrower than this. *See* Art. 28 Estonia- Italy Income Tax Treaty (1997): '1. Notwithstanding any other provision of this Convention, a resident of a Contracting State shall not receive the benefit of any reduction in or exemption from taxes provided for in this Convention by the other Contracting State if *the main purpose* or *one of the main purposes* of the creation or existence of such resident or any person connected with such resident was to obtain the benefits under this Convention that would not otherwise be available. 2. Nothing in this Convention shall affect the application of the domestic provisions to prevent fiscal evasion and tax avoidance concerning the limitation of expenses and any deductions arising from transactions between enterprises of a Contracting State and enterprises situated in the other Contracting State, if *the main purpose* or *one of the main purposes* of the creation of such enterprises or of the transactions undertaken between them, was to obtain the benefits under this Convention, that would not otherwise be available [emphasis added].' Art. 30 Italy-Latvia Income and Capital Tax Treaty

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However, in a hearing before the US Senate Committee on Foreign Relations, Phil West, International Tax Counsel for the US Department of the Treasury, declared that this broad, subjective anti-abuse rule in the Israel-Italy treaty was rejected for several reasons:

> First, it provided a less certain standard against which a taxpayer could meaningfully evaluate its transaction. Second, since the narrower rule ['main purpose' test] before you appears in a significant number of treaties around the world, and promises to appear in more, it is more consistent with international norms and will likely be the subject of more interpretive law than the other standards …
>
> We gravitated toward the 'main purpose' standard of our proposed rule because it corresponds to the U.S. 'a principal purpose' standard which is applied in a number of our statutory provisions and regulations.[78]

(1997); Art. 30 Italy-Lithuania Income and Capital Tax Treaty (1996); Art. 29 Italy-Kazakhstan Income Tax Treaty (1994): 'A person that is a resident of a Contracting State and derives income from the Contracting State shall not be entitled to relief from taxation in that other State otherwise provided for in this Convention if it was *the main purpose* or *one of the main purposes* of any person concerned with the creation or assignment of such item of income to take advantage of the provisions of this Convention. In making a determination under this Article, the appropriate competent authority or authorities shall be entitled to consider, among other factors, the amount and nature of the income, the circumstances in which the income was derived, the stated intention of the parties to the transaction, and the identity and residence of the persons who in law or in fact, directly or indirectly, control or beneficially own (i) the income or (ii) the persons who are resident(s) of the Contracting State(s) and who are concerned with the payment or receipt of such income [emphasis added].'

78. From a search in Westlaw, it can be seen that the language 'principal purpose' is included in almost thirty provisions of the IRC: § 269. Acquisitions made to evade or avoid income tax … and *the principal purpose* for which such acquisition was made is evasion or avoidance…); § 877. Expatriation to avoid tax … such loss of citizenship did not have for *one of its principal purposes* the avoidance of taxes…); § 7872. Treatment of loans with below-market interest rates … Any below-market loan *one of the principal purposes* of the interest arrangements of which is the avoidance of…; § 954. Foreign base company income … to any transaction or series of transactions *one of the principal purposes* of which is qualifying income or gain for the exclusion … this section, including any transaction or series of transactions *a principal purpose* of which is the acceleration or deferral of any item…); § 614. Definition of property … the Secretary shall, on showing by the taxpayer that *a principal purpose* is not the avoidance of tax…); § 9722. Sham transactions … If *a principal purpose* of any transaction is to evade or avoid liability under this chapter…); § 6105. Relief from joint and several liability on joint return … by the other individual filing such joint return if *the principal purpose* of the transfer was the avoidance of tax or payment…); § 357. Assumption of liability … it appears that *the principal purpose* of the taxpayer with the respect to the assumption … was a purpose to avoid Federal income tax on the exchange…); § 453. Installment method … neither the first disposition nor the second disposition had as *one of its principal purposes* the avoidance of Federal income tax…); § 1298. Special rules … *a principal purpose* of leasing the property was to avoid the provisions of this part…); § 1272. Current inclusion in income of original issue discount … Clause (i) shall not apply if the loan has as *one of its principal purposes* the avoidance of any Federal tax…); § 336. Gain or loss recognized on property distributed in complete liquidation … the acquisition of such property by the liquidating corporation was part of a plan *a principal purpose* of which was to recognize loss by the liquidating corporation with respect to such property in connection with the liquidation…); § 1031. Exchange of real property held for productive use or investment … neither the exchange nor such disposition had as *one of its principal purposes* the avoidance of Federal income tax…); § 311. Taxability of corporation on distribution … to property contributed to the partnership or trust for *the principal purpose* of recognizing such loss on the distribution…); § 306. Dispositions of certain stock … in pursuance of a plan having as *one of its principal purposes* the avoidance of Federal income tax…); § 7874. Rules relating to expatriated entities and their foreign parents … The transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are plan of a plan *a principal purpose* of which is to avoid the purposes of this section…); § 409. Qualifications for tax credit employee stock ownership plans … a nonallocation year occurs in any case in which *the principal purpose* of the ownership structure of an S corporation constitutes an avoidance or evasion of this subsection.); § 751. Unrealized receivables and inventory items … there shall be excluded any inventory property if *a principal purpose* for acquiring such property was to avoid the provisions of this subsection relating to inventory items…); § 269A. Personal service corporations formed or availed of to avoid or evade income tax … *the principal purpose* for forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax…); § 170. Charitable, etc., contributions and gifts … No deduction shall be allowed under this section for a contribution … if *a principal purpose* of the contribution was to avoid Federal income tax…); § 467. Certain payments for the use of property or services … *a principal purpose* for providing increasing rents under the agreement is the avoidance of tax imposed by this subtitle…); § 965. Treatment of deferred foreign income upon transition to participation exemption system of taxation … If the Secretary determines that *a principal purpose* of any transaction was to reduce the aggregate foreign cash position taken into account under this subsection, such transaction shall be disregarded for purposes of this subsection…); § 953. Insurance income … there shall be disregarded any change in the method of computing reserves *a principal purpose* of which is the acceleration or deferral of any item in order to claim the benefits of this subsection or section 954(i)…); § 197. Amortization of goodwill and certain other intangibles … The term 'amortizable section 197 intangible' does not include any section 197 intangible acquired in a transaction, *one of the principal purposes* of which is to avoid the requirement of subsection (c)(1) that the intangible be acquired after the date of the enactment of this section or to avoid the provisions of subparagraph (A)…); § 643. Definitions applicable to subparts A, B, C, and D … *a principal purpose* of such trusts is the avoidance of the tax imposed by this chapter…); § 864. Definitions and special rules … there shall be disregarded any item of income or gain from a transaction or series of transactions *a principal purpose* of which is the qualification of any corporation as a financial corporation...); § 355. Distribution of stock and securities of a controlled corporation … the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as *one of its principal purposes* the avoidance of Federal income tax…); § 382. Limitation on net operating loss carryforwards and certain built-in losses following

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A compromise was thus reached on the inclusion of the 'main purpose' clause in Articles 10 (Dividends), 11(9) (Interest), 12(8) (Royalties) and 22(3) (Other Income). Article 10(10) of the 1999 treaty with Italy provided that:

> The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.[79]

Lindy Paull, Chief of Staff of the Joint Committee on Taxation, told the US Senate Committee on Foreign Relations that:

> While the main purpose tests are intended to prevent inappropriate benefits under the treaty, such tests inject considerable uncertainty into the treaty provisions because such tests are subjective and vague. This uncertainty can create difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty.[80]

The US Senate Committee on Foreign Relations, in turn, stated that the inclusion of such tests represented a fundamental shift in US treaty policy, which was based on clear, bright-line objective tests (such as ownership and base erosion tests, and public company tests, as well as active business tests). In this regard, the Committee complained that it had not been afforded an opportunity to weigh the relevant policy considerations. Accordingly, the Committee placed a reservation on the main purpose test, citing subjectivity, vagueness and

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ownership change … Any capital contribution received by an old loss corporation as part of a plan *a principal purpose* of which is to avoid or increase any limitation under this section shall not be taken into account for purposes of this section…); § 302. Distributions in redemption of stock … The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as *one of its principal purposes* the avoidance of Federal income tax…). Emphasis added by authors.

79. The main purpose test was apparently modelled on similar provisions found in treaties of other countries, such as many of the modern treaties of the United Kingdom. A search in the IBFD database shows that the United Kingdom had included such standard in almost thirty of its tax treaties entered into force between 1 Jan. 1930 and 31 Dec. 1999. The predecessor to the main purpose standard first appeared in Art. 12(5) of the 1976 treaty with Ireland: 'The provisions of this Article shall not apply if the debt-claim in respect of which the interest is paid was created or assigned *mainly for the purpose* of taking advantage of this Article and not for bona fide commercial reasons [emphasis added];' followed by the 1992 treaty with Guyana, *see* Art. 12(9) (Interest): 'The provisions of this Article shall not apply if it was *the main purpose* or *one of the main purposes* of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment [emphasis added],' Arts 13(7) (Royalties) and 14(7) (Technical fees). Starting from 1993, it was then included in the treaty with Ghana: Arts 11(9), 12(7) and 17(8) (Management and technical fees); in the 1993 treaty with India: Arts 12(11) and 13(9); in the 1993 treaty with Ukraine: Arts 11(7) and 12(5); in the 1993 treaty with Indonesia: Arts 11(9) and 12(7); in the 1993 treaty with Uzbekistan: Arts 11(9), 12(7), 21(3) (Other Income) and 23(2) (Limitation of relief); in the 1994 treaty with Russia: Arts 11(6) and 12(5); in the 1994 treaty with Azerbaijan: Arts 11(8), 12(7), 21(3) and 23(2); in the 1994 treaty with Kazakhstan: Arts 11(9), 12(8), 21(3) and 23(2); in the 1994 treaty with Vietnam: Arts 11(7) and 12(7); in the 1994 treaty with Malta: Arts 11(7), 12(7) and 21(3); in the 1994 treaty with Estonia: Arts 11(9), 12(7), 22(3) and 24(2); in the 1994 treaty with Mexico: Arts 11(11), 12(7) and 21(5); in the 1994 treaty with Bolivia: Arts 11(8) and 12(7); in the 1996 treaty with Argentina: Arts 11(9), 12(7) and 21(4). The 1996 UK-Venezuela Income Tax Treaty was the first to include such standard in the Dividends article as well, *see* Art. 10(7): 'The provisions of this Article shall not apply if it was *the main purpose* or *one of the main purposes* of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment [emphasis added].' Arts 11(9), 12(7) and 21(5) of the 1996 treaty with Mongolia: Arts 10(6), 11(10), 12(7), 22(4) and 25(2); in the 1996 treaty with Latvia: Arts 11(8), 12(7), 22(4) and 24(2); in the 1996 treaty with Korea (Rep.): Arts 10(6), 11(10), 12(7) and 22(4); in the 1996 treaty with Malaysia: Arts 10(6), 11(7) and 12(7); in the 1997 treaty with Lesotho: Arts 10(6), 11(9), 12(7), 13(8) and 22(4); in the 1997 treaty with Singapore: Arts 10(7), 11(9) and 12(8); in the 1997 treaty with the Falkland Islands: Arts 10(6), 11(5), 12(5) and 22(4); and in the 1998 treaty with Oman: Arts 10(6), 11(5), 12(5), 21(4) and 23. However, it should be noted that Art. 2(2) of the Protocol to the 1984 Italy-US Income Tax Treaty already included '*a principal purpose*' standard: 'Paragraph 1 shall not apply unless the competent authority of the other Contracting State determines that either the establishment, acquisition or maintenance of such person or the conduct of its operations had as *a principal purpose* obtaining benefits under the Convention [emphasis added].' The Technical Explanation to Art. 2 of the 1984 Protocol (1985) states: 'This provision recognizes that ownership of an entity that is a resident of the United States or Italy by persons resident in third countries is not uncommon, and that granting Treaty benefits to such an entity may be consistent with the goals of the Treaty. For example, this test would be met if an Italian company owned by third country residents conducts business operations in Italy and its U.S. investments are related or incidental to those business activities, or if the aggregate Italian tax burden equals or exceeds the tax reduction claimed under the Convention. It could also be met in other situations.'

80. JCX-76-99, Testimony of the Staff of the Joint Committee on Taxation before the Senate Committee on Foreign Relations Hearing on Tax Treaties and Protocols with Eight Countries (25 Oct. 1999), p. 4.

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uncertainty as sources of the serious concerns about the provision. The reservation had the effect of striking the objectionable provision from the instrument of ratification.[81]

In the authors' opinion, Phil West's memorandum to Senator Hagel (R-NE) appears to be contradictory while seeking to give meaning to the term 'a principal purpose.' On the one hand, West cited Judge Posner's ruling in *Santa Fe Pacific Corporation v. Central States*, *Southeast and Southwest Areas Pension Fund*, a labour law case governed by the Employee Retirement Income Security Act rules. On the other hand, he listed § 877(a)(2) among the IRC provisions using 'a/one of the principal purposes' anti-abuse language. Firstly, *Santa Fe* was not a tax case and did not interpret any provisions of the IRC. Secondly, its conclusions totally oppose those of several judicial decisions involving §§ 367 and 877. *Santa Fe* might have caused enough confusion to lead the Senate to reject the inclusion of the 'main purpose' test in the tax treaties with Italy and Slovenia.

Under the Multiemployer Pension Plan Amendments Act of 1980, an employer that withdrew from a multi-employer pension plan could have been required to pay the plan a sum equal to the vested but unfunded benefits of the employer's employees. The purpose was to avoid situations where the other employers would have had to pay for those benefits. A parent and its subsidiaries were considered to be a single employer with the consequence that if a subsidiary withdrew from the plan, its withdrawal liability could have been assessed against the parent. But in the event that the parent had sold its subsidiary, the parent would have not been liable for withdrawal liability unless 'a principal purpose' of the transaction was to 'evade or avoid' parental liability.[82] In determining whether *a principal purpose* of Santa Fe was to evade or avoid its parental liability, the Court held:

> The imposition of withdrawal liability in a sale of business situation requires only that *a* principal purpose of the sale be to escape withdrawal liability. It needn't be the only purpose; it need only have been one of the factors that weighed heavily in the seller's thinking. We can find no decisions discussing situations in which there is more than one principal (major, weighty, salient, important) purpose, but we would be doing violence to the language and the purpose of the statute if we read 'a principal' as 'the principal.' The clear import of 'a principal' is to let the employer off the hook even if one of his purposes was to beat withdrawal liability, provided however that it was a minor, subordinate purpose, as distinct from a major purpose. To let the employer off even if avoiding such liability was a major purpose would ill serve the statute's goal of preventing one employer from unloading his pension obligations onto the other employers in a multiemployer plan.[83]

However, such interpretation of the term 'a principal purpose' contrasts starkly with settled case law involving IRC provisions, such as §§ 367 and 877. As mentioned above, Phil West adopted Judge Posner's interpretation of the term 'a principal purpose' while, at the same time, he made reference to § 877 as one of the many Code provisions which contains such language. A 1984 Tax Court case, regarding whether the petitioner had tax avoidance as one of her principal purposes in expatriating, clearly illustrates West's inconsistency.

Until 20 August 1996, when it was amended by the Health Insurance Portability and Accountability Act (P.L. 104-191, § 511(g)), § 877 generally provided that a non-resident alien individual who lost his US citizenship should be subject to tax on his US-source income, for the 10-year period following such loss, at the graduated tax rates applicable to US citizens rather than more favourable rates applicable to non-resident aliens, unless the loss did not have as *one of its principal purposes* the avoidance of US taxes. Section 877(e) specifically assigned the burden of proving the lack of a tax avoidance motive to the expatriate if the respondent established that it was reasonable to believe that the individual's loss of US citizenship would result in a substantial reduction in taxes. In *Furstenberg v. Commissioner*, the taxpayer was able to carry her burden under § 877(e).

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81. L.A. Sheppard & A. Adelchi Rossi, *Where Is the Italian Tax Treaty?*, 39 Tax Notes Int'l (29 Aug. 2005) at p. 791 et seq.; *see also* Diplomatic Note, 2007 U.S.-Italy Diplomatic Note: 'Ratification of the Convention by the Government of the United States of America is subject to the deletion of the final paragraph of Article 10 (Dividends), the final paragraph of Article 11 (Interest), the final paragraph of Article 12 (Royalties), the final paragraph of Article 22 (Other Income) of the Convention and paragraph 19 of Article 1 of the Protocol, with the renumbering of paragraph 20 of Article 1 of the Protocol as paragraph 19. The Embassy of the United States wishes to seek confirmation that the Government of the Italian Republic agrees to these deletions.' *See also* C.P. Tello, *Financial Products Anti-Abuse Provisions in New Income Tax Treaties Rejected by Senate*, 2 Derivs. & Fin. Instrums. 2 (2000), pp. 123–128.

82. *Santa Fe Pacific Corp. v. Central States*, *Southeast and Southwest Areas Pension Fund*, CAFC, Seventh Cir., 22 Apr. 1994, 22 F.3d 725, 73 A.F.T.R.2d 94-1820, 62 USLW 2703, at pp. 726–727.

83. *Santa Fe Pacific Corp*., at pp. 727–728.

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Furstenberg was the daughter of Robert Lee Blaffer, one of the founders of Humble Oil & Refining Co., the predecessor of Exxon Corporation. Because of the financial success of her father, the petitioner travelled extensively with her family, visiting Europe, in particular, France, where she spent several summers. By the time of her expatriation (23 December 1975), she was divorced from her second husband, Richard M. Sheridan, an international executive of Mobil Oil Corporation. The genesis for the expatriation was her third marriage to Prince Tassillo von Furstenberg (17 October 1975), a member of the Austrian aristocracy, whose ancestors were princes of the Holy Roman Empire in 1664. At the time of their decision to marry in early 1975, Furstenberg explained to the petitioner how important she was to him, given his Austrian heritage and ties, the fact that she should have adopted Austrian citizenship. Prior to expatriating, she met with her accountant and informed him that she intended to marry Furstenberg, adopt Austrian citizenship and live with her husband in Paris. He told her that adopting Austrian nationality would 'complicate' her taxes and warned that French taxes could be very high. The Petitioner had no further discussions with her accountant in 1975. Her income in 1975 and 1976 came from two trust distributions she received and from the sale of securities. The distribution from Trust No. 1, a complex inter vivos trust established by her parents, occurred on the day of her expatriation. In addition, in 1976 and 1977, after her expatriation she sold various securities realizing net capital gains in the amounts of USD 2.601.680.06 and USD 7.219.440.35 respectively. After careful consideration of all the evidence, the court was convinced that tax avoidance was not *one of her principal purposes* in expatriating. Interestingly, the Tax Court held the following:

> Although we have never specifically interpreted the phrase 'one of its principal purposes' in the context of section 877, we find instructive the following definition set forth in Dittler Bros, Inc. v. Commissioner, 72 T.C. 896, 915 (1979), affd. without published opinion 642 F.2d 1211 (5th Cir. 1981), in which the Court was called upon to determine, under section 367, whether or not a certain translation was 'in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax….'[84]

The Court then quoted the definition of the term 'principal purpose' as articulated in *Dittler Bros*., according to which:

> [T]he term [principal purpose] should be construed in accordance with its ordinary meaning. Such a rule of statutory construction has been endorsed by the Supreme Court. Malat v. Riddell, 383 U.S. 569, 571 (1966). Webster's New Collegiate Dictionary defines 'principal' as 'first in rank, authority, importance, or degree.' Thus, the proper inquiry hereunder is whether the exchange of manufacturing know-how was in pursuance of a plan having as one of its '*first-in-importance*' purposes the avoidance of Federal income taxes.

To better understand the logic of *Furstenberg*'*s* conclusions it is necessary to closely examine *Dittler Brothers*, *Inc*. *v*. *Commissioner of Internal Revenue*, which interpreted the term 'principal purpose' within the context of § 367.

Prior to the Deficit Reduction Act of 1984, § 367(a)(1) provided that certain outbound transfers of appreciated property would be non-taxable only if the exchange did not have the avoidance of Federal income taxes as *one of its principal purposes*. This determination was made by the IRS in accordance with guidelines set out in Rev. Proc. 68-23, 1968-1 C.B. 821. Section 1042(d) of the Tax Reform Act of 1976 afforded taxpayers a remedy through a declaratory judgment procedure in the Tax Court in cases where the IRS issued an adverse ruling or failed to make a determination as to whether a transfer had tax avoidance as a principal purpose. However, the scope of a Tax Court declaratory judgment was limited as to whether the IRS acted reasonably.

In *Dittler Bros*., the taxpayer had special know-how and trade secrets regarding the manufacturing of 'rub-off' lottery tickets. In order to expand its sales into foreign markets, Dittler entered into a 50-50 joint venture with a UK holding company, known as Norton & Wright Group Ltd. (NWG), which had developed a substantial market for the sale of lottery tickets. Dittler had previously granted two non-exclusive licences of its secret process to foreign companies, but since only nominal royalties were produced, both licences were cancelled. Dittler and NWG created two Netherlands Antilles corporations. NWG's representatives requested the joint venture to be located there primarily due to potential tax benefits: a low rate of Netherlands Antilles tax plus Netherlands tax exemption for dividends received. The first corporation, known as Stansfield Security N.V.

84. *Furstenberg v. Commissioner of Internal Revenue*, USTC, 26 Nov. 1984, 83 T.C. No. 43, 83 T.C. 755, Tax Ct. Rep. (CCH) 41, 633, at pp. 775–776.

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(SSNV), was owned 50% by Dittler and 50% by Norton & Wright (Holland) B.V. (NWBV), a NWG's wholly owned Netherlands subsidiary. The second corporation, known as Opax Lotteries International N.V. (OLINV), was wholly owned by SSNV. Dittler and NWBV each contributed USD 25.000 to SSNV as partial consideration for their respective 50% stock interest. In addition, Dittler transferred its secret process for the printing of rub-off tickets to SSNV while NWBV transferred, along with its cash contribution, specific marketing and customer information. Subsequently, SSNV transferred 80% of its cash, the manufacturing know-how and the marketing information to OLINV for 100% of its stock. This contribution qualified SSNV as an investment holding company under Netherlands Antilles law. Under the terms of a shareholder agreement, 75% of the net profits after taxes of OLINV would be declared and paid out as a dividend distribution to SSNV. SSNV would in turn declare and pay, pro rata, dividend distributions to its shareholders from the dividends received from OLINV. Accordingly, the fight with the IRS concerned whether the retention of 25% of OLINV's after-tax earnings was pursuant to a plan having as one of its principal purposes the avoidance of Federal income taxes.

The Tax Court determined that Dittler was denied a favourable ruling on two grounds. Firstly, the IRS concluded that neither SSNV nor OLINV would devote the property received (manufacturing know-how) to the active conduct of a trade or business, within the meaning of § 3.02(1) of Rev. Proc. 68-23, 1968-1 C.B. 821. Secondly, the transaction created a potential for tax avoidance in that income from the exploitation of the manufacturing know-how would be diverted to a passive recipient in a benign foreign tax country.

Perhaps the most significant part of the judgment is when the Court stated that:

> Neither Congress in its hearings nor respondent in his rulings has ever defined what is meant by a 'principal purpose.'
>
> Although we have never interpreted the term principal purpose within the context of section 367, we have interpreted the meaning of principal purpose in a somewhat analogous provision under section 269. That section, unlike section 367, focuses on whether the principal purpose for which an acquisition was made is the evasion or avoidance of Federal income tax. For section 269 to apply, *principal purpose has been interpreted to mean a tax-evasion or avoidance purpose which outranks or exceeds in importance, any other purpose*. VGS Corp. v. Commissioner, 68 T.C. 563, 595 (1977): Capri, Inc. v. Commissioner, 65 T.C. 162, 178 (1975).
>
> In contrast to section 269, section 367 speaks in terms of a plan having as one of its principal purposes the avoidance of Federal income taxes. When these two statutory provisions are laid side by side, it becomes apparent that *the subjective tax-avoidance motive in section 269 acquisitions must be greater than the tax-avoidance motive in section 367 transfers*. Consequently, section 269 is instructive in the instant case by defining the nature and scope of the tax-avoidance purpose.
>
> However, because of the statutory variance between section 269 and section 367, with respect to the intendment of the respective statutes, *we believe that the term* '*principal purpose' should be construed in accordance with its ordinary meaning*. Such a rule of statutory construction has been endorsed by the Supreme Court. Malat v. Riddell, 383 U.S. 569, 571 (1966). Webster's New Collegiate Dictionary defines '*principal*' as '*first in rank*, *authority*, *importance*, *or degree*.' Thus, *the proper inquiry hereunder is whether the exchange of manufacturing know-how was in pursuance of a plan having as one of its 'first-in-importance' purposes the avoidance of Federal income taxes* [emphasis added].[85]

In conclusion, what is the correct meaning of the term 'principal purpose'? In other words, is 'a principal purpose' standard met only when the avoidance of tax exceeds in importance any other purpose as stated in *Dittler*? Or is the standard also operative when the tax-avoidance motive was only one of the factors that weighed heavily in the taxpayer's thinking as argued in *Santa Fe*? Obviously, on the one hand, taxpayers would prefer the former interpretation, which is more lenient, because this allows them to preserve treaty benefits by asserting a relatively weak business purpose, while, on the other hand, tax authorities would prefer the latter,

85. *Dittler Brothers*, *Inc. v. Commissioner of Internal Revenue*, USTC, 27 Aug. 1979, 72 T.C. 896, at pp. 914–915.

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stricter, interpretation because it permits them to deny treaty benefits if tax avoidance was just more than a trivial or *de minimis* purpose.

Analysis of the legislative history[86] and regulations of § 129 of the 1939 IRC,[87] predecessor to § 269,[88] as well as the extensive case law before[89] and after[90] *Dittler*, clearly suggests that any standard using principal purpose is met only when the purpose of evading tax exceeds in importance any other purpose.[91]

Therefore, if the United States' ultimate goal were to incorporate these new anti-abuse rules in its Model Treaty and, at the same time, provide certainty to its business community that other countries' tax authorities will not inappropriately invoke the main purpose provisions to challenge legitimate business transactions, why cite the ambiguous *Santa Fe* ruling? In the authors' opinion, the United States should have requested the inclusion of an additional provision in the Protocol to the tax treaty with Italy, clarifying the scope of the 'main purpose' provision, which reads as follows: 'As was discussed and understood among the negotiators, the following Articles 10(10); 11(9); 12(8) and 22(3) should be operative only if the tax evasion or avoidance purpose outranks or exceeds in importance, any other purpose.'

The rejection of 'main purpose' tests in the tax treaties with Italy and Slovenia based on the incorrect interpretation of the term given in *Santa Fe* could be considered a posteriori to have been a strategic mistake. Oddly, in 1999, the United States did not take advantage of the opportunity to play a leadership role in shaping the future direction of this important principle. The fact that the PPT rule is currently included in more than 1,100 matched agreements demonstrates how important it was to the United States in 1999 to adopt such a standard in the tax treaties with Italy and Slovenia. However, as mentioned, the inclusion of this standard should have been explicitly based on the *Dittler* ruling, the only approach able to ensure a consistent and reasonable application of the standard. In 1999, the United States lost the chance to unilaterally impose its own interpretation of the PPT rule. Today, with the United States refusing to sign up to the MLI, the concerns of Ms Paull and of Sen. Hagel as to whether other countries' tax authorities would appropriately administer this provision are more important than ever.

1.6. Anti-Hybrid Provisions

Similarly to the ATAD, TRA17 contains two anti-hybrid provisions that directly implement the single tax principle. The first, § 14101 of the Senate amendment, the new § 245A(e), disallows the participation exemption for hybrid dividends that are treated as deductible payments at source. The second, § 14223 of the Senate amendment, the new/now?§ 267A, limits the deductibility of payments on hybrid instruments or to

86. Senate Report No. 627, 78th Cong. 1st Sess., 22 Dec. 1943, appearing at p. 1017, 1944 C.B..: 'The House bill made section 129 operative if one of the principal purposes was tax avoidance. *Your committee believes that the section should be operative only if the evasion or avoidance purpose outranks, or exceeds in importance, any other one purpose* [emphasis added].' For a comment, *see* H.J. Rudick, *Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58 Harv. L. Rev. 2 (Dec., 1944), at pp. 196–225; D.B. Chase, *Analysis of Section 129 of the Internal Revenue Code*, 30 Cornell L. Rev. 421 (1945), http://scholarship.law.cornell.edu/clr/vol30/iss4/3 (accessed 5 Apr. 2018).

87. Regs. 118, § 39.129-3 which provides in part: '*If the purpose to evade or avoid Federal income or excess profits tax exceeds in importance any other purpose, it is the principal purpose*. This does not mean that only those acquisitions fall within the provisions of section 129 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom [emphasis added].'

88. R.S. Rice, *Internal Revenue Code Section 269: Does the Left Hand Know What the Right is Doing?*, 103 U. Pa. L. Rev. 579 (1955); Peterson, *The 'principal purpose' test under Section 269: How it's being applied in the courts*, 20 J. Taxation 16 (1964); D.E. Watts, *Acquisitions Made to Avoid Taxes: Section 269*, 34 Tax L. Rev. 539 (1979).

89. *Commodores Point Terminal Corp. v. C.I.R.*, USTC, 27 Sept. 1948, 11 T.C. 411; *Hawaiian Trust Co. Limited v. U.S.*, CAFC Ninth Cir., 25 May 1961, 291 F.2d 761, 7 A.F.T.R.2d 1553, 61-1 USTC P 9481; *House Beautiful Homes, Inc. v. C.I.R.*, CAFC Tenth Cir., 19 Dec. 1968, 405 F. 2d 61; *Bobsee Corp. v. United States*, 411 F. 2d 231, 239 (5th Cir. 1969); *Canaveral International Corp. v. Commissioner of Internal Revenue*, USTC, 29 Jan. 1974 61 T.C. 520; *D'Arcy-Macmanus & Masius, Inc. v. Commissioner of Internal Revenue*, USTC, 2 Jan. 1975, 63 T.C. 440.

90. *Hershey Foods Corp. v. Commissioner of Internal Revenue*, USTC, 18 Feb. 1981, 76 T.C. 312; *Pitcher v. Commissioner*, 84 T.C. 85 (1985); *Finoli v. Commissioner*, 86 T.C. 697, 722 (1986); *Cottle v. Commissioner*, 89 T.C. 467, 486 (1987); *Teller v. C.I.R.*, USTC, 15 July 15, 1992 T.C. Memo. 1992-402 1992 WL 163668 64 T.C.M. CCH 166.

91. B.M. Willis, *A Principal Purpose: There Can Be Only One*, Tax Analysts (10 June 2013), http://www.taxhistory.org/www/features.nsf/Articles/178104B57F0667F985257B8600468B3E?OpenDocument (accessed XX); J. Ross Macdonald, *'Time Present and Time Past': U.S. Anti-Treaty Shopping History, Policy and Rules*, 70 Tax Lawyer 5 (Fall 2016).

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hybrid entities. These provisions clearly implement OECD BEPS Action 2 in accordance with the single tax principle.

In particular, on the one hand, § 245A(e)(1) provides that the dividend received deduction is not available for any dividend received by a US shareholder from a CFC if the dividend is a '*hybrid dividend*'. Hybrid dividend is defined as, 'an amount received from a controlled foreign corporation for which a deduction would be allowed under this provision and for which the specified 10-percent owned foreign corporation received a deduction (or other tax benefit) from taxes imposed by a foreign country'.[92] In addition, if a CFC receives a hybrid dividend from another CFC, the hybrid dividend is treated as Subpart F income.[93] Finally, § 245A(e)(3) provides, by reference to § 245A(d)(1) and (2), that no foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a hybrid dividend.

On the other hand, § 267A(a) denies a deduction for any 'disqualified related party amount' paid or accrued pursuant to a 'hybrid transaction' or by, or to, a 'hybrid entity'. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (i) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax,[94] or (ii) such related party is allowed a deduction with respect to such amount under the tax law of such country.[95] A hybrid transaction is defined as 'any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for Federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax'.[96] Finally, a hybrid entity is any entity which is either: (i) treated as fiscally transparent for Federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax,[97] or (ii) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax but not so treated for Federal income tax purposes.[98]

It may seem strange that the United States took this action while making the CFC-to-CFC look-through rule § 954(c)(6) permanent and thereby facilitating foreign-to-foreign profit shifting from high- to low-tax jurisdictions abroad. The fundamental question is whether all of this is consistent with the spirit of BEPS. Eventually, the United States will tax at residence if there is no tax at source (§ 245A(e)) and will tax at source if there is no tax at residence (§ 267(a)). But what about the case where both source and residence are foreign? The United States will not impose tax and will leave this situation to the foreign jurisdictions to resolve by adopting their own anti-BEPS rules, like the new ATAD II. Again, a strategic mistake made by the United States?

Early commentators highlighted how TRA17 prevents the use of hybrid instruments or entities that could reduce the US tax base but does not have any material impact on 'foreign-to-foreign hybrid planning, the type of United States multinational planning that many countries blame on the United States check-the-box rule.' In the same vein, a Baker McKenzie Client Alert stated:

> The new provision is a very limited version of the much broader anti-hybrid provisions recommended by the OECD under BEPS Action 2. In particular, *the rules only apply* to interest and payments, and only *to outbound payments*. *There is no equivalent provision that subjects hybrid income paid by a foreign related party to tax in the US where that income would otherwise escape US tax*. Moreover, the definitions of

92. § 245A(e)(4).
93. § 245A(e)(2). *See* Conference Report to TRA17, at p. 598: 'If a controlled foreign corporation with respect to which a domestic corporation is a U.S. shareholder receives a hybrid dividend from any other controlled foreign corporation with respect to which the domestic corporation is also a U.S. shareholder, then the hybrid dividend is treated for purposes of section 951(a)(1)(A) as subpart F income of the recipient controlled foreign corporation for the taxable year of the controlled foreign corporation in which the dividend was received and the U.S. shareholder includes in gross income an amount equal to the shareholder's pro rata share of the subpart F income, determined in the same manner as section 951(a)(2).'
94. § 267A(b)(1)(A).
95. § 267A(b)(1)(B).
96. § 267A(c). See Conference Report to TRA17, at p. 663.
97. § 267A(d)(1).
98. § 267A(d)(2).

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'hybrid entity' and 'hybrid transaction' are relatively narrow, so that the new Code Section would not seem to apply, for example, to permanent establishment hybrid mismatches [emphasis added].[99]

Thus, neither § 245A(e) nor § 267A(a) will significantly impact foreign reverse hybrid entities, i.e. entities that are treated as opaque by a foreign investor and transparent under the jurisdiction where they are established, such as a Dutch CV-BV or a Luxembourg SCS-Sarl structure. This might have adverse consequences for both US multinationals and tax authorities, considering that ATAD II also includes specific rules aimed at reverse hybrid mismatches, namely Article 9a.

Over the past few years, US multinationals have widely used either a Dutch CV-BV (Starbucks) or a Luxembourg SCS-Sarl structure (Amazon) in order to defer US taxation on their non-US earnings.[100] A US multinational establishes a limited partnership under Dutch (CV) or Luxembourg (SCS) law, which is a fiscally transparent entity under local law but elects to be treated as a corporation for US tax purposes. The CV/SCS licenses international IP rights from the US parent company and further develops such IP under a research and development (R&D) contract (CRA) or cost-sharing (CSA) arrangement with the US parent. It then grants an IP licence to a Dutch (BV) or Luxembourg (Sarl) principal. The BV/Sarl may either (i) sell products throughout Europe and retain local in-country service companies for support services or (ii) grant sub-licences to European operating companies. The tax consequences are the following: (i) service or operating companies across Europe remit local country tax on routine income; (ii) the BV remits 25% tax on net sales or licensing income reduced by royalty payments to the CV; (iii) there is no Dutch withholding on royalties under domestic law; (iv) the CV is treated as a pass-through for Dutch purposes and thus is not subject to Dutch tax; and (v) the US parent achieves deferral of US tax on its non-US profits as a result of the CV/SCS's hybrid treatment. On the one hand, the United States treats the CV/SCS as a corporation and, as a consequence, income that it earns will not generally be subject to current US tax. Moreover, even if the CV/SCS is treated as a CFC, interest and royalty income earned from the BV/Sarl?, which otherwise would qualify as Subpart F income, may nonetheless not be subject to current US taxation as a result of either § 954(c)(3) or § 954(c)(6). On the other hand, payments to the CV/SCS are also generally not subject to tax in the foreign jurisdiction in which it is established or organized (either Netherlands or Luxembourg) because the foreign jurisdiction views the CV/SCS as a fiscally transparent entity and therefore treats its income as derived by its owners, including its US owners.

It should be noted that as from 1 January 2020, the benefit of tax deferral for US MNEs derived from setting up those structures in Netherlands or Luxembourg will likely disappear due to the general hybrid mismatch rules of ATADII, whose territorial scope has been extended to third countries. In particular, Article 9(2)(a) of ATADII states that, 'To the extent that a hybrid mismatch results in a deduction without inclusion, the deduction shall be denied in the Member State that is the payer jurisdiction….'

This means that where the CV/SCS owns IP and licenses such IP back-to-back through the BV/Sarl in exchange for a royalty payment or enters into loan agreements with the BV/Sarl and/or its subsidiaries to lend surplus cash back to group companies, the payments of interest and royalties by the BV/Sarl to the CV/SCS should no longer be deductible. In those cases, indeed, the interest or royalty deduction will be denied in the payer's jurisdiction, i.e. the Netherlands and Luxembourg.
In addition, as mentioned above, ATADII also provides specific rules aimed at reverse hybrid mismatches. Article 9a(1) states that,

99. Baker McKenzie, *supra* n. 42, at pp. 31–32.
100. This description is derived from a Jones Day presentation held at the International Tax Seminar organized by the Detroit Chapter of Tax Executives Institute on 27 April 2016; *see*, http://teidetroitchapter.camp7.org/resources/Documents/Jones%20Day%20-%20TEI%20Detroit%20-%20International%20Tax%20Seminar%202016v2.pdf, at pp. 249–250 (accessed XX); *see also* J. Vleggeert, *Dutch CV-BV Structures: Starbucks-Style Tax Planning and State Aid Rules*, 70 Bull. Intl. Taxn. 3 (2016), at pp. 173–174: 'Specifically, a US MNE establishes a "closed" Dutch limited partnership (CV). A US-resident subsidiary of the US MNE is a more-than-95% limited partner in the CV. The less-than-5% general partner is usually resident in a tax haven, for example Bermuda. The CV holds all the shares in a Dutch operating company (BV). The BV may also be engaged in "real" activities, such as the production or production of goods. In addition, the CV may function as an intangible property (IP) holding company. Furthermore, the CV may enter into loan agreements with the BV and/or its subsidiaries and other group companies to lend surplus cash back to group companies. The benefit of the CV-BV structure is that the earnings of the subsidiaries are channelled into the CV by means of distributions of dividend or payments of interest and royalties. In a CV-BV structure, the BV typically licenses IP from the CV for which the BV pays royalties to the CV. The amount of the royalties payable by the BV to the CV depends on the difference between the pre-tax profit for accounting purposes before the payment of the royalties and the remuneration established in the advance pricing agreement (APA) concluded between the BV and the Dutch tax authorities.'

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> Where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50 percent or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity that is incorporated or established in a Member State are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person, the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that that income is not otherwise taxed under the laws of the Member State or any other jurisdiction.

This specific rule, which takes precedence over the general reverse hybrid mismatch rule of Article 9(2)(a), will become effective as from 1 January 2022. The Netherlands unsuccessfully tried to postpone the effective date to 1 January 2024 'to give third countries, like the United States, sufficient time to amend their legislation to neutralize the effects of a hybrid mismatch in the country of the payment recipient.'[101] Indeed, according to the OECD BEPS Action 2 Report (Recommendation 5), mismatch arrangements can also be addressed through changes to domestic law. The residence state of the foreign investor, in this case, the United States, could improve its CFC regime in order to ensure that income earned by the CV/SCS will be currently subject to US tax. As will be described below, this could be done by closing the two biggest loopholes of the Subpart F regime, namely the same-country exception of § 954(c)(3) and the look-through exception of § 954(c)(6). However, such proposal should consider whether US MNEs will end up being less competitive than foreign multinationals since they will not be able to redeploy their foreign earnings overseas without an additional US tax burden.

Regardless of the actions that have been undertaken by the United States, as a result of Article 9a(1), since the parent company is located in a jurisdiction, the United States, that treats the CV/SCS as a corporation, the CV/SCS would be treated as a Dutch or Luxembourg resident entity and taxed on the interest or royalty income received from the BV/Sarl, respectively.

In this regard, the first question that should be asked is whether rules addressing hybrid mismatches are actually necessary. In the authors' opinion, the answer to this is theoretically no, but practically yes. Theoretically no because a textual interpretation of Article 24(4) of the Netherlands-United States Income Tax Treaty (1992) suggests that the Netherlands does not have to allow for an exemption from or a reduction of Dutch tax. Article 24(4) of the treaty reads as follows:

> In the case of an item of income, profit or gain derived through a person that is fiscally transparent under the laws of either State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income, profit or gain of a resident.

As mentioned above, the CV is viewed as a pass-through entity for Dutch purposes, but as a company for US tax purposes, when it receives interest or dividends from its operating subsidiary, BV. As a result of this hybrid

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101. *See* unofficial translation of the assessment by the Dutch government of the proposal of the European Commission regarding hybrid mismatches with third countries, at pp. 4–5: 'An example serves to illustrate this. This is the example of the limited partnership/private limited liability (CV/BV) structure that the Netherlands and the United States (hereinafter: US) regularly include in structures involving head offices resident in the Netherlands. This involves a mismatch with a hybrid entity (a Dutch limited partnership; hereinafter: CV) that the Netherlands regards as transparent and the US, after the taxpayer has elected to be regarded as non-transparent, therefore regards as non-transparent. The US therefore does not tax payments made by a Dutch private limited liability company (hereinafter: BV) to the CV, for example royalty payments for operating intellectual property developed in the US, but does lay a tax claim on this payment at the time the CV distributes the royalties to the parent company established in the US. However, the US does not execute its tax claim for a very long time. The OECD report on Action 2 places the responsibility for eliminating the implications of the hybrid mismatch in this example on the US. Only if the US does not act, is it up to another country, in the present case: the Netherlands, to neutralize the mismatch, or refuse the deduction of the royalty payment from the BV to the CV. This means that the Netherlands would effectively be taxing profit, while the value is created in the US (the intellectual property was, after all, developed there). This is contrary to taxing profit where value is created, which is internationally accepted as the starting point for determining where profit must be taxed. This is an undesirable situation. *The Cabinet believes that the country to which a payment is made in such a situation (in the present case: the US), must be given sufficient opportunity in such cases to amend national legislation in order to execute its tax claim or to take the necessary measures before the EU Member State taxes the profit (or at least refuse the deduction)*. The implementation date of 1 January 2019 proposed in the present directive, will likely not give these third countries enough time. Furthermore, third countries will file notices of objection against an EU Member State taxing the profit, if these third countries believe that this profit is their due and if they consider that the EU Member State is wrongly taxing this profit by virtue of the directive. This is also an argument for giving third countries the chance to tax these profits themselves.' Available at https://www.nob.net/sites/default/files/content/article/uploads/english_translation_of_the_assessment_by_the_dutch_government_of_the_proposal_regarding_hybrid_mismatches_relating_to_third_countries.pdf (accessed 5 Apr. 2018).

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treatment, income earned by the CV generally would not currently be subject to tax in either the United States or the Netherlands. Consequently, Article 24(4) provides that the withholding rate should not be reduced.[102]

This view was initially also confirmed by J.G. Wine, State Secretary for Finance in a letter of 3 May 2005 to the President of the Senate of the States General, where he argued that the Netherlands was no longer obliged to reduce the withholding rate on dividends and interest paid by the BV to the CV.[103] He justified this result based on the purpose of the hybrid entity provision, according to which differences in the qualification of an entity should not lead to situations of double taxation or double non-taxation. However, in the same letter he also mentioned he was investigating the possibility of granting certain tax benefits to US MNEs that made use of such structure. If real and substantial activities had been performed in or via the Netherlands, Article 24(4) would not have been applied. Therefore, on 6 July 2005, the State Secretary for Finance published Decree IFZ2005/546M, according to which treaty benefits will be granted to an entity that is classified as transparent for Netherlands tax purposes and as non-transparent for US tax purposes, provided that the Netherlands subsidiary carries out real activities. In this regard, a company may request an advance tax ruling confirming that real activities are carried out. The Decree considered the following points as being relevant for the purposes of determining whether real activities are carried out: (i) whether the dividend distributing company is (for tax purposes only) established in the Netherlands; (ii) whether directors and/or employees are active in the Netherlands; (iii) whether these directors have sufficient professional knowledge; (iv) where important decisions are taken; (v) where the company's primary bank account is kept; (vi) where the bookkeeping takes place; (vii) the amount of equity and debts; (viii) which activities are carried out in or through the Netherlands; (ix) whether the employees active in the Netherlands are sufficiently qualified; (x) where real risks are run and (xi) whether the remuneration for the activities carried out and the risks run is at arm's length.[104] Granting treaty benefits to entities that do not qualify based on the literal interpretation of Article 24(4) is the reason why the present authors believe that hybrid mismatch rules are necessary in practice. In the absence of any tax holiday granted to foreign direct investors, Article 24(4) is perfectly adequate since it provides that dividend withholding tax should not be reduced. Indeed, similar provisions to Article 24(4) have been included in the treaties with Canada,[105] Denmark,[106] France,[107] Iceland,[108] Ireland,[109] Italy,[110] South Africa,[111] Thailand[112] and Venezuela.[113] In particular, examples in the Technical Explanation address the issue of reverse hybrid entities. The language contained in the Technical Explanation to Article IV(7)(a) of the Canada-United States Income and Capital Tax Treaty (1980) is very clear:

102. *See* http://www.nortonrosefulbright.com/knowledge/publications/154270/holland: 'Dividends paid by a Dutch company to someone without the benefit of treaty protection attract a 25% withholding tax. The new protocol to the United States Treaty has a clause that bars treaty benefits in cases where "hybrid" entities are used, like in this case. Even though the Dutch view a dividend paid by the BV as received in the United States directly, the protocol rules out treaty benefits. The protocol language is intended to prevent governments from being whipsawed by clever tax planning' (accessed 5 Apr. 2018).

103. *See* https://zoek.officielebekendmakingen.nl/dossier/29632/kst-20042005-29632-B-h1?resultIndex=1&sorttype=1&sortorder=4 (accessed 5 Apr. 2018). For an English translation, *see* Vleggeert, *supra* n. 100, at p. 177.

104. The Netherlands; United States- Netherlands Decree on application of Netherlands-United States tax treaty re hybrid entities (12 July 2005), News IBFD; *see also* P.J. Connors & R.V. Femia, *Application of U.S. Treaties to Hybrid Entities*, 35 Tax Management Int'l J. 3 (10 Mar. 2006, at p. 154, https://www.millerchevalier.com/sites/default/files/news_updates/attached_files/femia202006-03-1020bna20tax20management.pdf (accessed 5 Apr. 2018).

105. Art. IV(7)(a) *Can.-US Income and Capital Tax Treaty* (1980) (as amended through 2007).

106. Art. 4(1)(d) *Den.-US Income Tax Treaty* (1999) (as amended through 2006).

107. Art. 4(3) *Fr.-US Income and Capital Tax Treaty* (1994) (as amended through 2009). *See also* Explanation of the Proposed Protocol to the Income Tax Treaty Between the United States and France, Scheduled for a Hearing Before the Committee on Foreign Relations United States Senate on November 10, 2009, at p. 34: 'The Technical Explanation also illustrates the application of the fiscally transparent entities rules in a circumstance in which a French-source item of income is paid to an entity organized in France rather than … in the United States. In this circumstance, if U.S. tax law treats the French entity as a corporation and the entity is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, the income received by the entity is not considered derived by the U.S. shareholder even if the entity is treated as fiscally transparent under French tax law. Under U.S. law, the French corporation is treated as a separate taxable entity, and the U.S. shareholder of that corporation generally is not subject to U.S. tax on income received by the entity until the shareholder receives a distribution on the income.' Available at https://online.ibfd.org/data/treaty/docs/pdf/tt_fr-us_02_eng_1994_tt__ad13.pdf (accessed 5 Apr. 2018).

108. Art. 1(6) *Ice.-US Income Tax Treaty* (2007).

109. *Ir.-US Income Tax Treaty* (1997) (as amended through 1999), Protocol, para. 1.

110. Art. 4(1)(b) *It.-US Income Tax Treaty* (1999).

111. Art. 4(1)(d) *S. Afr.-US Income Tax Treaty* (1997).

112. *Thai.-US Income Tax Treaty – Technical Explanation to the 1996 Treaty* (1997).

113. Art. 4(2) *US-Venz. Income and Capital Tax Treaty* (1999).

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> For example, assume USCo, a company resident in the United States, is a part owner of CanLP, an entity that is considered fiscally transparent for Canadian tax purposes, but is not considered fiscally transparent for U.S. tax purposes. CanLP receives a dividend from a Canadian company in which it owns stock. Under Canadian tax law USCo is viewed as deriving a Canadian-source dividend through CanLP. For U.S. tax purposes, CanLP, and not USCo, is viewed as deriving the dividend. Because the treatment of the dividend under U.S. tax law in this case is not the same as the treatment under U.S. law if USCo derived the dividend directly, subparagraph 7(a) provides that USCo will not be considered as having derived the dividend....[114]

Canada is therefore not obliged to grant treaty benefits, e.g. reduction or elimination of dividend withholding tax imposed under domestic law. Here, the taxable event is the distributive share of dividend paid to CanLP. Because the distributive share of dividend income is not taxed in the United States, there is no reduction in Canadian withholding tax on the share belonging to USCo.

The second question that should be asked is what would be the interaction between US tax reform and ATADII? In particular, what would be the effect of the new GILTI regime on the CV/BV reverse hybrid structure? Would the hybrid mismatches be shut down? Some practitioners have pointed out that since there will be a 10.5% immediate tax, it could be argued that the United States has resolved the issue of stateless income made possible by the CV/BV structure. In their opinion, due to GILTI, the United States no longer allows profits from IP, such as royalty fees, to be transferred out of a Netherlands-based entity without being taxed anywhere.[115] Only time will tell if that is true, but, in that event, EU Member States should refrain from taxing those profits through either the denial of deduction or by including the payments in the taxable income of the reverse hybrid.

In conclusion, it should be noted that all these problems, especially avoiding taxation by other countries of what the United States believes is its income, would have been resolved if TRA17 had adopted a similar provision to that proposed by? the Obama Administration,[116] according to which § 954(c)(3) and § 954(c)(6) would not have been applied to payments made to a foreign reverse hybrid held by one or more US persons when such amounts were treated as deductible payments received from foreign related persons. Indeed, as a consequence of that proposal, the IP income of a CV would currently be subject to US tax. However, the proposal would have modified some of the core provisions of the Subpart F regime denying the possibility for US MNEs to engage in foreign-to-foreign profit shifting. When the US Congress, on behalf of US multinationals, forced Treasury to withdraw Notice 98-11, 1998-1 C.B. it used two arguments to justify foreign-to-foreign profit shifting. Firstly, it was said that reduction of foreign taxes through hybrid entities is a good thing for the US Treasury because if US MNEs pay less tax to foreign administrations, that means they will pay more tax to the United States when earnings are eventually repatriated. Secondly, foreign-to-foreign profit shifting is also good economically because US MNEs will have at their disposal more resources that could be used to expand their domestic business operations, thereby increasing the well-being of US workers and customers. It is therefore clear why TRA17 did not include the Obama Administration's proposal. In the authors' opinion, the United States finds itself confronted by a difficult choice: (i) either tax MNEs' offshore income now by eliminating deferral or (ii) do nothing and risk that other countries, such as EU Member States through ATAD II, might tax what the United States believes is its tax base. Basically, it is like a zero-sum game; if US tax authorities gain, US multinationals lose and vice-versa.

1.7. Conclusion: The Future of BEPS

114. *Can.-US Income and Capital Tax Treaty – Technical Explanation to the 2007 Protocol* (2007). Similar language is contained in *Den.-US Income Tax Treaty – Technical Explanation to the 1999 Treaty* (1999): 'For example, income from sources in Denmark received by an entity organized under the laws of Denmark, which is treated for U.S. tax purposes as a corporation and is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the other State, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by an entity resident in Denmark.'

115. I. Gottlieb, *Dutch Hybrid Rules May Not Be Needed After U.S. Tax Reform*, Tax Management Transfer Pricing Report (BNA) (22 Feb. 2018).

116. *See* General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals, Department of the Treasury (Feb. 2016), at p. 26. The proposal is substantially similar to a proposal found in the President's fiscal year 2015 budget proposal, except that it now describes the foreign reverse hybrid subject to the proposal as owned by one or more US persons, rather than a hybrid held directly by a US owner, which could have been interpreted to limit the proposed rule to hybrids with only one owner. For a description of that proposal, *see* Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2015 Budget Proposal* (JCS-2-14) (Dec. 2014), pp. 58–66.

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The authors believe that with TRA17, the future of BEPS as the underlying standard of the international tax regime (ITR) is assured. As long as the United States stood aside, it was not clear that the European Union would be able to implement BEPS on its own, and China is only now just beginning to adopt BEPS measures.[117] But TRA17 represents the incorporation of BEPS into US domestic tax law. Moreover, TRA17 should not be considered as a 'tax war': it is a long-overdue response to the BEPS by US and other multinationals and a correct application of the single tax principle to prevent double non-taxation. It turns out that the immense effort of the OECD in 2013–15 was not in vain and a new and better ITR is on the horizon.

117. R.S. Avi-Yonah & H. Xu, *China and the Future of the International Tax Regime* (21 Oct. 2017). U of Michigan Law & Econ Research Paper No. 17-017; U of Michigan Public Law Research Paper No. 572, https://ssrn.com/abstract=3056796 (accessed 5 Apr. 2018).

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FORUM

Tax Reform, Round One

Understanding the real consequences of the new tax law

by Mihir A. Desai

The Trump administration's successful efforts at tax legislation stand out as the primary achievement of its first year. But the hurried, largely furtive drafting, and rush to passage at the end of 2017, have helped obscure the new tax regime's real impact. Much of the reporting and debate has focused on the politicking that went into passing the bill, and the purported effect on the federal budget deficit. That has diverted attention from the true significance of the Tax Cuts and Jobs Act (TCJA). Instead of simply changing rates and addressing loopholes, the TCJA represents a structural change to the income tax and, consequently, will lead to major changes in behavior. Teasing out those details reveals that the new law is likely to generate different incentives for economic growth than commonly claimed, unwanted complexities that invite still further gaming of the tax code (which the reforms themselves were intended to minimize), and larger deficits than forecast. If the past is a guide, and we can hope it is, the TCJA will be a precursor to further reforms that correct these shortcomings and address important distributional and fiscal concerns.

In the context of other legislation during the past 40 years, the magnitude of this tax reform is unremarkable when framed relative to gross domestic product. Indeed, the 1981 tax bill reduced federal revenue by an amount equaling more than twice the share of the estimated reduction in the Trump edition. But no reform during the last four decades approximates the scope and depth of the TCJA's changes to the overall structure of the tax system.

The unwieldy legislation is best understood by separately considering its impact on corporations, pass-through entities (businesses that are taxed not as entities, but rather at the individual or proprietor level, to whom income is "passed through"), and individuals. The congressional Joint Committee on Taxation has estimated the

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These changes improve corporate investment incentives in the United States, but they vary by type and economic sector—contradicting the simple view that a rate reduction greatly helps investment.

TCJA's revenue cost to be $1.5 trillion over 10 years, distributed among individuals (60 percent), corporations (22 percent), and pass-throughs (18 percent).

These are *net* figures, reflecting tax *cuts* offset by tax *increases.* For example, for individuals, the legislation creates $3.2 trillion of cuts and $2.4 trillion of increases, resulting in a net revenue loss of $862 billion. The total revenue lost through the corporate provisions is $329 billion, representing $1.85 trillion of cuts and $1.52 trillion of increases. As such, the scope of the provisions is far larger than net numbers reveal, and there will be sizable numbers of winners *and* losers.

Revolutionizing the Corporate Tax: Domestic Effects

Any of the five major changes to the corporate tax code described below would constitute a significant reform if examined separately. Taken together, they constitute a revolution in the way corporations are taxed (see Figure 4)—a revolution that was long overdue. The corporate tax featured the worst of all worlds: a relatively high marginal rate that created incentives for companies to move income around the world through various techniques, and enough loopholes to allow for the average rates actually assessed to be considerably lower. The U.S. regime of taxing corporations' international income, earned in other jurisdictions, was problematic because it was out of step with the practices of comparable countries around the world. These effects were visible in the tax-motivated efforts of U.S. corporations to move their headquarters abroad, and in the large piles of cash—most recently estimated to exceed $2.0 trillion—they held in offshore jurisdictions.

The first reform is to *reduce the statutory corporate tax rate* from 35 percent to 21 percent, a reduction that easily eclipses any undertaken by a developed country during the last several decades. The second is to *liberalize the tax treatment of capital expenditures on equipment*; previously, such investments were deducted over time according to depreciation schedules, but now they can be deducted entirely in the year they are undertaken (so-called expensing)—resulting in lower reported income, and therefore a lower tax bill, in the year of the expenditure. Third, rather than taxing corporations on their income realized around the world and then providing credits for taxes already paid abroad, the United States will now move to an emphasis on taxing only domestic profits (*transitioning from a worldwide to a territorial regime*). As part of that transition, the stockpiles of foreign profits, previously held abroad in order to defer tax obligations, will be taxed. A fourth set of reforms introduces *three new international tax instruments* that are completely novel on the global scene. Finally, the *deductibility of interest at the corporate level will be limited to 30 percent of a corporation's operating profit*.

A major rationale for the corporate reforms is to incentivize corporate investment, prompting gains in productivity and, ultimately, greater wages for workers. How well will the TCJA perform? That turns out to depend on the interaction of the statutory-rate reduction, the implementation of full expensing, and the limits on interest deductibility. Far from being uniform, these features are likely to interact in surprising ways for different types of investments. In general, the rate reduction and the move from depreciation to expensing improve investment incentives, but the limitation on interest deductibility raises the cost of investment.

For investment in *equipment*—a key element in the productivity equation—expensing is the critical factor. In fact, expensing allows the tax rate on new investment to become irrelevant. Under expensing, the firm gets tax relief at the time of investment and then later gives up profits—meaning the government is effectively functioning as a joint-venture partner with an ownership level that corresponds to the tax rate. As such, the pretax and post-tax rates of return are the same, ensuring no distortion to investment decisions. This improves investment incentives, but only slightly: the government was already providing accelerations of depreciation that yielded some of the benefits of expensing. At the same time, the lower tax rate and limits on interest deductibility *decrease* investment incentives because they make debt financing less beneficial than before. Curiously, in fact, firms now will also have incentives to locate debt-financed investment abroad, where these limits on interest deductions don't bite. Overall, investment incentives for equipment are improved, but not enormously because of these offsetting effects.

For structures and real property, with expected long lives and limited TCJA changes in depreciation, the reduction in the tax rate is critical—and those improved incentive effects from the new law are only partially offset by the limits on interest deductibility, so the incentive to invest in structures will increase significantly. Along with some of the changes to pass-through taxation described below, these changes amplify generous pre-existing benefits to the real-estate sector.

Finally, some investment incentives for intellectual property (research and development, patents) are actually *reduced* under the TCJA, because of the switch away from expensing toward amortization over time for these investments, plus the fact that a lower tax rate reduces the value of interest deductibility. Other changes (for example, limiting the use of net operating losses) are major deterrents to investment and offset these improved incentives across all investment types.

Taken together, these changes improve corporate investment incentives in the United States, but they vary by investment type and economic sector of the economy—contradicting the simple view that a rate reduction greatly helps investment. And, some fraction of these corporate-tax reductions will flow to workers, although the magnitude of that benefit has been considerably exaggerated. Indeed, the primary effect of the rate reduction alone is to provide a windfall to investments already in place that were undertaken with the expectation of a higher tax rate.

Taxing Corporations' Overseas Activities

The more notable corporate changes relate to the taxation of overseas activities. First, taxing profits previously warehoused abroad will raise significant revenue—and the transition from a worldwide

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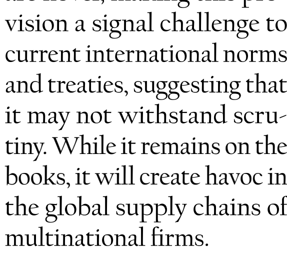
regime to a territorial one removes the perverse incentives to store future profits abroad. Combining those two changes will raise a serious challenge for corporations as they consider how to allocate their capital. When and how should cash be distributed to shareholders, or invested? If cash is to be distributed, are dividends or share buybacks preferred? If companies invest, do they prefer organic investment or mergers? The value creation (or destruction) associated with these decisions will ripple through the economy for the next decade and, given the sheer size of the stock of cash held overseas, may dominate the TCJA's effects on the economy.

Going forward, the shift to territoriality and the reduction in the corporate tax rate will make the United States a more hospitable domicile for corporations, reducing their incentives to leave (or be acquired by a foreign company) and to transfer profits abroad through convoluted structures. So far, so good.

But as with so much surrounding the TCJA, that simple story is complicated—in this case, by three novel tax instruments that are embedded in the law. Each is motivated by the fear that a move to territoriality will provide incentives for firms to move profits out of the country to lower-tax jurisdictions, given that the United States now attempts only to tax profits within its borders. The already sizable operations and profits of multinational firms in low-tax countries, such as Ireland, may now grow considerably because firms would no longer face a U.S. tax on foreign profits.



First, a minimum tax attempts to ensure that corporations pay a minimum tax (effectively at 13.125 percent) on their profits abroad. This provision is meant to discourage moving profits to ultra-low-tax jurisdictions, as that income will still face a 13.125 percent rate at home. Unfortunately, this mechanism has several perverse effects. It strongly encourages governments around the world to change their rates to 13.125 percent, shifting all revenue from this tax to foreign governments. Indeed, this supposed *floor* on taxes paid around the world may well become a *ceiling*. Such a minimum tax will effectively vitiate the transition to a territorial system. In reality, the TCJA creates a new worldwide regime at a 13.125 percent rate without the historic advantages of deferral—undoing many of the benefits of moving to territoriality. The actual operation of the minimum tax also provides an incentive to move investment abroad—and its complexity and unresolved details have created havoc for multinational firms as they struggle to understand how it will actually work. One example of this complexity: firms will not benefit domestically from expensing fully because of this minimum tax abroad.

Second, in an effort to ensure that intellectual property is not moved abroad—a favorite tax strategy of various technology giants—the legislation provides a preferential rate (also 13.125 percent) on income from intellectual property domiciled domestically that is associated with exports. This provision aims to make the United States a more competitive location for intellectual property, an imperative created by the spread of preferential regimes for intellectual property called "patent boxes" around the world. Unfortunately, the emphasis on exports means this provision may not comply with international agreements. And again, its actual workings may make firms want to move real investment abroad in order to maximize the benefit of the provision.

In a final effort to curtail profit-shifting out of the United States, the new "base-erosion anti-avoidance tax" (BEAT) tax presumes that services transactions by multinational firms with related parties are motivated by tax-avoidance. Both the presumption of avoidance and the willingness to tax transactions rather than profits are novel, making this provision a signal challenge to current international norms and treaties, suggesting that it may not withstand scrutiny. While it remains on the books, it will create havoc in the global supply chains of multinational firms.

The Corporate Change in Context

In many ways, the corporate provisions are the best part of the TCJA: the shift to territoriality and the rate reduction were long overdue and had enjoyed bipartisan support. Unfortunately, that core of the corporate provisions was spoiled by several decisions. The desire to get the rate to 21 percent was enormously expensive, as every percentage point reduction represented a $100-billion cost over 10 years—and created a larger windfall to older investment. To offset that revenue loss, the tax treatment of research expenditures was made less generous, interest limitations were introduced, and a host of international taxes were created that undo the benefits of the shift to territorial taxation. A rate reduction to 25 percent and a simpler move to territoriality would have been preferable.

The actual legislation has created noteworthy winners and losers. As one example, multinational firms that employ intellectual property widely were previously able to pay global tax rates in the low teens or below; they now face a new world of tax complexity and potentially *higher* rates. In contrast, domestic firms that invest in real estate and have moderate debt will be clear winners.

Most ambitiously, the reform can be viewed as retreating from the idea of taxing income itself, given the mobility of income in a

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The most significant individual-tax changes are the new rates and brackets. Collectively, they are large tax reductions and, unsurprisingly, largely accrue to high-income individuals.

global setting with lots of intellectual property. The base for corporate taxation is becoming consumption rather than income: witness the preferential regime for exports, the denial of deductions for imported services from related parties, and the expensing of investment and limiting of interest deductibility—all of which move toward a cash-flow tax that gives up on taxing something as mobile as income in favor of taxing consumption. While other countries tax consumption via a value-added tax, we may be transitioning to a consumption tax effectuated through the corporate sector.

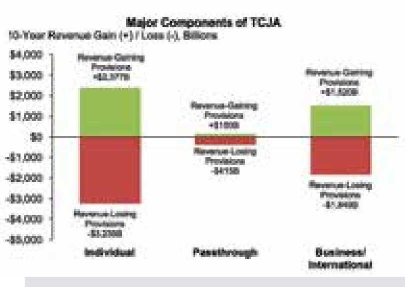
Who Am I?

The reduction in the corporate tax rate prompted so-called "small business" interests to advocate for comparable relief. These interests typically employ pass-through entities, so named because there is no taxation at the entity level (as with corporations); instead, all income is passed through to, and taxed at, the individual level. During the last 30 years, the share of business income that is associated with pass-through entities (partnerships, limited-liability corporations, and Subchapter S corporations) rose from less than 20 percent to more than 50 percent.

The 2017 legislation creates a new regime for pass-through entities by granting them a 20 percent reduction in their tax rate: an individual facing the new top 37 percent rate on labor income, for example, will now face a 29.6 percent tax rate on pass-through income. This new regime for pass-through income creates a host of tax-planning opportunities of mind-numbing complexity. For the first time since the tax reforms of the early 1980s, individuals will have to confront existential tax questions: Who am I? Do I want to be a corporation, a pass-through entity, or just an individual?

The legislation creates a large gap between corporate tax rates and top personal marginal rates, a gap not present in the tax code during the last 40 years. Such a gap can make a corporation a tax shelter for individuals who want to avail themselves of the lower 21 percent rate. As an example, an individual could corporatize and provide consulting services to clients and pay herself only a small amount of that income. Wealth saved in the corporation could also grow and pay that lower tax rate. (This opportunity is limited in two ways. First, there are accumulated-earnings and personal-holding-company taxes designed to deter such opportunism, but they have not been used widely and pose significant implementation issues. The bigger limitation is that distributing the cash from the corporation will incur additional taxation as it is delivered to the individual. Absent reaching tax nirvana—the ability to exempt historic returns from taxation by dying (the step-up basis for inherited assets)—the combination of corporate and individual tax can make this strategy less desirable.)

HM▶ Visit harvardmag.com for Mihir Desai's charts depicting the composition and magnitude of all the tax changes.



The TCJA's new pass-through regime will also provide an incentive for some corporations and individuals to become pass-through entities. Corporations that don't want to pay both the corporate tax and shareholder-level taxes can avail themselves of one level of taxation by becoming pass-through entities.

Similarly, individuals who would rather pay at a 29.6 percent rather than a 37 percent rate can stop being employees and contract with their employers as pass-through entities. Indeed, it may become commonplace for similarly situated workers to find that they are paying very different taxes because some are pass-through entities and others are employees. (Taking advantage of these provisions is easiest for families earning less than $315,000. Higher-income earners will need to be more savvy about this, as many engaged in "services" activities will not be allowed to take advantage of this provision easily. What is a service? The legislation ensures that some services are specifically identified but leaves much more to be articulated. At a minimum, one can imagine that firms that are service providers might find it advisable to split into separate services and technology branches so that part of the firm can avail itself of the advantageous rate.)

Taken together, the TCJA's pass-through provisions are enormously complex, create numerous tax-planning opportunities, and will create windfalls to those best positioned to navigate that complexity. As such, they represent some of the worst parts of the legislation—and will likely cost the federal government far more revenue than projected, given the myriad behavioral responses to this new regime. The pass-through regime was designed to limit the incentive to corporatize by reducing the relevant gap from 16 percentage points (37 percent versus 21 percent) to 8.6 percentage points (29.6 percent versus 21 percent). It would have been wiser to police the corporatization margin more effectively, rather than create an entirely new regime with its own difficulties.

Individual Taxes: Simplification and Redistribution

At the individual level, the changes are somewhat less structural. New brackets and lower rates are typical in "reforms," and this one lowers the top marginal tax rate from 39.6 percent to 37 percent and raises the income level at which this top bracket begins.

The structural change occurs in the way zero-tax brackets—ranges of income where no income tax is due—are accomplished. Historically, personal exemptions and a standard deduction combined to create a zero bracket. Now, exemptions are gone; the standard deduction has increased considerably; and an expanded, more refundable child credit has been created. Overall, the changes to exemptions, child credits, and standard deductions add up roughly to a zero effect on tax revenue; they are structural changes that help simplify the individual code by enabling more people to avoid item-

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izing. The increased refundability of the child credit, along with the phase-out of the credits for higher-income taxpayers, mean that these changes are moderately progressive.

The other notable changes limit the deductibility of state and local taxes to $10,000 and reduce the limit on interest-deductibility on mortgages and home-equity loans from $1.1 million to mortgages alone of $750,000. These changes adversely affect higher-income individuals and, notably, individuals in high-income-tax states with high property values. Although these provisions can be viewed as targeting coastal Democratic states, it's also the case that those individuals are the cohort most likely affected by the Alternative Minimum Tax; its bite is lessened under the TCJA. Taken together, these changes should amplify the incentives for high-income individuals to relocate from high-income-tax states; absent some remedies, they will also create fiscal pressure on state governments.

The context of this sweeping overhaul has eclipsed the importance of otherwise important reforms. In particular, a variety of miscellaneous business deductions have been limited, the scope of the estate tax was reduced considerably, and the tax penalty that underpinned the mandate of the Affordable Care Act was repealed. Each of these provisions will have major impacts on the self-employed, the estate-planning industry, and the healthcare market.

In economic terms, the most significant individual-tax changes are the new rates and brackets. Collectively, they are large tax reductions and, unsurprisingly, largely accrue to the largest tax payers: high-income individuals. But the share of all taxes paid across the income spectrum is distributed similarly before and after the tax reform.

One key difference is that most individual tax changes are *phased out* over time; the TCJA's corporate changes are *permanent*. Because corporate tax changes are thought to accrue mostly to higher-income taxpayers, the long-run effects are regressive: they appear to shift a greater share of taxes paid to lower-income individuals after the individual changes are phased out. Of course, it is not clear that the individual tax cuts will be allowed to phase out, nor is it completely true that corporate tax changes don't benefit workers across the income spectrum.

The Challenge to Universities

During the last decade, several ideas that take aim at the tax-exempt status of universities have percolated through legislative hearings. Two of them came to fruition as part of the recent legislation. First, a 1.4 percent tax on the returns of large endowments has been enacted; it is forecast to raise $1.8 billion for the federal government over 10 years. Harvard has suggested that its annual taxes due will be greater than $40 million, an estimate that corresponds to the University's contributing more than 20 percent of the revenue raised by this provision (see "Endowments, Taxed," March-April, page 18). Second, $3.8 billion will be raised by prohibiting universities from offsetting the profits and losses of their unrelated businesses (hotels and conference centers, for example), making more of their income subject to taxation.

These efforts are notable for three reasons. First, although they are relatively small in the scope of the overall legislation, they should be understood as the first step in a continuing effort to challenge the tax-exempt status of elite universities. Second, they are quite targeted: the endowment tax will apply to fewer than 50 institutions, with the vast majority of tax revenue coming from a handful of universities. Along with the limitations on the deductions of individuals, these steps represent the "weaponization" of the tax code—a particularly problematic development. Finally, they go to the core of universities' tax-exempt status. Taken together, these efforts represent the culmination, for now, of long-simmering doubts about the degree to which elite institutions are conducting themselves in a manner consistent with the expectations created by tax-exempt status.

Missed Opportunities…and What's Next?

The core of the TCJA is a long overdue modernization of the corporate tax. The desire to reduce the rate below 25 percent, and Congress's inability to pass a pure corporate tax reform, required additional changes, including new international taxes that undo some of the benefits of those core improvements. Changes in pass-through taxation have added remarkable complexity and scope for gaming the tax system, with few associated benefits. Finally, in pursuit of a headline trumpeting middle-class tax cuts, individual changes were included that dramatically increased the fiscal cost of the legislation.

That stated fiscal cost of $1.5 trillion is likely severely understated because it envisions future reversals of tax cuts that, once granted, are in fact hard to reverse. The complex international and pass-through provisions open the door to tax-reducing strategies that we can only begin to imagine. And that fiscal cost, in the context of current federal-budget deficit realities and an economy near or at full employment, will likely be associated with interest-rate increases that partially undo the economic benefits associated with the law's improved investment incentives.

The most noteworthy missed opportunities in this legislation relate to the inability to make the in- *(please turn to page 87)*

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world. Despite Harvard's dreadful investment performance, the world still watches and cares about what Harvard does.

Such a glimmer would not be hard to find. For example, the world is awash in fossil fuels, with reserves at a level four times higher than can ever be used if the world is to stay below the two-degree warming ceiling increase agreed in Paris; more is being found all the time. Harvard could simply decide that the University was no longer going to invest in the research for or development of further, new resources of fossil fuels (which can never be burned anyway if we hope to maintain the globe as a sustainable habitable environment). Further decisions for squeezing down fossil-fuel use would follow, including but not limited to difficult decisions concerning the extensive travel of its faculty.

While some critics have suggested that even such an evolutionary approach to fossil-fuel use would signal an unwanted "politicization" of University decisions, to the contrary, Harvard would simply be working to right-size all its actions for the challenges of our climate-challenged world.

New leadership always brings new promise. I hope that Harvard's transition will also bring fresh thinking about the responsibilities that accompany the management of the University's sizable endowment.

Timothy E. Wirth '61
Former Harvard Overseer; Chair of University Committee on the Environment
Former Congressman and Senator, Colorado
President emeritus and vice-chair of The United Nations Foundation
Washington, D.C.

ENDOWMENT TAXES

I note a few letters about the negative impact on Harvard of the tax on its endowment income in the new tax bill, but I strongly disagree with the idea that all is forgiven as long as the stock market, in part because of this bill, goes up. A writer's statement that Harvard should thus welcome the new tax bill "by embracing the greatest innovation in the history of mankind, namely capitalism itself" (March-April, page 4), is misguided.

Such a one-dimensional notion could be countered with a similarly one-dimensional idea: that capitalism's primary focus on making money may lead to the destruction of the planet as environmentally harmful but profitable enterprises see their stock prices soar.

Capitalism isn't the last word in economic theory, and the stock market isn't the only relevant consideration when evaluating investments. I'd like to think the future of mankind itself merits at least a little consideration in evaluating the impact of any tax bill.

Hugh R. Winig '65
Lafayette, Calif.

IT'S (STILL) LATIN TO THEM

"Yesterday's news" reports, under 1963, the large number of A.B.s in the Peace Corps (March-April, page 25). Harvard ceased granting A.B.s in favor of B.A.s in 1961, the bitter year English replaced Latin on our diplomas. "Latin Sí, Pusey No!"

Arkie Koehl '61
Honolulu

Editor's note: Harvard *did* drop Latin diplomas in 1961, but the degree is still listed as A.B. The 2017 Commencement book states: "Harvard still uses the abbreviations for degrees in the Latin order rather than in the English, for example: A.B., *Artium Baccalaureus;* A.M., *Artium Magister;* and Ph.D., *Philosophiae Doctor.*"

MISCLASSIFICATION OF SPELT

"Brew's clues" (March-April, page 50), called spelt gluten-free. Andy Robin, M.B.A. '80, let us know it is not. We regret the error.

TAX REFORM, ROUND ONE

(continued from page 61)

dividual tax considerably more progressive to address current appetites for redistribution. Specifically, a large increase in the earned-income tax credit (EITC) for the lowest-income Americans could be financed by a new top bracket and a repeal of the step-up basis for inherited assets. The EITC provides good work incentives but is currently undersized and an expansion enjoys bipartisan support. Additionally, the population in the top bracket has grown to capture 1.0 percent of taxpayers; historically the top bracket captured 0.1 percent of taxpayers. The growth of the population in the top bracket is problematic, because very different taxpayers are being treated similarly and because such a populous top bracket makes raising the rate on the very wealthy difficult. Creating a new top bracket for taxpayers with income above $2 million, associated with a higher tax rate, on the other hand, could help finance an expansion of the EITC, as suggested above. And the step-up basis for inherited assets continues to benefit the wealthiest and provides incentives to hold on to assets all too long—reasons this benefit for the most privileged Americans might productively be subjected to taxation. More ambitiously, the relatively broad support for carbon taxes remains an untapped opportunity.

What comes next? We should expect a significant response from other nations in the form of challenges and policy moves in reaction to the TCJA provisions that have tenuous underpinnings under international agreements and treaties. These legal challenges may be particularly problematic at a time when the U.S. government seems eager to turn its back on international treaties and norms. The consequential moves by the United States to slash the statutory corporate tax rate and try to enact a minimum worldwide tax rate will narrow the corridor of desirable tax rates for other countries to between 13 percent and 21 percent—a dynamic that could lessen the tax competition that was present under the previous regime, in which corporations sought ever-lower tax rates with their overseas income.

Domestically, the TCJA is most reminiscent of the 1981 tax cuts. That legislation was followed by a 1982 reform that reversed some of its effects, and additional annual reforms that further patched and improved the initial act. Ultimately, these more minor fixes prompted the transformational reform of 1986—a genuinely comprehensive simplification and rationalization of the tax code.

If the next five years follow suit, the TCJA will have accomplished much by beginning that process. Of course, skeptics will quickly point to the differing political dynamics between and within parties today relative to the 1980s—and to the resulting general inability to pass any meaningful legislation. But those same skeptics, including me, would have argued that the TCJA would never have passed in the first place. Given current fiscal realities, we should all hope that the TCJA represents the beginning of tax reform, rather the end.

Mihir A. Desai is Mizuho Financial Group professor of finance at Harvard Business School and professor of law at Harvard Law School. His book The Wisdom of Finance *was featured in Open Book in the May-June 2017* Harvard Magazine.

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MICHAEL DEVEREUX

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A MARXIST APPROACH TO INTERNATIONAL TAXATION

When Margaret Hodge complained about how little tax Amazon paid in the UK, the tax cognoscenti rather patronisingly pointed out that the existing system does not generally give the right to tax profit to the country in which a sale in made. But since then the US House of Representatives Ways and Means Committee, the European Commission, and also the OECD have all put forward proposals which move the system in this direction.

Of these, only the Ways and Means Committee (in its June 2016 proposal) seriously considered replacing the existing system with a new system based on the principle that companies should be taxed in the market country. That represents a clear new principle for the allocation of taxing rights – and one that is worthy of consideration. But the Commission and the OECD would maintain the existing system, but add a layer of tax in the market country. Their main concern seems to be that profit should be taxed somewhere – anywhere – rather than be untaxed. For them, a tax in the market country is a response to the failure of the existing system to adequately tax multinational profit elsewhere. But that is not a principled approach; there is no consideration of what is the best location for taxation, only a desperate scramble for more revenue.

To think things through, let's start with the pre-BEPS position – which remains with us, despite the tweaks from BEPS. It is a system based on a 1920s compromise that, very broadly, taxes passive income in the country of "residence" and active income in the country of "source". But neither of those terms – particularly "residence" – is being applied in ways the 1920s founders of the system intended. Did those founders really intend the country of "residence" to be a tax haven where a company owns IP, or lends to the rest of a multinational group? The founders did not really foresee the rise of intermediate companies, with the result that any economic notion of the residence of the ultimate investors has lost out to the notion of the legal residence of a multinational subsidiary. How the system of allocating MNC income globally developed over the intervening 90 years is explained in an excellent new OUP book by Richard Collier and Joe Andrus.

Unfortunately, things became less clear with the BEPS project's insistence that tax should be levied in the place of "economic activity", "relevant substance", "substantial activity" or "value creation". The OECD was presumably trying to reduce profit shifting to countries without such activity or substance. But there is no apparent reason for a country of "residence" to have any such activity or substance.

Where does that leave us? At a conceptual level, the OECD has attempted to overlay a new principle – of taxing in the place of value creation – on top of the existing principles of source and residence. Practical problems arise as a result. For example, when does the principle of value creation take precedence over the principle of residence? One answer appears to be when there is no-one in a residence country who may be bearing risk. So the principle of value creation is interpreted as saying that we have to see where the controller of risk is located. But that no more defines the location of risk – or value creation – than does a clause in a contract. In truth, no approach to assigning risk to a single subsidiary makes any economic sense. Risk is borne by the owners of a multinational company, who may be located around the world – it is not borne by any single subsidiary.

Perhaps not surprisingly, given that the principles on which it is based are so unclear, the system we now have is of mind-boggling complexity. Taxpayers and tax inspectors around the world are struggling to make sense of it, let alone apply it. The weight of complexity has brought the system to its knees.

But we haven't completed outlining the confusion of principles. BEPS Action 1 also considered the notion that the country in which a sale is made – the market country – might also be a suitable place for taxing profit. The concern here was that nothing else would adequately tax the profits of digital companies. Hence we must now consider the possibility of a digital PE being located in the market country – an idea taken up enthusiastically by the European Commission. Indeed, it seems likely that in the near future some countries will introduce an "equalization tax" on sales by digital companies in market countries. What the proposed tax is supposed to equalize, and why it should be levied on turnover rather than profit, remains a mystery. What does appear to be clear is that it will only apply to digital companies – precisely the opposite of the line taken by both the OECD and the Commission's own Expert Group on Taxation of the Digital Economy in 2014 (of which I was a member).

For many reasons – complexity, distortions to real economic behaviour leading to economic inefficiencies, and profit shifting – there is an unquestionable need to reconsider the principles of where profit is taxed. Let us have a proper debate about what principles to apply to taxing profit, including where to tax it. And let us try to find principles that might conceivably achieve some basic aims, such as fairness, efficiency and simplicity.

But simply adding a new location – the market country – through new ad hoc measures such as a digital PE or an equalization tax, does not amount to a reconsideration of principles. It is rather another attempt to overlay new principles on the old. The new additions will do little to address the current problems, and may well make them worse. So why is this a Marxist approach? Because it is really an attempt to collect tax on the profits of multinationals by any means, and any principles, available – like the old Groucho Marx quote, "those are my principles, and if you don't like them, well I have others".

This is the first of a regular blog to be written by staff and associates of the Oxford University Centre for Business Taxation.

Research from the Centre for Business Taxation relevant to this blog includes:

- *Richard Collier and Joe Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, August 2017.*
- *Michael Devereux and John Vella, "Implications of digitalization for international corporate tax reform", in Sanjeev Gupta, Michael Keen, Alpa Shah, and Genevieve Verdier (editors) Digital Revolutions in Public Finance, International Monetary Fund, November 2017.*
- *Michael Devereux and John Vella, "Are we heading towards a corporate tax system fit for the 21st century?", Fiscal Studies 2014, 35.4, 449-475.*

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The Moral Law ›

8 RESPONSES TO "A MARXIST APPROACH TO INTERNATIONAL TAXATION"

1.

guillermo says:
November 17, 2017 at 4:53 pm

Nice piece!

Reply

2.

Iain Campbell says:
November 17, 2017 at 4:57 pm

Very accurate. From memory I think Groucho also once described an impossibly garbled legal contract as so simple a child of 5 could understand it. So a request went out looking for a child of 5.
Maybe there are no 5 year olds out there who can explain international tax. But even the idea of trying to decide where the profits "really" arise seems fanciful. Why should it be where the consumer is? Why not with the R&D Dept or the investment in manufacturing? But these are also old and familiar problems.
We may as well look to Groucho's earlier comedy stars for advice – another fine mess you've got us into..

Reply

3.

Taxing the Digitalised Economy: Targeted or System-Wide Reform?

Michael P. Devereux[*]

John Vella[**]

Abstract

Digitalisation has brought the international corporate tax debate to a critical point, with different reform options being considered. In previous work the authors argued that digitalisation exacerbated problems that have long troubled the existing system thus necessitating system-wide reform. This position is broadly aligned with that of one of the two groups of countries favouring reform. The present article complements this work by focusing on the "long-term" targeted reform proposals favoured by another group of countries. These proposals are criticised on conceptual and practical grounds.

I. Introduction

The existing system for taxing corporate income in an international setting is at a critical juncture. Despite having only recently undergone "the most significant re-write of the international tax rules in a century",[1] there is a real possibility that the system will be reformed—including, perhaps, some of its fundamental features—in the not too distant future. Whether it is, and if so, what type of reform it will be, hinges on the outcome of the ongoing international debate on digitalisation.

As the OECD candidly explained in its March 2018 Interim Report, *Tax Challenges Arising from Digitalisation* (Interim Report),[2] countries have different views on how to address these challenges, but they broadly fall into three groups. One group of countries holds the view that there is a need to undertake targeted reform to address the problems posed by certain "highly digitalised businesses" (HDBs). In particular, this group favours reform that allocates taxing rights over the profits of certain HDBs to countries were users are located. A second group holds the view there is a need to introduce reform to address not only challenges posed by digitalisation, but also globalisation and other factors. Critically, this group believes that reform should extend

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Extracts from OECD materials are republished with permission of the OECD: permission conveyed through Copyright Clearance Center Inc. The authors would like to thank Richard Collier and Giorgia Maffini for helpful comments. The usual disclaimers apply. Michael Devereux drew on this joint paper to deliver the Klaus Vogel Lecture, *Should we use Value Creation or Destination as a Basis for Taxing Digital Business?* at the Institute for Austrian and International Tax Law, Vienna University of Economics and Business, in September 2018.

[1] OECD/G20 Base Erosion and Profit Shifting Project, *2015 Final Reports: Information Brief*, available at: *https://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf* [Accessed 20 September 2018].

[2] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2018), available at: *http://dx.doi.org/10.1787/9789264293083-en* [Accessed 20 September 2018].

to the system as a whole and should not be limited to certain HDBs. The difference between the positions of the first two groups is partly captured by identifying the source of the challenges as the "digital economy" or the "digitalisation of the economy". A third group holds the view that the Base Erosion and Profit Shifting (BEPS) project largely addressed concerns with double non-taxation. These countries are generally satisfied with the existing system and do not currently see the need for significant reform of the international tax rules. The immediate future of the international tax system depends on which of these views prevails. At the time of writing, reform options in line with the first two views are being considered by the 122 countries that comprise the OECD's Inclusive Framework, with the aim of reaching a consensus based solution by 2020. An update is expected in 2019.

It is not surprising that digitalisation drove the debate on the international corporate tax system to this point. Digitalisation exacerbates and exposes even more clearly the problems plaguing the existing system. Consider, for example, the problems caused by "hard to value intangibles" and how central they are in a digitalised economy.[3] It is also not particularly surprising that the debate has been driven to this point so soon after the BEPS project was concluded, because, as the OECD acknowledged, "BEPS measures do not necessarily resolve the question of how rights to tax are shared between jurisdictions, which is part of the long term issue".[4]

But a number of countries have been dissatisfied with the current allocation of taxing rights for some time, as the 2013 BEPS Action Plan noted,[5] and this dissatisfaction has spread further and intensified as a result of digitalisation. Ultimately, the underlying issue in this debate is nothing less than how to allocate taxing rights among countries in the digital age.[6]

This issue is currently at the very top of the international political agenda. The Communiqué from the G7 Summit that took place in Charlevoix on 8 to 9 June 2018 expressly noted that "[t]he impacts of the digitalization of the economy on the international tax system remain key outstanding issues" and the G7 countries thus reaffirmed their commitment to working together "to seek a consensus based solution by 2020".[7] However the debate is taking place against a challenging political background, both domestically and internationally. Media commentators, campaigners and members of the public—particularly in European countries—continue to demand immediate political action to ensure that large multinationals pay their "fair share" of tax.[8] There

[3] Although one should acknowledge the work done to address some of these problems in BEPS Actions 8–10: OECD/G20 Base Erosion and Profit Shifting Project, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports* (Paris: OECD Publishing, 2015), available at: *http://dx.doi.org/10.1787/9789264241244-en* [Accessed 20 September 2018].

[4] OECD, *Brief on the Tax Challenges Arising from Digitalisation Interim Report 2018* (March 2018), available at: *https://www.oecd.org/tax/beps/brief-on-the-tax-challenges-arising-from-digitalisation-interim-report-2018.pdf* [Accessed 21 September 2018], para.5.

[5] "In the changing international tax environment, a number of countries have expressed a concern about how international standards on which bilateral tax treaties are based allocate taxing rights between source and residence States." OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), available at: *https://www.oecd.org/ctp/BEPSActionPlan.pdf* [Accessed 20 September 2018], 11.

[6] Interim Report, above fn.2, 376.

[7] *The Charlevoix G7 Summit Communique* (9 June 2018), available at: *https://g7.gc.ca/en/official-documents/charlevoix-g7-summit-communique/* [Accessed 11 October 2018].

[8] "Faced with rising inequalities and perceptions of a lack of social justice, EU citizens are calling for member States and the Commission to take action to improve the fairness of the tax systems": EU Commission, *Communication from the Commission to the European Parliament and the Council: Time to establish a modern, fair and efficient*

are also increasing calls to rein in the power of dominant digital companies because of their influence on the dissemination of information, political debate and, possibly, even electoral outcomes. At the same time, it is impossible to ignore the fact that many of these companies are American. Proposals to tax HDBs could be perceived—and have been perceived by some on the other side of the Atlantic[9]—as deliberately targeting American companies. Rightly or wrongly, this could aggravate a sense of injustice resulting from the perceived unfairness of the trade system[10] and the EU Commission's state aid rulings concerning prominent American companies,[11] as well as other factors.

In March 2018 the EU Commission put forward two proposals targeted at certain HDBs and which are thus aligned with the views of the first group of countries. A number of influential EU Member States, including the UK—as evidenced by the position paper *Corporate tax and the digital economy* (the Position Paper) released by HM Treasury in November 2017, and updated in March 2018 (the Updated Position Paper)[12]—are also aligned with the views of this group. On the other hand, the US is aligned with the views of the second group.[13]

The political pressure to act is high—indeed there have been calls to shorten the timeframe for consensus to be reached[14]—but this delicate political environment makes it harder to have a sensible public and political debate on this issue and to reach a consensus. If no consensus is reached it is likely that a number of countries will proceed with uncoordinated unilateral measures that could potentially lead to an even more fractured, complex and distorting international tax system.[15] The stakes in this debate are high.

In previous work the authors argued for the need to reform the system as a whole[16]; therefore, of the three groups, the authors' views are most closely aligned with those held by the second. This article complements that work and focuses on the position adopted by the first group of countries, particularly their favoured long-term reform. It argues that the proposed reform is

taxation standard for the digital economy (2018 Communication) (Brussels: 21 March 2018, COM(2018) 146 final), available at: *https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_fair_taxation_digital_economy_21032018_en.pdf* [Accessed 20 September 2018].

[9] See the discussion of this issue in M. Herzfeld, "Digital Economy Taxation: Fake Tax Policy", *Tax Notes International*, 7 May 2018.

[10] See for example, "Trump lashes out at Canada and France ahead of G7", *Financial Times*, 8 June 2018; and "Economists reject Trump claims of unfair trade system", *Financial Times*, 8 June 2018.

[11] See US Department of the Treasury, *The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings: White Paper* (24 August 2016), available at: *https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/White-Paper-State-Aid.pdf* [Accessed 20 September 2018].

[12] HM Treasury, *Corporate tax and the digital economy: position paper* (November 2017); and HM Treasury, *Corporate tax and the digital economy: position paper update* (March 2018), both available at: *https://www.gov.uk/government/consultations/corporate-tax-and-the-digital-economy-position-paper* [Accessed 20 September 2018].

[13] U.S. Department of the Treasury, press release, *Secretary Mnuchin Statement On OECD's Digital Economy Taxation Report* (16 March 2018), available at: *https://home.treasury.gov/news/press-releases/sm0316* [Accessed 20 September 2018].

[14] S.S. Johnston, "OECD Mulls Faster Timeline for Taxation of Digital Economy Work", *Tax Notes International*, 7 May 2018.

[15] Concern is also often raised about the possibility of increased double taxation as a result of such unilateral measures. Note, however, that the overall tax paid on a given profit is more important than the number of taxes imposed on it.

[16] M.P. Devereux and J. Vella, "Are we heading for a corporation tax fit for the 21st century?" (21st Century) (2014) 35(4) *Fiscal Studies* 449 and M.P. Devereux and J. Vella, "Implications of digitalisation for international corporate tax reform" (Implications) in S. Gupta, M. Keen, A. Shah and G. Verdier (eds), *Digital Revolutions in Public Finance* (IMF, 2017).

questionable conceptually and problematic in practice. It also fails to address the wider problems faced by the existing system that threaten its long-term viability.

This article proceeds as follows. Section II provides some brief background. Section III critically evaluates the reform favoured by the first group of countries. In particular, it makes four high-level criticisms of their favoured long-term reform. Section IV makes the case for system-wide reform. Section V concludes.

II. Background

The international debate on how to address the challenges posed by digitalisation[17] can be traced back a few decades, with highlights including the 1998 Ministerial Conference on Electronic Commerce in Ottawa. For the purposes of this article, the debate can be taken up during the recent BEPS project by recalling that these challenges were considered in Action 1. However, consensus was not reached and the Final Report for Action 1 published in October 2015 did not propose any of the measures it discussed.[18] Instead, the Final Report explained that account had been taken of the specific issues raised by the digital economy when developing the general proposals put forward in the other BEPS action points. Work on these challenges was to continue, leading to an updated report by 2020.

In the meantime the number of countries adopting or openly considering unilateral measures increased.[19] The UK and Australia adopted Diverted Profits Taxes in 2015 and 2017 respectively. These taxes are of broad application, but they could be seen to address some of the challenges posed by digitalisation; recall that the UK tax was widely known as the "Google Tax".[20] Other countries adopted or openly considered adopting targeted measures. For example, India adopted an Equalisation Levy in 2016, while Germany, France, Spain and Italy issued a joint communication proposing similar levies in September 2017.

In March 2018, the EU Commission put forward two proposals for taxing the digital economy, partly to avoid the adoption of uncoordinated unilateral measures within the EU. The first—a "short-term measure"—is a tax on revenues created from: 1. selling online advertising space; 2. digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them; 3. the sale of data generated from

[17] Several other academic articles have already been written about the challenges posed by the digitalisation of the economy and potential responses to them. See for example, A. Báez and Y. Brauner, *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy* (White Paper Series IBFD, 2015); P. Hongler and P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* (White Paper Series IBFD, 2015); M. Olbert and C. Spengel, "International Taxation in the Digital Economy: Challenge Accepted?" (2017) 9(1) *World Tax Journal* 3; W. Schon, "Ten Questions About Why and How to Tax the Digitalized Economy", *Bulletin for International Taxation*, April/May 2018; and the papers in *Intertax* (June/July 2018) 46(6 and 7).

[18] OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Action 1—2015 Final Report) (Paris: OECD Publishing, 2015), available at: *https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page3* [Accessed 20 September 2018].

[19] See Interim Report, above fn.2, Ch.4 for more detail.

[20] V. Holder, "'Google tax' take swells to £281m as levy starts to bite", *Financial Times*, 13 September 2017.

user-provided information.[21] The second—the "long-term solution"—consists in a proposal for a "significant digital presence" (a form of digital Permanent Establishment (PE)) and accompanying profit attribution rules.[22] Despite putting forward these two proposals, the EU Commission's preferred long-term solution remains the Common Consolidated Corporate Tax Base (CCCTB), which it re-launched in 2016.

The OECD also published its much-awaited Interim Report in March 2018.[23] The Interim Report identified three characteristics found in certain HDBs and the challenges they pose to the existing tax system. The first characteristic is being able to have large commercial operations in a jurisdiction with little or no physical presence, and hence no taxable presence there ("cross-jurisdictional scale without mass"). The second is heavy reliance on data and user participation. According to the OECD, this may indicate a deep participation in the economic life of the jurisdictions where they are found, however, the existing international tax system does not take these factors into account for the purpose of allocating taxing rights over companies' profit. The third is the increasing reliance on intangible assets, which pose considerable and well-known difficulties for the international tax system.

The Interim Report explains that there is "no agreement" amongst countries over the tax implications of the first and third characteristics.[24] There is also no agreement on whether, and if so how, data and users should be taken into account when allocating profit among countries; and this is where the divergence between the first two groups of countries can be seen particularly clearly. The first group favours reforming PE and profit attribution rules to allocate taxing rights over the profits of certain HDBs to countries where users are found, but the second group opposes such targeted reform, favouring system-wide reform.

Given this divergence of views, at the time the Interim Report was written, agreement could only be reached to undertake a "coherent and concurrent review"[25] of the PE threshold and profit attribution rules with the goal of reaching a consensus by 2020. It will be up to the Inclusive Framework to decide whether to proceed with changes targeted at certain HDBs (in line with the views of the first group) or changes applicable to the broader economy (in line with the views of the second group). In the meantime "technical solutions [are being] explored to test the feasibility of the different options".[26]

Some countries—presumably from the first group—also favour interim solutions in the form of turnover taxes on certain digital companies. The Interim Report does not propose such turnover taxes—due to the divergent views among countries on the need for and merit of such taxes—but it sets out guidance for countries that wish to adopt them.

[21] EU Commission, *Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services* (Brussels: 21 March 2018, COM(2018) 148 final).
[22] EU Commission, *Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence* (Brussels: 21 March 2018, COM(2018) 147 final); EU Commission, *Commission Recommendation relating to the corporate taxation of a significant digital presence* (Brussels: 21 March 2018, C(2018) 1650 final) (Significant Digital Presence Proposal).
[23] Interim Report, above fn.2.
[24] Interim Report, above fn.2, para.372.
[25] Interim Report, above fn.2, para.373.
[26] Interim Report, above fn.2, para.398.

III. Targeted reform

A. Digital PE and profit attribution rules

Under the EU Commission's proposal, a business will be deemed to have a significant digital presence in a Member State if one or more of the following criteria are met: if the revenues from providing digital services to users in a jurisdiction exceed €7,000,000 in a tax period; if the number of users of a digital service in a Member State exceeds 100,000 in a tax period; or if the number of business contracts for digital services exceeds 3,000. Attributing profits to a digital PE is harder than defining it. The Commission's proposal is said to maintain the authorised OECD approach (AOA) as the underlying principle for attributing profits to a digital PE, but adjusts it to a digital context. Little detail is given on these modified attribution rules and on how they are meant to apply in practice. After opining that "[t]he profit split method would therefore often be considered as the most appropriate method to attribute profits to the significant digital presence" the Commission then concedes that:

> "The proposed rules only lay down the general principles for allocating profits to a significant digital presence as more specific guidelines on the allocation of profits could be developed at the appropriate international fora or at EU level."[27]

Much more work is required to flesh out this proposal.

The approach put forward in the UK's Updated Position Paper appears to be more developed, but, clearly, it is also at an early stage of development. The basic idea behind this approach is to distinguish between a multinational's "routine" and "residual" profit. The part of the residual profit that derives from the contribution of users would then need to be identified, separated out and shared among countries where those users are located.

These proposals give rise to technical challenges, as the EU Commission and HM Treasury openly acknowledge.[28] This section does not address these challenges; instead it provides four high level critiques of these proposals: 1. they are based on a guiding principle that is conceptually flawed and unable to provide guidance in practice; 2. they seek to ring-fence a set of companies in a way that is conceptually unjustified and practically difficult; 3. they are likely to involve considerable complexity; and 4. they fail to deal with the broader challenges faced by the international tax system.

This section focuses primarily on HM Treasury's Updated Position Paper, as it provides the most carefully articulated case for proposals of this kind.

(1) Guiding principle: profit taxed where value created

Supporters of these proposals tend to start from the premise that "the international tax framework is based on a principle that the profits of a business should be taxed in the countries in which it creates value" (the "value creation principle").[29] Users, they then argue, create value, but existing rules do not allocate taxing rights to countries where they are located, thus producing a

[27] Significant Digital Presence Proposal, above fn.22, 9.
[28] Updated Position Paper, above fn.12, 15–21.
[29] Updated Position Paper, above fn.12, para.1.

misalignment between where value is created and profit is taxed. This misalignment "threatens to undermine the fairness, sustainability and public acceptability of the corporate tax system",[30] and, therefore, these proposals seek to correct it.

In previous work, the authors criticised the value creation principle at some length.[31] In this section the authors argue that the case for granting taxing rights to countries where users are located, on the grounds that the existing system is and should be based on the value creation principle, fails for a number of reasons.

a. The descriptive and normative claims

Value creation is a vague concept, which means different things to different people. Most countries in the first group, the Commission and HM Treasury deem value to be created by activities on the "supply" side (including R&D, production, marketing, etc.) but not those on the "demand" side (purchasing the good or service). In this article the authors refer to this as the "common understanding" of value creation.

i. Descriptive claim

For a start, the existing system *is* not based on the common understanding of the value creation principle, as claimed. Consider an example where P, a company resident in Country A, receives a loan from S, a company resident in Country B, and uses the loan to fund a productive activity in A. Under the existing system Country A is likely to allow P to deduct the interest paid to S, and Country B is likely to tax the interest received by S. In this case the value creating activity presumably would be deemed to take place in Country A, but Country B taxes the income generated in proportion to the interest payment. Consider also that a country can—and some countries still do—tax the foreign business income of resident companies. It might give a credit for tax paid at source, but even then it could still tax the foreign source income. The point here is that nobody would object to such a tax on the basis that it contravenes the principle on which "the international tax framework is based".

ii. Normative claim

The normative claim, that profit *should* be taxed where value is created, is also questionable.[32] It cannot be easily justified on *fairness* grounds—whether formulated along the lines of the benefit principle (profit is not commensurate with benefit, and benefit is provided by countries other than those where value is said to be "created", including the market country) or the ability to pay principle (which is generally thought to justify world-wide residence based taxation). It certainly cannot be justified on *efficiency* grounds because it is conducive to real distortions and, therefore, economic inefficiency.

[30] Updated Position Paper, above fn.12, 3.
[31] Devereux and Vella, 21st Century, above fn.16; and M.P. Devereux and J. Vella, "Value Creation as the Fundamental Principle of the International Corporate Tax System" (Value Creation), *European Tax Policy Forum*: Policy Paper, July 2018.
[32] See Devereux and Vella, Value Creation, above fn.31, for further detail.

b. Conceptual considerations

Supporters of these proposals tend to argue that users create value but consumers do not. They thus justify extending taxing rights to countries where the former but not the latter are located. This is problematic for the following three reasons.

i. An economically unsound understanding of value creation

As explained above, under the common understanding of value creation, value is deemed to be created only by supply side activities. In other words, consumers—found in the "market" or "destination" country—are not deemed to create any value. The OECD Interim Report explains

> "most of the countries in this group reject the idea that a country that provides the market where a foreign enterprise's goods and services are supplied on its own provides a sufficient link to create a nexus for tax purposes, regardless of the scale of these supplies. Instead, they consider that profits should continue to be taxed exclusively where the factors that produce the income are located, in accordance with long-standing principles of the existing tax system (e.g., aligning profit with value creation)."[33]

HM Treasury defend this position directly in the Updated Position Paper.[34] But this flies in the face of basic economic logic. From a standard economic perspective, it is simply incorrect to state that consumers are not "factors that produce the income". The income being allocated among countries owes as much to the market as it owes to the various parts of a supply chain. Income depends on the price charged at the point where supply and demand meet; it simply would not have arisen in the absence of a market. It is not entirely clear why the international corporate tax system should depart from a simple and uncontroversial economic understanding of value creation.[35]

Consumers' contribution to the production of income is seen particularly clearly where businesses generate a higher income simply because of *consumer preferences*. For example, due to higher demand in Japan for high quality tuna, businesses can sell such tuna at a higher price in Japan than anywhere else. This higher consumer demand clearly is a factor that generates value for the supplier, but this notion is absent from the usual understanding of the principle of value creation.

Given that this article is written in a World Cup year, it is fitting to add a football-related example. Blueland go into the World Cup as rank outsiders. Bookmakers offer the longest odds on Blueland winning the tournament (5,000–1) of any of the 32 participating teams. Sportclothing Ltd, a company resident in Yellowland, produces 10,000 limited edition Blueland World Cup replica shirts. The replica shirts are designed and manufactured in Yellowland before the competition starts, to be sold remotely to consumers in Blueland at £30 each. Under the usual conception of value creation all the profit resulting from this activity should be allocated to Yellowland because no value is created in Blueland. Against all expectations, the Blueland football team progresses through the group and then the knockout stages of the World Cup. They

[33] Interim Report, above fn.2, para.390.
[34] Updated Position Paper, above fn.12, paras 2.26–2.32.
[35] In future work the authors will discuss the relation between value creation and the return to investment.

reach and—unbelievably—win the World Cup final, sending Blueland residents into football-fuelled delirium. As the Blueland team progresses through the tournament, the demand by Blueland residents for the limited edition shirts shoots up. After the Final is won, Sportclothing Ltd charges £300 per replica shirt, making a vastly greater profit than expected. It is hard to comprehend how the additional profit made by Sportclothing Ltd can be understood as arising from factors in Yellowland, as would be the case under the common conception of value creation.

It might be argued that consumers do not create value—and therefore corporate profits should not be allocated to countries where they are located—because consumers merely consume, but this simply ignores the role of consumers in the generation of profits. Furthermore, arguing that no value is created in market countries because such countries (might) already levy value added taxes (VATs) or sales taxes on the same activity is equally unpersuasive. It suggests that the value creation principle has (had or will have) a different meaning in relation to countries that have (had or will have) a corporation tax but not a sales tax or a VAT.

Finally, note that proposals for unitary taxation and formulary apportionment systems often allocate taxing rights according to sales as well as labour and assets.[36] These proposed systems, therefore, do not allocate taxing rights according to the common understanding of value creation. But the EU Commission is a long-standing proponent of a formulary apportionment system *and* an ardent supporter of the value creation principle as commonly understood, arguing: "This principle is essential for a fair and effective taxation in the single market."[37] At certain points the Commission even explicitly endorses the view that value is also created where sales take place:

> "The Commission continues to believe that the CCCTB provides an EU framework for revised permanent establishment rules and for allocating the profit of large multinational groups using the formula apportionment approach based on assets, labour and sales that should better reflect where the value is created."[38]

ii. Value creation, users and consumers

From a basic economic perspective value is created by a wide-range of factors, including consumers and users. The narrower understanding adopted by proponents of these proposals, and which deems consumers not to create any value, presents them with a problem. It requires a distinction to be drawn between the contributions of users and consumers. Can this be done?

HM Treasury defines user participation as "the process by which users can generate value for certain types of digital businesses through their engagement and active contribution".[39] Users are believed to create value through at least four channels: the generation of content; the depth of engagement with the platform; network effects and externalities; and contribution to the brand.

[36] Note also that in the US subnational context corporate profit is largely allocated to the market. See W. Hellerstein, "A US Subnational Perspective on the 'Logic' of Taxing Income on a 'Market' Basis", *Bulletin for International Taxation*, April/May 2018.
[37] EU Commission, *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market* (2017 Communication) (Brussels: 21 September 2017, COM(2017) 547 final), 3.
[38] 2017 Communication, above fn.37, 9. Note, however, that under the CCCTB proposal, profit is allocated to a country on the basis of sales only if there is a PE there.
[39] Updated Position Paper, above fn.12, para.2.4

Through these channels "users can be seen participating in a non-traditional value chain and performing supply-side functions that would historically have been undertaken by the business itself".[40] The Updated Position Paper is at great pains to distinguish user participation from the role of consumers. However, it concedes that: consumers can play a role in product development, marketing and enhancement of a business's brand[41]; digitalisation will allow traditional businesses to "build stronger and more interactive relationships with customers"[42]; and traditional multi-sided and intermediation business models exist.[43]

The difference between users and "pure" consumers is clear in a number of cases. A consumer who walks into a bakery and pays for a loaf of bread in cash does not contribute in a way a user does. However, there is a continuous spectrum from here to the users described in the Updated Position Paper. Along this spectrum consumers perform an increasing number of functions undertaken by users. Consider a consumer who purchases a mobile phone app. While purchasing and using the app he provides valuable data to the vendor that is used for targeted advertising purposes and to improve the product. The consumer also reviews the app, provides guidance on its use, and even answers questions posed by other consumers on a digital forum. He is so taken by the app that he even sets up a digital fan club that quickly gathers a large number of followers. This consumer also seems to be a user. But if he is, do the functions he performs as a user suffice for taxing rights to be allocated to the country where he is located? Where is the tipping point? There are no good conceptual answers to these questions. And the difficulty in answering them will only increase over time.

The authors do not find the fine distinctions drawn in the Updated Position Paper between a user and a consumer persuasive. It is hard not to suspect that they are driven by a desire to tax certain companies whose users are located in the UK[44] while being careful not to justify the taxation of UK companies by countries where their consumers are located.

iii. Value creation and the purchase of inputs

Thus far the authors have argued that the common understanding of value creation is economically unsound, and is problematic on its own terms because it requires impossible distinctions to be drawn between users and consumers who perform similar functions. But even if these issues are set to one side, another issue arises. From a company's perspective a user is a third party who provides an input at a favourable price. Conceptually there is no reason to allocate taxing rights to countries where users are located but not to other providers of inputs at favourable prices. If one is deemed to create value, it is not clear why the other is not.

The authors have previously argued that the relation between a user and the company offering the service being used is akin to one of barter.[45] An individual does not pay to use a social media platform but provides content and reveals information valuable to the multinational enterprise in selling advertisements that subsequently appear on his or her screen. Suppose that the social

[40] Updated Position Paper, above fn.12, para.2.30.
[41] Updated Position Paper, above fn.12, para.2.27.
[42] Updated Position Paper, above fn.12, para.2.31.
[43] Updated Position Paper, above fn.12, para.2.32.
[44] The same applies to other countries in the first group.
[45] Devereux and Vella, Implications, above fn.16.

media platform provider is a multinational enterprise that charged a fee for its use, and also paid an equal amount to those using the site for the content and information that they supplied. Then the multinational enterprise's worldwide profit would be unaffected (apart from greater transactions costs); it would have revenue and costs, but no net profit, in the country of the user. Another possibility is that the value of the content and information collected by the multinational exceeds the cost of the provision of the social media platform. In this case, the barter is favourable to the multinational enterprise thus creating value for it.

This seems comparable to other situations where companies acquire a product or a service from a third party at a favourable price. But the existing system does not allocate taxing rights to countries where the third-party provider of this input is located. Consider the case of a cider manufacturer resident in the UK, purchasing apples with a market price of £2 per kilo for a discounted price of £1 per kilo from a farmer in France.[46] This is analogous to the acquisition of content and information at a minimal cost by the multinational running the social media platform. In a broad economic sense, some value is created in France; part of the profit made by the cider manufacturer results from the lower costs incurred on the purchase of apples there. Put in another way, if the discount was not secured and apples were purchased for the full price of £2 per kilo from farmers in the UK, the cider manufacturer's profit would have been lower.

The existing system would not allocate taxing rights over the cider manufacturer's profit to France, as this merely constitutes the purchase of an input. But if under the existing system value is not deemed to be created in France in this case, it is not clear why value should be deemed to be created by users of digital businesses in analogous situations. A number of countries appear to share the view of users being mere third-party contributors of inputs at a favourable price.[47]

c. Practical application

To allocate taxing rights among countries on the basis of the common understanding of the value creation principle it is not sufficient to identify the countries where value-creating activities take place. It is also necessary to establish *how much* value is created in each country. But this is extremely difficult, even impossible, in most cases, thus bringing the principle into question. A principle guiding the allocation of taxing rights among countries ought to be able to provide such guidance.

The value creation principle struggles to provide guidance in all sectors, not just in the digitalised economy. Consider the example of a multinational with a parent company and its headquarters in Country A, R&D activities in Countries B and C, production in Country D and sales and marketing teams in countries around the world. One could argue that the arm's length principle (ALP) could be relied on for these purposes, but the difficulties bedevilling this system are well known.[48] A clear difficulty here is how to allocate the residual profits arising from synergies or other factors, as one cannot easily identify the activities creating them.

But these difficulties are even more pronounced in a digitalised economy. As the EU Commission itself explained:

[46] On the point that this transaction is akin to a barter see Devereux and Vella, Implications, above fn.16, 107–110.
[47] Interim Report, above fn.2, para.39.
[48] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle after BEPS* (OUP, 2017).

> "[I]n a digitalised world, it is not always very clear what that value is, how to measure it, or where it is created."
>
> "Arriving at a meaningful solution to capture and allocate the value created in the digital economy across countries can take time. This is further complicated by the multidimensional nature of this challenge, to the constantly changing nature of the digital economy, and the diversity of the business models and the complexity of ecosystems in which they create value."[49]

HM Treasury's Updated Position Paper concedes that "there would be challenges in coming up with a suitable approach to measuring that value directly [i.e. that created by users]"[50] and that while "[t]here may be indirect indicators of the value of a user base to a business…it would be difficult to use those indicators to calculate an appropriate reward".[51] So it reaches the inevitable, yet troubling, conclusion:

> "For that reason, the UK thinks that it might be necessary to reward user-created value through a percentage share of the residual profit realised by principal companies in the group…That share would be designed to approximate the value that users generate for the business. *This approach wouldn't be indicative of the deemed value of user participation relative to other group activities. It would instead be recognition of the complexities in measuring the value generated by user participation*."[52]

Once this process is completed, that percentage share of the residual profit has to be shared among countries where users are located. Again the value creation principle does not provide meaningful guidance, because in many cases one cannot know how much value is actually created by users in each country. The Updated Position Paper thus considers different allocation keys, based on rough proxies.[53]

The long-term solutions favoured by the Commission and HM Treasury do not achieve their goal of allocating taxing rights among countries on the basis of the value created by users in each country, because—as proponents themselves admit—the value created by users is not known. It is deeply concerning that, despite conceding the value creation's inability to provide guidance for allocating taxing rights among countries, the Commission, HM Treasury and others persist with this principle to guide the design of a tax system in the age of digitalisation.

d. The long-term sustainability of the value creation principle

Although the Updated Position Paper expressly confirms the UK's belief in and continued support for the value creation principle, it leaves open a question that casts some doubt on it. When discussing the issue of cross-jurisdictional scale without mass, the Updated Position Paper first rejects the notion that taxing rights should be allocated to market countries, and argues that this issue does not undermine the value creation principle. However, it then notes that:

[49] 2017 Communication, above fn.37.
[50] Updated Position Paper, above fn.12, para.3.16.
[51] Updated Position Paper, above fn.12, para.3.17.
[52] Updated Position Paper, above fn.12, paras 3.18–3.19, emphasis added.
[53] Updated Position Paper, above fn.12, 16–17.

> "Some countries might argue that increased business centralisation, and the increase in artificial intelligence and robotics, threatens the foundations of the existing international tax regime by making the allocation of taxable profits increasingly sensitive to the location of a small number of decision-makers."[54]

This argument is not dismissed; instead the Updated Position Paper simply notes that this "is a question about the long-term sustainability of the principle underpinning the international tax rules".[55] Could this be a crack in the otherwise unshakeable belief in the value creation principle?

e. Conclusion

The case for allocating taxing rights to countries where users are located on the grounds that they create value there is made in two steps. The first step posits that the existing system is and should be based on the common understanding of the value creation principle. The second argues that users create value. The case falls on multiple grounds.

The existing system is not based on the common understanding of the value creation principle and the case that it should be is not made. This understanding of value creation is also economically unsound. Distinguishing between value created by users and consumers who undertake similar functions, and between users and other third parties who provide inputs at favourable prices is problematic. This point does not question the claim that users may create value in a broad economic sense, but argues that consistency dictates that analogous situations should be treated in the same way. The case to adopt different allocation rules for users of certain HDBs is not made. Finally, the case falls because it is generally impossible to know how much value users create. A system that allocates taxing rights to users' location will not do so on the basis of the value created there.

f. Alternative rationale for taxing companies where users are located

A more compelling rationale for taxing multinational enterprises where users are located is that users are relatively immobile.[56] If the barter between the user and a multinational enterprise is favourable to the latter, as explained above, in effect, the profit, or economic rent generated by the multinational enterprise is to some extent location specific since it depends on the place of residence of the user of the social media platform. This gives that state an opportunity to impose a tax on the barter transaction, which in principle could be set at a rate that would not have any effect on the underlying activity, but would allow that state to capture a share of the economic rent earned by the multinational enterprise. This would be an attractive option for that state, in principle. However, practical difficulties remain, in particular the difficulty of determining the profit generated, and hence an efficient level of tax. The difficulty is made worse since there would be no actual transactions, nor, in all probability, any comparable transactions. If the level of tax were too high, then the service provider might not be willing to continue to provide the service.

[54] Updated Position Paper, above fn.12, para.1.16.
[55] Updated Position Paper, above fn.12, para.1.17.
[56] This analysis follows that in Devereux and Vella, Implications, above fn.16.

In principle this seems to be an interesting opportunity for countries to levy what could be an efficient tax on economic rents of digital multinational enterprises. However, further work is needed on whether and how such a tax could be constructed and levied in practice. Furthermore, and critically, such a tax appears open to the criticism set out in sub-sections 2, 3 and 4 below.

(2) Ring-fencing certain digital companies

The European Commission Expert Group on Taxation of the Digital Economy's report of May 2014[57] and the BEPS Final Report for Action 1[58] both concluded that the digital economy could not be ring-fenced. This was reiterated in the Interim Report:

> "The rapid spread of digitalisation, coupled with the liberalisation of trade policy, has increased the pace of globalisation and induced an ongoing structural transformation of the economy. As this transformative process is having an impact across the board, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy."[59]

Yet, proponents of targeted proposals seek to do just that. In fact, they seek to target a subset of digital businesses.[60]

As the Interim Report explains reliance on users and data is in fact "not exclusive to HDB models",[61] however, other "digital" businesses and "traditional" businesses[62] are excluded from the Commission and HM Treasury's proposals, even if they rely on users. The Updated Position Paper does not provide much clarity on the criteria which bring businesses within the ambit of HM Treasury's proposal. It simply states that user participation appears to be more important for the businesses targeted. These businesses are described as ones where "user participation represents significant contribution to value creation",[63] that "participation and engagement of users is an important aspect of value creation"[64] for these companies, and that user participation "will be materially relevant to their success or failure".[65] Once again the Updated Position Paper makes a number of unpersuasive fine distinctions here. For example, it acknowledges that users/consumers of businesses that are not within the ambit of the proposal can provide data that informs decisions on product selection, helps develop tailored marketing and pricing strategies, allows performance to be monitored, and the businesses to improve technologies and to enhance future revenue growth.[66] However, this data—which is said to be collected from consumers (or even users) through "passive or transactional relationships"—does not justify taxing rights being allocated to countries where the user/consumer is located.[67] On the other hand, data that results

[57] European Commission, Expert Group on Taxation of the Digital Economy, *Report of the Commission High Level Expert Group on Taxation of the Digital Economy* (2014).
[58] OECD, Action 1—2015 Final Report, above fn.18.
[59] Interim Report, above fn.2, para.375.
[60] HM Treasury's proposal only targets "certain" or "some" digital businesses. Updated Position Paper, above fn.12, 3, para.1.18.
[61] Indeed all three characteristics of HDBs identified above are shared by non-HDBs.
[62] Or "less digitalised companies" since companies which are entirely non-digital are a dying breed.
[63] Updated Position Paper, above fn.12, para.2.49.
[64] Updated Position Paper, above fn.12, 3.
[65] Updated Position Paper, above fn.12, para.2.46.
[66] Updated Position Paper, above fn.12, para.2.38–2.39.
[67] Updated Position Paper, above fn.12, para.2.40.

"from a much broader and more active user relationship", and is "central to how the businesses create value",[68] does.

The digital business models that are deemed to derive most value from users are online networks, such as social media platforms, search engines, file sharing platforms and online marketplaces.[69] Other companies might derive value from users but that is not deemed to suffice somehow. Digital software providers, for example, are among the businesses for which "user participation *appears to be a less important* source of value and *less integral* to the success of the business".[70]

The question here is one of degree, and very vague guidance is provided as to where the line is drawn. User contribution lies on a spectrum, and, *conceptually*, there is no point at which the value created by users (or consumers who also perform the functions of users) triggers a justification for a different tax treatment. The line drawn is necessarily arbitrary. This also poses immediate *practical* difficulties, which will undoubtedly worsen over time due the speed and broadening scope of technological change. As the Interim Report notes the

> "range of businesses intensively benefitting from data and user participation is likely to increase as a result of the continued digitalisation of the economy".[71]

The precise nature of the change is hard to predict, but it is easy to predict that any definitions enshrined in law or guidance to target specific "digital" businesses will have to be updated regularly to keep up with the change. The Updated Position Paper appears to concede this point, noting that

> "given the rapid pace of innovation in the digital sector there is a need to consider the relevance of user participation for newer digital business models".[72]

Proposals targeting specific (existing) types of digital businesses appear misguided. The pace and reach of digitalisation is likely to make a mockery of such attempts. They certainly do not seem to meet the oft-stated goals of being "future-proof"[73] or of providing a "long-term"[74] solution.

(3) Complexity

Measuring how much value is created by users in a particular country under revised profit attribution rules—as proposed by the Commission—will be difficult, requiring lengthy and complex guidance, increasing costs and uncertainty. Presumably different guidance will be required for different business models. After identifying four channels through which users create value, the Updated Position Paper recognises that "the relevance and materiality of these channels will differ between businesses".[75] As argued above, it appears likely that these rules

[68] Updated Position Paper, above fn.12, para.2.41.
[69] Updated Position Paper, above fn.12, para.2.45.
[70] Updated Position Paper, above fn.12, para.2.48, emphasis added.
[71] Interim Report, above fn.2, para.386.
[72] Updated Position Paper, above fn.12, para.2.59. The Updated Position Paper identifies two such developments that are not included in its analysis, those based on artificial intelligence and on augmented reality.
[73] 2017 Communication, above fn.37.
[74] Updated Position Paper, above fn.12, 3.
[75] Updated Position Paper, above fn.12, para.2.7.

and guidance will have to be updated regularly to keep up with technological development, thus exacerbating the problem. Legislators and/or authorities will find themselves playing a never-ending game of "catch up".

Countries with substantial capacity and resources will find it challenging to apply such complex rules. Countries without such capacity and resources—not only developing countries but also some EU Member States—are unlikely to be able to do so.

Of course, one could use cruder and arbitrary measures that may proxy for value creation—as HM Treasury appear to propose in their Updated Position Paper—because of the impossibility of measuring how much value is created in a particular location. Clearly, that would not remove all complexity, as the discussion in the Updated Position Paper demonstrates, but it should improve matters.[76] Reduced complexity and administrative burden would then be traded off against adherence to the principle that the proposal is meant to follow. But the use of such measures again brings into question the choice of value creation as a principle on which to base the design of an international corporate tax system in the first place.

(4) Other issues

These targeted proposals do not address the other two issues identified in the Interim Report: cross-jurisdictional scale without mass and the increasing reliance on intangibles. Even more significantly, they also fail to address the other pressing problems that trouble the existing system and threaten its long-term viability. These issues can only be addressed through system-wide reform, as discussed in section IV below.

B. Turnover taxes

Some countries in the first group also favour interim measures, primarily in the form of turnover taxes. As seen above, the EU Commission proposed one such measure in March 2018 and the UK Government has repeatedly expressed its willingness to proceed unilaterally if multilateral co-ordination proves impossible.[77]

The underlying policy justification for these *turnover* taxes is—again—that of aligning the location of value creation and taxable *profit*, more specifically that of "compensating for unrecognised user created value".[78] The Commission explained, for example, without apparent regard to the mainfest contradiction: "[The proposal for a turnover tax] remains fully grounded on the most basic principle of corporate taxation – namely, that profits should be taxed where value is created."[79] The criticism in section A above levelled at the value creation principle applies in the context of this proposal too.

Turnover taxes are not generally favoured from a tax policy perspective; their weaknesses—and their strengths—are well known and for this reason the authors do not cover them at any length. The OECD Interim Report sets out several weaknesses: turnover taxes can have a negative impact

[76] See for example Updated Position Paper, above fn.12, 18–19.
[77] Updated Position Paper, above fn.12, para.4.11.
[78] Updated Position Paper, above fn.12, para.4.6.
[79] European Commission, *Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market* (Brussels: 21 March 2018). See, similarly, Updated Position Paper, above fn.12, paras 4.5–4.6.

on investment, innovation and welfare; the incidence of the taxes might be borne by other businesses and consumers; they might lead to over-taxation; they might prove not to be "interim" measures, even if intended as such; and they can give rise to significant compliance and administrative costs.[80] The Interim Report explains that countries considering these taxes themselves acknowledge the challenges they pose,[81] indeed this is why they have only been proposed as interim measures (although there is a distinct possibility that they will become permanent).[82] But these countries are driven by "a strong imperative to act"[83] while the long-term solution is agreed. The EU Commission is surprisingly frank about the political drivers behind these proposals: "*Member States are under increasing political pressure to act now* on taxing the digital economy, to safeguard revenues and ensure a level playing field."[84]

IV. System-wide reform

The countries in the second group

> "take the view that the ongoing digital transformation of the economy, and more generally trends associated with globalisation, present challenges to the continued effectiveness of the existing international tax framework for business profits. Importantly, for this group of countries, these challenges are not exclusive or specific to highly digitalised business models."[85]

They thus favour system-wide reform. The Interim Report does not provide more detail on the reasoning behind this view, however this view chimes with that held by the authors.[86] This section outlines the reasoning that led the authors to their view and also their favoured type of reform.[87]

Digitalisation exacerbates long-standing problems that plague the international tax system.[88] Under the existing system companies have an incentive to move their real activities to low tax countries,[89] thus causing distortions and real economic inefficiency. Companies also have an incentive to shift their profit to low tax countries by using well-known techniques. The BEPS project addressed some of these techniques, however the problem has not been eliminated. As

[80] Interim Report, above fn.2, 178–179.
[81] Interim Report, above fn.2, 178. See also Updated Position Paper, above fn.12, para.4.10.
[82] Consider the EU proposals. The short-term *measure* is intended to be in force in EU Member States "only until" they agree and implement the long-term *solution*. But the long-term solution requires existing double tax treaties to be amended. (2018 Communication, above fn.8, 9.) The political will to amend treaties between EU Member States should be in place once agreement on the long-term solution is reached, but there is no guarantee that non-EU Member States will agree to such amendment. Crucially, of course, for the long-term solution to be implemented in a meaningful manner in EU Member States, existing treaties with the US will have to be amended, but the US is unlikely to acquiesce.
[83] Interim Report, above fn.2, 179.
[84] 2018 Communication, above fn.8, 8 (emphasis in original).
[85] Interim Report, above fn.2, 172.
[86] These views are set out at length in Devereux and Vella, 21st Century, above fn.16, and Devereux and Vella, Implications, above fn.16.
[87] To be clear, this reasoning does not necessarily match, at least not in all respects, that which led the second group of countries to their view. It is the reasoning that led the authors to a similar view.
[88] Devereux and Vella, Implications, above fn.16.
[89] Or countries offering favourable tax regimes.

the Updated Position Paper explained, "there remain weaknesses in the international tax rules".[90] The ever-growing set of anti-avoidance rules necessary to dampen the profit-shifting activity that would otherwise be rampant under the existing system contributes to a third problem: the great complexity and hence administrative and compliance costs involved in running the system. A fourth problem follows from the first two: because companies move their real activities and shift their profits to countries offering low tax rates, countries, in turn, have an incentive to lower their tax rates to attract real activities and profit. But this leads to a race to the bottom, as evidenced by steadily declining corporate tax rates across the world. As the OECD recently noted: "CIT rate reductions are continuing" and, in fact "CIT rate cuts have accelerated in the last few years".[91] The critical point here is that the existing system generates competitive forces that threaten its long-term viability.

These problems existed pre-digitalisation, but are exacerbated by it. Consider intangibles. They are increasingly central to corporate value in a digitalised world, however they pose several formidable challenges for the existing system, including profit shifting. Despite efforts to address this issue in BEPS Actions 8, 9 and 10 the Interim Report concedes that

> "…it may still often be very difficult to determine how to allocate income from intangible assets among different parts of an MNE group. In turn, this may increase the responsiveness of business decisions to tax competition between countries. For instance, the location of the ownership and management of some important intangibles for digitalised firms (e.g., various types of knowledge-based capital) may not always be clearly discernible. In addition, intangible assets may easily be shifted around within an MNE group provided there is a correlation with a certain level of physical activity…."[92]

Ideally, reform should address all these issues. Furthermore, as these issues affect all companies and ring-fencing a subset of HDBs is problematic, the system should be reformed as a whole.

The question then is: what type of reform should be favoured? The authors have argued that many problems faced by the system ultimately stem from its fundamental framework. The key underlying problem is that the existing system seeks to tax companies' profit where *mobile* factors are located, including their place of residence, where production takes place and where IP is located. This results in distortions of real economic activity, profit-shifting and instability due to competition among states.

But if this is the underlying problem, it is best addressed by moving towards a system that seeks to tax companies' profit where more *immobile* factors are located. Consumers are considered to be relatively immobile—and therefore one option is to tax companies where their consumers are located—which in the jargon is known as the place of destination (or the market country). Moving towards a destination basis for taxing business profit would have significant advantages on the points mentioned above—though the advantages depend on exactly what tax base is chosen. To be clear, the case for such a move is based on immobility, and not on the view that

[90] Updated Position Paper, above fn.12, para.1.7.
[91] OECD, *Tax Policy Reforms 2018: OECD and Selected Partner Economies* (Paris: OECD Publishing, 2018), available at: *https://doi.org/10.1787/9789264304468-en* [Accessed 21 September 2018], 65–69.
[92] Interim Report, above fn.2, para.385, footnote omitted.

value is created in the market country. As argued above, the authors do not believe that the value creation principle can or should be used as a guide for allocating taxing rights among countries.

A move towards a destination basis can take different forms. One option would be to move to a pure destination system such as a Destination Based Cash Flow Tax,[93] which would have significant advantages in relation to all four points identified above. The intuition behind this is that if a multinational is taxed where its consumers are located it cannot lower its overall tax paid by moving its real activities or shifting its profits—which in turn means that countries are released from competitive pressures to cut their tax rates. Other reform options move towards a destination basis but only partially. One possibility currently being studied by the Oxford International Business Tax Group—a Residual Profit Allocation system—allocates the right to tax routine returns to countries where economic activity takes place and the right to tax any residual profit to the destination country.[94] It will be noted that HM Treasury's proposal for allocating taxing rights to countries where users are located adopts this approach, distinguishing between routine and residual profits. However, the proposal applies this approach to a narrow group of companies and only for the part of the residual profit that is deemed to reflect the contribution of users.

Proposals that move towards a destination basis in a partial way can be more politically palatable than a pure destination system, while still harnessing some of the benefits brought by a move in that direction. Further work is needed on these proposals before they can be put into practice, and no doubt they will give rise to challenges of their own. However, moving towards a destination basis in a coherent and comprehensive way should allow the tax system to have a stronger conceptual underpinning that is also less distortive, less avoidance ridden, more stable, and viable in the long run.

It is not clear what type of system-wide reform the countries in the second group favour. Clearly, a move towards a destination basis would constitute a departure from the existing system, where—in line with the widespread understanding of value creation—taxing rights are not allocated to market countries. However, it seems that countries in the second group are in fact considering a move in this direction. Commenting on their views, Pascal Saint-Amans, Director, Centre for Tax Policy and Administration at the OECD explained that:

> "If you will read between the lines, it looks like it's a plea for reconsidering international tax rules, to give more space to the marketplace."[95]

A system-wide move in this direction can constitute a significant improvement, although, it should be emphasised, this depends on how it is done.

[93] A.J. Auerbach, M.P. Devereux, M. Keen and J. Vella, *Destination based cash flow taxation*, Oxford University Centre for Business Taxation working paper 17/01 (2017).
[94] Residual profit splits are well known in current transfer pricing practice. This proposal can be seen as building on this practice to some extent, but it also diverges from it in some important respects. See the discussion in J. Andrus and P. Oosterhuis, "Transfer Pricing After BEPS: Where Are We and Where Should We Be Going" (March 2017) 95(3) *Taxes - The Tax Magazine* 89.
[95] S.S. Johnston and Alexander Lewis, "Countries Agree to Disagree on Taxing Digital Economy, OECD Says", *Tax Notes International*, 26 March 2018.

V. Conclusion

At a different point in time, each of a number of recent developments would have dominated attention in tax policy circles for a protracted period: country-by-country reporting; developments in Exchange of Information; the Multilateral Instrument; the creation of the Inclusive Framework; an EU direct tax Directive; and US corporate tax reform. But these are particular times, even in the tax policy world. While much practical and academic work is being done on, and in response to, these developments, the focus of attention is now firmly on the challenges posed by digitalisation.

Digitalisation has brought the international corporate tax debate to a critical point, with different reform options being considered. In previous work the authors argued for system-wide reform in response to the challenges posed by digitalisation, as well as other broader issues facing the existing tax system. This position is aligned with that of one of the two groups of countries favouring reform. The precise reform favoured by this group of countries is yet unclear, but there are signs it is a partial move towards a destination basis. This could bring significant benefits, depending on how this is done. This article focused instead on the reform favoured by another group of countries. This reform, which targets certain HDBs that rely on users, can be criticised on conceptual and practical grounds. It also fails to address the broader issues that threaten the long-term viability of the existing system.

This article considered the position of these groups of countries from an academic and policy perspective. In practice, of course, political considerations and negotiation will determine whether a consensus can be reached and, if so, what it will be. The negotiations will certainly be challenging. Agreement on a number of issues could be reached among G20/OECD countries participating in the BEPS project because it essentially sought to reallocate taxing rights away from tax havens or countries offering favourable regimes. But these negotiations concern the allocation of taxing rights among countries that believe they have strong claims to tax the income in question, thus making it harder to reach a consensus. If no consensus is reached it is likely that a number of countries will adopt unilateral measures, such as turnover taxes, which could have severe negative consequences. Of course, matters could become even worse if other countries responded through retaliatory unilateral measures of their own.

Targeted reform is politically attractive to the countries proposing it, not least because it would reallocate taxing rights in their favour. It might also be argued that system-wide reform is harder to achieve. But the existing system is gradually wasting away under competitive forces, and the ever-increasing complexity threatens to bring the system crashing down in its own right. This is the hard reality that will have to be faced, sooner or later. ☞

☞ keywords to be inserted by the indexer

Value Creation as the Fundamental Principle of the International Corporate Tax System

EUROPEAN TAX POLICY FORUM
Policy Paper

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Oxford University Centre for Business Taxation

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1. Introduction

It is now widely taken as axiomatic that the existing international corporate tax system is based on the principle that corporate profits are taxed where value is created (the "value creation principle"). There also appears to be widespread agreement, at least amongst policymakers, that the system should be based on this principle. This policy paper disputes both these descriptive and normative claims.

The ascendency of the value creation principle has been remarkable, as has its influence. We do not here investigate the precise historical origins of this principle, but it was certainly articulated and put centre stage in the Base Erosion and Profit Shifting (BEPS) project led by the G20/OECD between 2013 and 2015.[1] The value creation principle was adopted as the guiding principle of the BEPS project but quickly become widely accepted as the guiding principle for taxing corporate profit in an international setting more generally.

The OECD, the EU Commission and Parliament, Finance Ministries around the world, and many academics now repeat the mantra that profits should be taxed where value is created without question. Recent EU Commission documents, for example, explain that "[s]ince the start of its mandate, this Commission has taken action to ensure the principle that all businesses operating in the EU pay their taxes *where profits are made and thus where value is created*"[2] and that "[i]t is an internationally

[1] Mindy Herzfeld "The case against BEPS: Lessons for Tax Coordination", *Florida Tax Review* 1, p. 42, 2017, considers it a "brand new standard".
[2] EU Commission, *Impact Assessment Accompanying the document Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence and Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services*, 21.03.2018, SWD (2018) 81 Final (emphasis added).

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agreed principle that profits should be taxed where value is created".[3] Even the Addis Ababa Action Agenda of the Third International Conference on Financing for Development adopted the principle: "[W]e will make sure that all companies, including multinationals, pay taxes to the governments of countries where economic activity occurs and value is created, in accordance with national and international laws and policies."[4] Finally, a number of multinational companies have referred to this principle in their tax strategies.[5] The FTSE4Good Index and the Dow Jones Sustainability Index assess, among other things, whether companies make declarations on paying taxes according to where value is created.[6]

The value creation principle has been embraced broadly and its influence is being felt keenly, as can be seen in the on-going debate on how to respond to the challenges posed by digitalisation. The EU Commission and a number of member states, including the United Kingdom, have used this principle to justify proposals extending the Permanent Establishment (PE) concept and attribution rules in the context of highly digitalised companies. Indeed, astonishingly, the principle is also used to justify proposals for *turnover* taxes on certain highly digitalised companies: "[the proposal for a turnover tax] remains fully grounded on the most basic principle of corporate taxation – namely, that profits should be taxed where value is created."[7]

We criticised this principle in an article written in 2013 and published in 2014,[8] while the BEPS project was still on-going. This policy paper extends and develops this criticism.[9] Section 2 considers the descriptive claim that the existing tax system follows the value creation principle. Section 3 explores the possible conceptual justifications for allocating taxing rights among countries according to where value is created. Section 4 examines the application of this principle from a conceptual and practical perspective.

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[3] EU Commission, *Time to establish a modern, fair and efficient taxation standard for the digital economy*, Brussels, 21.03.2018, COM(2018) 146 Final.
[4] Para. 23.
[5] For example, "[T]hroughout the Group tax is paid in the country in which the value arising from our presence is earned" and "[W]e aim to pay the right amount of tax at the right time, on the profits we make, and in the countries where we create the value that generates those profits."
[6] See, for example, Maya Forstater, 'Publishing corporate tax strategies', *Tax Journal*, Issue 1320, 10, 5 August 2016.
[7] European Commission, *Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market*, Brussels, 21 March 2018.
[8] Michael P. Devereux and John Vella, 'Are we heading towards a corporate tax system fit for the 21st century?' (2014) *Fiscal Studies*, Vol 35. No. 4, 449; see, in particular, pages 463-468.
[9] We examine this principle in the context of the digitalised economy in Michael Devereux and John Vella, "Taxing the Digital Economy: Targeted or System-Wide Reform?" *British Tax Review* (forthcoming).

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2. The Descriptive Claim

The value creation principle is posited in descriptive as well as normative terms. Consider the undeniably descriptive (and normative) statement made in the opening paragraphs of HM Treasury's recent revised position paper *Corporate Tax and the Digital Economy:* "[T]he international tax framework is based on a principle that the profits of a business should be taxed in the countries in which it creates value. The UK continues to support that position."[10]

Some authors question the meaning of the location of value creation. For example, Morse (2018) suggests that it could refer to "employee location, sales location, location of production capacity, location of management or location where capital is raised".[11] Hey (2018) points out that the concept has never been clarified in any of the OECD BEPS publications, nor do any of these publications explain why it should be the underlying principle of the international location in respect of taxing rights.[12] Christians (2018) states that "it is not even conceptually coherent as a theory".[13]

Despite the unquestionable uncertainty about the meaning of the value creation principle, there appears to be a general understanding among its proponents that it includes only supply side and not demand side activities. In this this policy paper we refer to this as the "common" understanding of the value creation principle.

The claim that the existing system follows the common understanding of this principle appears to be wrong, in that there are clearly cases where it does not. For example, under the existing system countries are perfectly entitled to tax foreign profits earned by resident companies, but in such cases it is hard to see how value is created in the country of residence, even on a broad interpretation of the concept. Even if there is a growing tendency for countries not to tax their resident companies on active foreign income, there are countries which do tax on this basis and there is nothing to suggest that doing so goes against the foundational principle of the international tax framework.

[10] HM Treasury, *Corporate Tax and the Digital Economy*. March 2018.
[11] Susan Morse, "Value Creation: a standard in search of a process", *Bulletin for International Taxation* April/May 2018, 196-202. Morse describes value creation as "a messy, political, idea" (p.197).
[12] Johanna Hey "'Taxation where value is created' and the OECD/G20 Base Erosion and Profit Shifting initiative", *Bulletin for International Taxation* April/May 2018, 203-208.
[13] Allison Christians, "Tax according to value creation", *Tax Notes* July 5, 2018. Christians claims that the principle "has very little to do with capturing income accurately, and everything to do with preserving a distributive justice status quo that cannot be defended on normative grounds", p.1.

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When passive income is paid across borders it is generally taxed in the recipient's country of residence solely by virtue of the recipient's residence in that country. No economic activity in the country of residence is required. To take a simple example, consider the case where company P, resident in Country A, extends a loan to subsidiary S, resident in Country B. S uses the funds to finance real activity which generates a pre-tax profit. When S pays interest to P, the deduction afforded by Country B could wipe out the taxable profits of S, but the interest will be taxed by Country A. Unless the notion of value creation is stretched to breaking point, in this case the existing framework simply does not allocate taxing rights where value is created.

The common understanding of the value creation principle does not describe the existing international corporate tax framework. Looking back at the articulation of the value creation principle in the BEPS project the issue seems to be that the principle was not fully aligned with the target of the project.

The BEPS project was launched in 2013 following the public and political clamour over the tax planning activities of multinationals. Unprecedented press coverage of these activities and campaigning struck a chord; possibly because of broader factors, including perceptions of fairness at a time characterised by the lingering effects of the financial crisis and increasing awareness of rising inequality among income groups.

In its 2013 BEPS Action Plan the OECD reached the conclusion that:

> "Fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that *artificially segregate taxable income from the activities that generate it*. (…) A realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments."[14]

The guiding principle thus adopted by the BEPS project was that "profits are taxed where economic activities generating the profits are performed and where value is created". Guided by this principle, the substantive actions produced by the BEPS project sought to address specific planning channels (hybrid mismatch arrangements,

[14] OECD (2013), *Action Plan on Base Erosion and Profit Shifting* (Paris: Organisation for Economic Cooperation and Development), p.13 (emphasis added).

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debt contracts, patent boxes, treaty abuse, planning around the PE threshold and transfer pricing) to better align taxing rights and value creation.

Perhaps part of the issue here is that the value creation principle as it emerged from BEPS did not properly track the specific problem BEPS was designed to address: "no or low taxation…when it is associated with practices that *artificially* segregate taxable income from the activities that generate it". Note that this implies that that taxable income can be segregated from the country where it is generated – for example through the payment of cross-border dividends or interest, as long as it is not done *artificially*. Of course, this requires a workable distinction between "real" and "artificial", which can be difficult or even impossible, especially in the context of capital structuring. But setting that to one side, this qualification leads to a principle that comes closer to describing the existing system. Without this qualification, as the principle is now commonly formulated, it certainly does not.

3. Conceptual basis for the value creation principle

The options available for taxing multinational enterprises include four broad locations: the residence of the ultimate shareholders, the residence of the ultimate parent company, the location of subsidiaries and permanent establishments of the multinational enterprise, and the residence of its customers.[15,16]

The conceptual case for taxing multinational companies in the residence of the ultimate shareholders or customers is based on their relative immobility.[17] This brings a number of benefits, including a greater likelihood of economic efficiency, increased robustness to profit shifting and long-term stability. For example, suppose that the corporate tax base were located in the country of consumers; then the incentives to move real activities or sources of passive income to low tax countries would be removed and therefore, in turn, countries would not be under competitive pressure to cut their rates to attract them.

[15] See Michael P. Devereux and John Vella, "Implications of digitalisation for international corporate tax reform" in Gupta, Keen, Shah and Verdier (eds) *Digital Revolutions in Public Finance*, IMF (2017).
[16] See Michael P. Devereux, "Economic Theory of the Optimal Taxation of Multinational Profit", ETPF Policy Paper 6, 2016, for a survey of the prescriptions of the academic literature on the optimal location of taxation.
[17] See Michael P. Devereux, (2012), Issues in the Design of Taxes on Corporate Profit, *National Tax Journal*, 65:3, pp. 709-30; Auerbach, A.J. M.P. Devereux and H. Simpson (2010) "Taxing Corporate Income", in J. Mirrlees et al (eds.), Dimensions of Tax Design: The Mirrlees Review, Oxford: Oxford University Press, 837-893. Michael P. Devereux and John Vella, 'Are we heading towards a corporate tax system fit for the 21st century?' (2014) *Fiscal Studies*, Vol 35. No. 4, 449.

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It might be argued that there is a conceptual case for taxing multinational companies in the location of the parent company based on the ability-to-pay principle.[18] The ability-to-pay principle prescribes that individuals pay tax on their income whether it is derived domestically or abroad. For parent companies owned entirely by domestic shareholders, this arguably generates a case for taxing the parent companies on their worldwide income. Local taxation of a foreign subsidiary or PE would be inconsistent with this approach, at least without a credit being offered by the country of the parent company. However, this argument is considerably weakened if there is cross-border portfolio investment, so that companies have foreign shareholders. In principle, this approach would require countries to tax foreign companies which are partly owned by domestic residents and not to tax domestic companies which are owned by foreign residents.

What is the conceptual case for taxing companies in the location of subsidiaries and PEs? Indeed, what is the conceptual case for allocating taxing rights among these entities based on the value creation principle? Although the conceptual case is rarely made, and certainly not in any detail, there have been hints that it might be based on a notion of fairness. For example, the EU Commission has noted that "[t]his principle is essential for a fair and effective taxation in the single market."[19] The principle's popular appeal perhaps can also be understood on the grounds that it appears to follow an intuitive understanding of fairness, along the lines of the benefits principle – that contributions to the cost of publicly-provided goods and services should be allocated based on the benefits derived from them.[20] But this is problematic on at least two counts.[21]

First, profit is likely to be a poor proxy for the benefit received. Highly profitable companies may make limited use of public services and resources, while loss-making companies may place a very heavy burden on them. Second, the benefits principle would seem to prescribe allocating taxing rights to all four possible locations noted above, including that of the consumers. Companies clearly derive a benefit from the country of consumers, not least because of the legal system which allows them to conclude contracts with consumers, protects them against counterfeit products through trademarks and so on. This is clearly not in line with the common understanding of the value creation principle by its proponents. So the benefits

[18] J. Clifton Fleming, Robert J. Peroni and Steven S. Shay, "Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income", *Florida Tax Review*, Vol 5., No. 4, 2001.
[19] EU Commission, Impact Assessment, ibid. p. 5.
[20] Susan Morse (2018), op cit, claims that it is "roughly in line with the benefit principle".
[21] For a broader discussion on the difficulty in using the benefits principle to allocate taxing rights Wolfgang Schön, 'International Tax Coordination for a Second-Best World (Part I),' *World Tax Journal,* Vol. 1, No. 1, pp. 67-114, September 2009.

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principle cannot be used to justify this version of the value creation principle.

4. Application of the principle

In this section we first examine the principle as commonly understood by its supporters from a conceptual perspective. We then examine the application of the principle in the existing system from a practical perspective.

4.1. Conceptual

Under the existing system taxing rights are not allocated to market countries on the mere strength of the fact that the sales generating profits are located there. It is thus said that under the existing system taxing rights are allocated to countries where the supply side takes place but not the demand side. At least some supporters of the value creation principle back this position by arguing that no value is created by consumers and therefore countries should not have a right to tax on the basis of sales.[22]

Standard Economic Analysis

From a standard economic perspective, it is simply incorrect to state that no value arises in the market. The profits being allocated among countries owe as much to the market as they owe to the various parts of a supply chain. Profit depends on the price charged at the point where supply and demand meet; it simply would have not arisen in the absence of a market. It is not entirely clear why the international corporate tax system should depart from a simple and uncontroversial economic understanding of value creation.

Consumers' contribution to the production of income is seen particularly clearly where businesses generate a higher income simply because of consumer preferences. For example, due to higher demand in Japan for high quality tuna, businesses can sell such tuna at a higher price in Japan than anywhere else. This higher consumer demand clearly is a factor that generates value for the supplier, but this notion is absent from the usual understanding of the principle of value creation.

[22] See for example the robust defense of this position in HM Treasury's *Corporate Tax and the Digital Economy* – 2.26-2.32.

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Taxes on corporate profit and consumption

Arguing that corporate profits should not be allocated to market countries because consumers merely consume, simply ignores the role of consumers to the generation of profits. Furthermore, arguing that corporate profits should not be allocated to market countries because such countries (might) already levy VATs or sales taxes on the same activity is equally unpersuasive. It suggests that the value creation principle has (had or will have) a different meaning in relation to countries that have (had or will have) a corporation tax but not a sales tax or a VAT.

Finally, claims that corporate profits should not be allocated to market countries also have to contend with the fact that in the US subnational context corporate profit is in fact largely allocated to the market[23] and proposals for unitary taxation and formulary apportionment systems often allocate some taxing rights to the market (including the European Commission's proposals for the CCCTB).[24]

4.2. Practical

4.2.1. Partial Adoption

The reform of the international corporate tax system undertaken in the past few years did not seek to redesign the existing system following the value creation principle. It simply introduced rules that – in some cases - better aligned the system with the principle. As the basic structure has been kept in place and the principle overlaid on top of it, the international corporate tax regime has now become even less principled and coherent. In some situations taxing rights will be aligned with value creation, but in others it will not.

Consider the following example. P is a company resident in Country A, which operates a patent box regime. Country A's statutory corporate tax rate is 20% but its patent box regime offers a tax rate of 5% for IP income. P's subsidiary, S, is resident in Country B, which has a statutory corporate tax rate of 25%. P had set up S pre-BEPS to run its R&D facilities in Country B and had planned to transfer the IP created by S to P so as to benefit from Country A's patent box regime.

[23] Walter Hellerstein, 'A US Subnational Perspective on the "Logic" of Taxing Income on a "Market" Basis', *Bulletin for International Taxation*, April/May 2018.
[24] Albeit only if there is a PE in the country of sales.

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Action 5 of the BEPS Action Plan addresses harmful tax practices, with a focus on patent box regimes. Very broadly, and subject to qualification, through the introduction of the so-called "modified nexus approach" it sought to align taxing rights with value creation by limiting the income which can benefit from the patent box regime to that generated by R&D which is undertaken in the country offering the regime.

The multinational has the following options, following the changes brought about by Country A to bring its patent box regime in line with Action 5:

- It can keep the IP in Country B in which case the royalty income resulting from the IP is taxed in Country B.
- It can transfer the IP to P in which case the royalty income resulting from the IP is taxed in Country A, but not at the favourable rate of its patents box regime.[25]

Presumably, value would be deemed to have been created in Country B in this case. However, under the existing regime taxing rights over the IP will not be allocated to Country B under all circumstances.

Assume now that Country A eventually repeals its patent box regime and simply cuts its statutory corporation tax rate to 5%. Now the multinational could transfer its IP to Country A where it will be taxed at 5%. Assume further that P is owned by Company H in Country C and that Country C operates a robust controlled foreign company (CFC) regime. If the IP is transferred to P, the CFC regime in Country C might lead to the royalty income received by P being taxed in the hands of H. In this scenario Country C would tax the profits ultimately resulting from the value created in Country B.

This example is simplistic and abstracts from a number of complications. But it shows that the existing system has not been reformed so that profits are coherently and consistently taxed in line with the common understanding of the value creation principle. The post-BEPS international tax system is likely to be more incoherent, with taxing rights being aligned with this principle in some cases but not in others. There does not appear to be any rationale for distinguishing between the two sets of cases; reliance is placed on perceived abuse.

[25] In this case Country B can tax S on the gains made from the sale of the IP. However, the need for Action 5 clearly shows the lack of faith in the ability of the system to price this intra-group sale properly.

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4.2.2. Real Economic Distortions and Instability

A system which taxes profit in line with the common understanding of the value creation principle is likely to be distortive and thus unstable in the long run. Companies have an incentive to shift real economic activity to countries with lower tax rates; in turn, that leads to greater tax competition. Of course, the system pre-BEPS was distortive and unstable, but a system that is more closely aligned with this principle is likely to be even more distortive and even less stable. While in the past multinationals might have been able to undertake real activities in their preferred location – absent tax considerations – and then shift profit to a low tax country, under this system multinationals would have to move their real activities - that are deemed to create value - to achieve the same result.

Shifting real economic activity in response to tax differences creates real reductions in economic welfare. Let's return to the example given above. Assume that Country B is renowned as a hotbed of R&D, due to the high quality of its infrastructure, scientists and other relevant factors. This makes Country B the multinational's location of choice – absent tax considerations – for setting up its R&D activities. But if profits are taxed where value is created and Country A offers a favourable tax regime for IP income while Country B does not, this tax consideration could lead the multinational to move its R&D facility to Country A. Tax would then have created a real economic distortion with a consequent global welfare loss.

Furthermore, countries can be expected to compete even more strongly under a system following this principle since attracting real activities is more beneficial to a country than simply attracting profit due to known spill-over effects.

4.2.3. Difficulty in Application

There is considerable difficulty in allocating taxing rights in accordance with value creation – even as interpreted by its proponents. Note that to allocate taxing rights among countries on the basis of this principle it is not sufficient to identify the countries where activities creating value take place. It is also necessary to establish *how much* value is created in each country.

This is true in all sectors, not just in the digitalised economy. Consider the example of a multinational with a parent company and its headquarters in Country A, R&D activities in Countries B and C, production in Country D and sales and marketing teams in countries around the world. One could argue that the arm's length principle

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(ALP) could be relied on for these purposes, but the difficulties bedevilling this system are well known.[26] A clear difficulty here is how to allocate the residual profits arising from synergies – or other factors – if one cannot clearly identify the activities which led to these profits and where they took place.

But this difficulty is even more pronounced in a digitalised economy.[27] As the EU Commission itself explained recently:

> "[i]n a digitalised world, it is not always very clear what that value is, how to measure it, or where it is created."
>
> "Arriving at a meaningful solution to capture and allocate the value created in the digital economy across countries can take time. This is further complicated by the multidimensional nature of this challenge, to the constantly changing nature of the digital economy, and the diversity of the business models and the complexity of ecosystems in which they create value."[28]

The UK is strongly supportive of the value creation principle. In HM Treasury's recently updated position paper *Corporate Tax and the Digital Economy*, it made the case for allocating taxing rights to country where users of certain digital services are located on the grounds they create value.

This is highly questionable in principle, when the "user" is not necessarily a "consumer". An example is a multinational offering a search engine, where advertisements appear on the user's screen, paid for by advertisers that may be resident in a different country. The European Commission and the UK proposals for digitalised companies are intended to allow the country of the user to tax the multinational on the grounds that the user creates value. But it is questionable whether the user makes a contribution to the company's value, and if so, how it would be measured. To the extent that she does, this seems comparable to a non-digital company acquiring a product or service for below market value, for example in a country where the labour force is willing to work for low wages.[29] By analogy, tax on the digital company should only be levied in the country of the user if tax is

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[26] Collier, Richard, and Joseph Andrus (2017) *Transfer Pricing and the Arm's Length Principle after BEPS* (Oxford University Press).

[27] This is addressed at greater length in Michael Devereux and John Vella, "Taxing the Digital Economy: Targeted or System-Wide Reform?" *British Tax Review* (forthcoming).

[28] EU Commission, Parliament and Council, *A Fair and Efficient Tax System in the European Union for the Digital Single Market*, Brussels, 21.9.2017 COM(2017) 547 final.

[29] On the point that this transaction is akin to a barter see, Michael P. Devereux and John Vella, "Implications of digitalisation for international corporate tax reform" in Gupta, Keen, Shah and Verdier (eds) *Digital Revolutions in Public Finance*, IMF (2017), pages 107-110.

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also levied on the non-digital company in the low-wage country.

However, even if the principle is accepted, the Treasury's position paper concedes that "there would be challenges in coming up with a suitable approach to measuring that value directly" and that while "[t]here may be indirect indicators of the value of a user base to a business … it would be difficult to use those indicators to calculate an appropriate reward." So it concludes:

> "For that reason, the UK thinks that it might be necessary to reward user-created value through a percentage share of the residual profit realised by principal companies in the group … That share would be designed to approximate the value that users generate for the business. *This approach wouldn't be indicative of the deemed value of user participation relative to other group activities. It would instead be recognition of the complexities in measuring the value generated by user participation*.[30]

It is thus not surprising to find strong disagreement among countries, and even business, as to whether certain factors generate value, let alone how much.[31] But it does seem surprising that despite this, the EU Commission, the OECD and a number of countries persist with this principle to guide the design of a tax system in the age of digitalisation.

Measuring how much value is created in a particular country will at times be difficult, requiring lengthy legislation and guidance, creating costs and uncertainty. Countries with substantial capacity and resources will find it challenging to apply such rules. Countries without such capacity and resources - as is the case in many countries, not only developing countries but also some EU Member States – simply will not be able to apply such rules.

Of course, one could use cruder and arbitrary measures that may proxy for value creation because of the impossibility of measuring how much value is created in a particular location. Ease of administration and simplicity would then be traded off with adherence to the principle. But the use of such measures brings into question the choice of value creation as a principle on which to design an international corporate tax system in the first place.

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[30] Emphasis added.

[31] See OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018.*

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International Taxation in an Era of Digital Disruption: Analyzing the Current Debate

Itai Grinberg
Draft of 10/29/2018

Abstract

The "taxation of the digital economy" is currently at the top of the global international tax policymaking agenda. A core claim some European governments are advancing is that user data or user participation in the digital economy justifies a gross tax on digital receipts, new profit attribution criteria, or a special formulary apportionment factor in a future formulary regime targeted specifically at the "digital economy." Just a couple years ago the OECD undertook an evaluation of whether the digital economy can (or should) be "ring-fenced" as part of the BEPS project, and concluded that it neither can be nor should be.

Importantly, concluding that there should be no special rules for the digital economy does not resolve the broader question of whether the international tax system requires reform. The practical reality appears to be that all the largest economies have come to agree either that a) there is something wrong with the taxation of the "digital economy," or b) there is something more fundamentally wrong with the structure of the current international tax system given globalization and technological trends.

This paper is intended as a limited exploration of the second (or third, or fourth) best. It analyzes three policy options that have been discussed in general terms in the current global debate. First, I consider whether "user participation" justifies changing profit allocation results in the digital economy alone. I conclude that applying the user participation concept in a manner that is limited to the digital economy is intellectually indefensible; at most it amounts to mercantilist ring-fencing. Moreover, at the technical level user participation faces all the same challenges as more comprehensive and principled proposals for reallocating excess returns among jurisdictions. Second, I consider one such comprehensive international tax reform idea, loosely referred to by the moniker "marketing intangibles." This idea represents a compromise between the present transfer pricing system and sales or destination-based reforms to the transfer pricing regime. I conclude that splitting taxing rights over "excess" returns between the present transfer pricing system and a destination-based approach is complex, creates new sources of potential conflict, and requires relatively extensive tax harmonization. This conclusion applies equally to user participation and marketing intangibles. If such a mechanism were nevertheless pursued, I suggest that a formulary system for splitting the excess return is the most manageable approach. Third, I consider "minimum effective taxation" ideas. I conclude that, as compared to the other two policy options discussed herein, minimum effective taxation provides a preferable path for multilateral cooperation.

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Introduction[1]

For the upcoming University of Chicago Federal Tax Conference, I was asked to write a paper "discussing what the US position should be and how the US tax rules should be changed (or not) in reaction to European tax changes such as the proposed gross tax on digital receipts, the digital PE, and the diverted profits tax."

A core tax policy claim some European governments are advancing is that user data or user participation in the digital economy justifies a gross tax on digital receipts, new profit attribution criteria, or a special formulary apportionment factor in a future formulary regime. One fundamental question these claims raise is whether there is anything unique about the digital economy. In the BEPS project the OECD undertook an evaluation of whether the digital economy can (or should) be "ring-fenced," and concluded that it neither can be nor should be. But the OECD's conclusion is not stopping some European governments from pursuing proposals that attempt to apply special tax regimes to a limited set of digital businesses.[2]

Importantly, simply concluding that there should be no special rules for the digital economy does not resolve the broader question of whether the international tax system requires reform prompted in part by the digitalization of the economy. Indeed, a debate about this question is ongoing at the OECD. We know more about the contours of that debate today than we did when I was first asked to undertake this paper. The practical reality appears to be that all the largest economies have come to agree either that a) there is something wrong with the taxation of the "digital economy," or b) there is something more fundamentally wrong with the structure of the current international tax system in an era of globalization and digitalization.[3] Government representatives have now made this plain in multiple public forums. So, one way or the other, we lack a stable status quo. [4]

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[1] I thank Pamela Olson and Michael Plowgian for comments on an earlier draft. Oscar Velutini provided excellent research assistance. Any errors are my own.

[2] *See, e.g.*, HM Treasury, Budget 2018 Digital Services Tax (Oct 29. 2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752172/DST_web.pdf

[3] *See* Organisation for Economic Cooperation and Development [OECD], *Tax Challenges Arising from Digitalisation – Interim Report 2018* (2018), https://www.oecd-ilibrary.org/content/publication/9789264293083-en; remarks of Brian Jenn at OECD-USCIB 2018 tax conference (all major economies believe either the first or the second of the options). Stephanie Soong Johnston, *Official Previews Coming OECD Digital Economy Work*, 90 Tax Notes Int'l 1329 (June 11, 2018).

[4] For instance, David Bradbury of the OECD suggested the question of whether issues in the international tax system were limited to the "digital economy" or were more pervasive was at the core of the current OECD debate in his remarks at the International Fiscal Association [IFA] annual conference in Seoul in September. *See* Stephanie Soong Johnston, *OECD Makes Headway on Long-Term Answers to Tax Digital Economy*, 91 Tax Notes Int'l 1164 (Sept. 10, 2018); Stephanie Soong Johnston, News Analysis: *Geeking Out: Digital Taxation Debate Goes Viral at IFA Congress*, 92 Tax Notes Int'l 19 (Oct. 1, 2018).

This paper sets out some considerations for US international tax policymaking and international tax diplomacy in this uncertain environment. To that end, Part I briefly describes four disparate background considerations that should inform our thinking. Part IA describes the decline of the arm's length standard, which underpinned our historic understandings about how to attribute profits as among entities within a multinational corporation. I argue that internationally the arm's length standard as we knew it before the BEPS project is largely gone, and has been replaced by an unsustainable concept for profit attribution that I label the "bourgeois labor theory of value." Part IB describes the relationship between the arm's length standard, jurisdiction to tax, and the attribution of profits to permanent establishments. It highlights that under OECD principles, attribution of profits to permanent establishments is accomplished through application of the OECD's transfer pricing guidelines. Part IC recounts various acts of tax unilateralism abroad, often focused on the tech sector, and including the trend towards abandoning historic limits on jurisdiction to tax. Part ID describes the United States' 2017 tax reform in that global context, with a particular focus on the GILTI and the BEAT.

The remainder of the paper is intended as an exploration of the second (or third, or fourth) best. For purposes of this paper, I therefore do not analyze options that were considered and rejected in the most recent US tax reform, including a destination-based cash flow tax or an integrated corporate tax system, and certain options that never made it into the most recent tax reform debate, such as adopting a VAT.

The discussion is instead limited to three options that have been discussed in general terms in the current global debate. Each of these options preserves a classic corporate tax system that includes an entity-level tax on the normal return to capital. One further important caveat is that in this paper I attempt as best I can to fill in ideas that have been described with a very high level of generality with additional potential content, in order to motivate the analysis.

Part II focuses on the European Commission and Her Majesty's Treasury ("HMT") stated view that user participation should be acknowledged as a source of value creation in the digital economy and concludes that the user participation concept has application well beyond the so-called digital economy. Applying the concept in a manner that is limited to the digital economy is intellectually indefensible; at most it amounts to mercantilist ring-fencing.

The user participation theory does, however, have an important relationship to other more generally applicable proposals for international tax reform. In particular, it involves a shift towards destination-based income taxation, in much the same manner as some other proposals for fundamental international income allocation reform, albeit only for one sector.

At least two more comprehensive and principled proposals to reform the international tax system's attribution of profits are apparently now being considered at the OECD. These respectively are often loosely referred to by the monikers "marketing intangibles" and

"minimum taxation." As publicly described, these ideas seem to be at an early stage of development.

Part III evaluates a version of the "marketing intangibles" idea which I label the destination-based residual market profit allocation ("DBRMPA"). Part IV evaluates a version of a minimum tax system that combines inbound and outbound measures, and which I label "minimum effective taxation."

Part III builds on the discussion about "where we go from here" in transfer pricing provided by Andrus and Oosterhuis in a paper for the 2016 University of Chicago conference. The DBRMPA is related to that conference discussion of two years ago. In particular, it represents a compromise between the present transfer pricing system and sales or destination-based reforms to the transfer pricing system described in the Andrus/Oosterhuis paper. Part III concludes that splitting taxing rights over "excess" returns[5] between the present transfer pricing system and a destination-based approached is complex. It creates new sources of potential conflict as between sovereigns and as between sovereigns and multinationals. Moreover, some destination specification problems for which solutions do not exist or at least are not widely known would need to be addressed. Finally, the DBRMPA likely requires extensive tax harmonization and information exchange; more so than a minimum tax approach. Importantly all of the above conclusions regarding a DBRMPA apply with equal rigor as technical critiques of user participation. The difference is simply that a DBRMPA applies to the whole economy and therefore – unlike user participation – has some principled basis. If a DBRMPA were pursued, Part III suggests that a formulary mechanism for doing so is the least technically challenging approach.

Part IV builds on the discussion of the GILTI and the BEAT in Part I as well as other discussions of the pros and cons of those provisions in tax forums over the last year. Part IV postulates that there may be a more sensible path for multilateral cooperation around minimum effective taxation. This approach could be both responsive to the current global international tax debate and build on (and help repair) our 2017 international tax reform. I conclude that a minimum effective taxation approach would be preferable to a DBRMPA.

Part I. Background

IA. The Decline of the Arm's Length Standard

Article 9 of the OECD Model Tax Convention is intended to ensure that multinational corporations ("MNCs") do not obtain inappropriate tax advantages by pricing transactions

[5] The term "super-normal return" has an understood meaning in economic theory. The term "excess return" does not. I view the returns for which taxing rights may be reallocated in a DBRMPA to be related to but not always the same as the "super-normal return" concept in economics, and so I use the term "excess returns" going forward in this paper.

within the group differently than independent enterprises would do at "arm's length." More than half of world trade is now intra-firm.[6] Thus, more than half of world trade is subject to transfer pricing.

Under the arm's length principle, multinational groups are supposed to divide their income for tax purposes among affiliates in the different countries in which the MNC does business, in a way that is meant to emulate the results that would transpire if the transactions had occurred between independent enterprises.[7] For most of the last forty years, the arm's length principle represented a consensual solution reached among technicians for the problem of allocating tax between different parts of an MNC.[8] Although the mantra of "arm's length" masked real disagreement, and members of the transfer pricing practitioner community often held the view that there was substantial controversy as to the proper implementation of the arm's length standard, the range of interpretation was, in practice, reasonably narrow. Major transfer-pricing disputes arose with regularity, but they were addressed within a framework that largely respected intercompany contracts and the concept of allocation of risk within a multinational group.[9]

In the last decade, however, the "arm's length standard" became extraordinarily controversial.[10] Transfer pricing even became the subject of contentious discussion among

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[6] "More than half of U.S. imports from its main non-NAFTA trading partners (with the exception of China and Italy) are also intra-firm transactions. In contrast, U.S. exports to its main non-NAFTA trading partners are predominantly arm's-length – 53-65 percent of U.S. exports to large European Union and Asian countries (France, Germany, Japan, Korea, Netherlands, and United Kingdom…) fit this description." World Bank, *Arm's-Length Trade: A Source of Post-Crisis Trade Weakness, Global Economic Prospects Special Focus 2* (June 2017), http://pubdocs.worldbank.org/en/222281493655511173/Global-Economic-Prospects-June-2017-Topical-Issue-Arms-length-trade.pdf.

[7] *See, e.g.*, OECD, *OECD/G20 Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10-2015, at 9* (2015), https://doi.org/10.1787/9789264241244-en [https://perma.cc/25E8-UCKY] [hereinafter "BEPS ACTIONS 8–10"]. The arm's length principle requires that transactions between associated enterprises be priced as if the enterprises were independent, such that the pricing reflects what third parties operating at arm's length would agree upon with one another.

[8] John Neighbour, *Transfer pricing, Keeping it at arm's length*, OECD Observer, Apr. 21, 2002, at 29, http://www.oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html. Of course, important academic critiques and alternative proposals existed before the onset of the BEPS project. *See generally*, Reuven Avi-Yonah, *Splitting the Unsplittable: Toward a Formulary Approach to Allocating Residuals Under Profit Split*, Univ. of Michigan Pub. Law & Legal Theory Working Paper Series, Paper No. 378 (2013) (proposing that the OECD use formulary apportionment to allocate residual profit of the "profit split method").

[9] *See* Matthias Schroger, *Transfer Pricing: Next Steps in the International Debate*, Tax Policy Challenges in the 21st Century 310-12 (Karoline Spies & Raffaele Petruzzi eds., 2014). Whether one views that outcome as good policy or not, the relatively clear intellectual boundaries for these disputes were an outgrowth of the fact that discussion of transfer pricing was limited to tax administrators and other specialists.

[10] *See, e.g.*, Reuven S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 World Tax J. 3, 3 (2010) (arguing that while debate quieted with regard to the arm's length standard after the adoption of the 1995 regulations and OECD guidelines, the arm's length standard is unworkable and should be replaced by formulary apportionment); David Spencer, Senior Adviser, Tax Justice Network, *Statement by the Tax Justice Network* (Mar. 21, 2012, 5:07 AM), http://taxjustice.blogspot.com/2012/03/tjn-statement-on-transfer-pricing.html (asserting that the "OECD's

high-level elected officials with no tax expertise at all.[11] Moreover, the so-called "stateless income"[12] narrative became commonly accepted by tax policymakers in almost every developed economy.

As a result, preexisting norms developed by the community of transfer-pricing specialists came under heavy and perhaps deserving scrutiny. Views around the level of deference to be given to intergroup contractual arrangements in transfer pricing analyses diverged substantially, the consensus on the scope for recharacterizing intergroup transactions frayed, the consensus on respecting intergroup equity contributions declined. Disputes among government officials about whether value creation in cross-border transactions undertaken by multinationals should be attributed to capital, labor, the market, user participation, or government support are now aired routinely.[13]

Enormous political pressures coming from the highest levels of government and the G-20 meant that some sort of outcome on transfer pricing was politically necessary as part of the BEPS project.[14] Thus, in 2015, the BEPS project in effect endorsed the commonly held idea that the then-existing OECD transfer pricing guidelines were broken. However, at the technical level bureaucrats failed to reach meaningful consensus on a clearly delineated alternative. The result was a reliance on high levels of constructive ambiguity buried in many pages of technocratic language in the transfer-pricing outputs of the BEPS project.[15]

One phrase that captures this ambiguity is the commitment to "align income taxation with

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theory of the arm's length principle no longer applies to multinational enterprises which are highly integrated").

[11] *See generally* Stephen Timms, Fin. Sec'y to Treasury UK, Address at the OECD Tax & Development Conference (Jan. 27, 2010); G-20, Cannes Summit Final Declaration – Building our Common Future: Renewed Collective Action for the Benefit of All (Draft of November 4) (Nov. 4, 2011), http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html; *see also* Arun Jaitley, Hon. Fin. Minister, India, A Tax Vision for India, Peterson Institute for International Economics (Apr. 16, 2015).

[12] Ed Kleinbard deserves credit for naming the phenomenon and writing the most well-read article about how US MNC international tax planning in the pre-BEPS era worked. *See generally* Edward D. Kleinbard, *Stateless Income*, 11 Fla. Tax Rev. 699 (2011). However, his US outbound centric view created real difficulties for the United States as a matter of international tax diplomacy. US tax reform is highlighting the extent to which foreign multinationals, especially those headquartered in Europe, have been achieving stateless income with respect to revenues earned in the United States for many years. Unfortunately, no European academic has emerged who is willing to publicize and generalize about aggressive tax planning by European MNCs in the manner Ed did for US-headquartered MNCs.

[13] *See generally* Mindy Herzfeld, *Input Needed on Transfer Pricing Drafts*, 77 Tax Notes Int'l 392 (Feb. 2, 2015); China International Tax Center / IFA China Branch, *Comments on Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains and other Related Transfer Pricing Issues* (Feb. 6, 2015). US officials, for example, have bemoaned this phenomenon in multiple public appearances.

[14] *See, e.g.*, comments Marlies de Ruiter, *Interview: OECD's de Ruiter says Forthcoming Changes to Transfer Pricing Guidelines Achieve Correct Balance*, 24 Tax Mgmt. Transfer Pricing Rep. 775 (Oct. 15, 2015) [hereinafter "de Ruiter Interview Comments"].

[15] *See generally* BEPS ACTIONS 8–10*, supra* note 7; *see also* Michael L. Schler, *The Arm's-Length Standard After Altera and BEPS*, 149 Tax Notes 1149 (Nov. 30, 2015) (discussing ambiguities in the revised transfer pricing guidelines associated with attributing income to various forms of activity, control of risk, or something else).

value creation." Everyone agrees on the principle – but no one agrees what it means.[16]

Nevertheless, if there was one central theme to the BEPS transfer pricing guidance taken as a whole, it was to put great weight for purposes of allocating intangible income and income associated with the contractual allocation of risk on "people functions." The people functions of interest were activities by people who are of sufficiently high skill to engage in the development, enhancement, maintenance, protection, and exploitation of intangibles (the so-called "DEMPE functions") as well as to be able to control financial risks, including those associated with the employment of intangibles. It is these people functions that the post-BEPS transfer pricing guidelines treat as "meriting" the allocation of excess returns from intangibles. In contrast, contractual or legal ownership of an intangible is not particularly significant, nor is "routine" labor.[17] I call this approach to transfer pricing the "bourgeois labor theory of value" ("BLTV").

The labor theory of value asserts that the value of a good or service is fully dependent upon the labor used in its production. This theory was an important lynchpin in the philosophical ideas of Karl Marx. In contrast, conventional capitalist economic theory relies on a theory of marginalism, in which the value of any good or service is thought to be determined by its marginal utility. Moreover, the pricing of a good or service is based on a relationship between that marginal utility, and the marginal productivity of all the factors of production required to produce the relevant good or service. In addition to labor, a key factor of production required to produce most goods and services is capital – including real and intangible assets purchased with capital.

The BLTV attributes profits quite heavily to the labor of certain highly educated workers who occupy upper middle management roles – roles and backgrounds broadly similar to those who negotiate transfer pricing rules for governments. The theoretical basis in economics for this BEPS transfer pricing settlement is unclear. It turns the Marxian labor theory of value on its head while being inconsistent with the conventional economic view, too. To my mind this feature makes it even less coherent than other possible bases for transfer pricing.

In the 2013 to 2015 period, the BLTV clearly seemed like an attractive alternative theory to various government officials. It addressed the "cash box" problem of multinational income being parked in zero tax places like the Cayman Islands and Bermuda, while attributing income to what the relevant officials viewed as "meaningful" activity.

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[16] Public presentations offer an illustration of this disagreement: the national delegates and OECD officials that participated in negotiations of the revised transfer pricing guidelines began providing conflicting interpretations of what those guidelines meant almost immediately after the OECD's new transfer pricing guidelines were released. *Compare* de Ruiter Interview Comments, *supra* note 14 *with* comments of Brian Jenn, quoted in Ryan Finley, *Transfer Pricing Report Obscured by Terminology*, 80 Tax Notes Int'l 229, 230 (Oct. 19, 2015).

[17] *See* BEPS ACTIONS 8-10, *supra* note 7, ¶¶ 6.42-6.46.

However, the post-BEPS BLTV version of the OECD's transfer pricing guidelines, if implemented in good faith by tax administrations around the world, would effectively provide that a multinational corporation can in various situations save hundreds of millions or even billions of dollars by moving twenty or a hundred key jobs to a low-tax jurisdiction from a high-tax jurisdiction. And many of those jurisdictions – Switzerland, Ireland, and increasingly the UK – are attractive places to live, with talented, high-skill labor pools already in place.

Requiring that DEMPE activities be conducted in tax-favorable jurisdictions in order to justify income allocations to those jurisdictions encourages DEMPE jobs to move to those jurisdictions. This transfer pricing result – that income may be shifted by moving high-skilled jobs – is deeply geopolitically unstable. From the corporate perspective, there can be huge incentives to shift DEMPE jobs if enough tax liability rides on the decision. At the same time, large developed economies with higher tax rates simply will not accept an arrangement that sees them losing both tax revenue and headquarters and R&D jobs.

In providing the above critique regarding the BEPS transfer pricing settlement, I do not wish to be misunderstood. Outside the transfer pricing area (BEPS Actions 8-10), I believe the BEPS project had many notable accomplishments. Global best practices and minimum standards were developed with respect to important issues like hybridity, interest expense deductions, information reporting, and more. The BEPS project certainly showed how soft law in the international tax space can be quite efficacious. But transfer pricing is sufficiently important that the failure to reach a sensible result in this space casts a shadow over the BEPS project generally. The failure to grapple in a sensible way with the questions raised by transfer pricing is one important reason the post-BEPS environment is characterized by much of the global tax chaos the BEPS project was supposed to prevent.[18]

IB. The Relationship Between the Arm's Length Standard, Jurisdiction to Tax, and the Attribution of Profits to Permanent Establishments

Tax treaties specify when an enterprise based in one state has a sufficient connection to another state to justify taxation by the latter state. Under Article 5 of the OECD Model Tax Convention, a sufficient connection exists when an enterprise resident in one state (the "residence state") has a "permanent establishment" in another state (the "source state"). The permanent establishment threshold must be met before the source state may tax that enterprise on active business income properly attributable to the enterprise's activity in the source state. The permanent establishment rule encapsulated in Article 5 thus represents the basic international standard governing jurisdiction to tax a non-resident enterprise.

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[18] *Cf. The Global Tax Environment in 2016 and Implications for International Tax Reform: Hearing Before the H.R. Comm. on Ways & Means*, 114th Cong. (2016) (Testimony of Itai Grinberg, Associate Professor, Georgetown University Law Center), https://waysandmeans.house.gov/wp-content/uploads/2016/02/20160224fc-Grinberg-Testimony.pdf.

Under Article 7 of the OECD's Model Tax Convention, profits attributable to a permanent establishment ("PE") are those that the PE would have derived if it were a separate and independent enterprise performing the activities which cause it to be a PE.[19] In 2010, the OECD issued a report on the attribution of profits to permanent establishments. The report concluded that a PE should be treated as if it were distinct and separate from its overseas head office; and that assets and risks should be attributed to the PE or the head office in line with the location of "significant people functions."

The post-2010 OECD approach to attributing profits to a PE is commonly referred to as the Authorized OECD Approach ("AOA").[20] This approach is based on the adoption of the 2010 version of the business profits article (Article 7) of the OECD Model Tax Convention. Step one of the AOA leads to the recognition of internal dealings between the PE and its head office.[21] Then, under step two, the guidance in the OECD's transfer pricing guidelines ("TPG") is applied by analogy to determine the arm's length pricing of the internal dealing between the PE and the head office.[22] The 2010 report on the AOA made clear that as the TPG were modified in the future, the AOA should be applied "by taking into account the guidance in the Guidelines as so modified from time to time."[23]

In the BEPS project, many countries focused on the idea that technological progress (especially the internet) and the globalization of business have made it easier to be heavily involved in the economic life of another jurisdiction without meeting the historic permanent establishment threshold. In the end the BEPS project produced some notable changes to the permanent establishment threshold.[24] These changes to Article 5 of the OECD Model Tax Convention are now being transposed into the global tax treaty network via the multilateral instrument, which itself represents another success of the BEPS project. Importantly, however, the BEPS project concluded that the AOA did not need to be revisited in light of the changes to Article 5.

Fundamentally, the AOA was developed because if associated enterprises in different countries were taxed under the arm's length standard under Article 9, but PEs were taxed

[19] OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017*, art. 7 (2007), https://www.oecd-ilibrary.org/content/publication/mtc_cond-2017-en [hereinafter "OECD Model Treaty"].
[20] Not all countries adopted the AOA; as such the attribution of profits to PEs and various countries' interpretations and practices with respect to Article 7 have continued to vary considerably.
[21] *See* Commentary to Article 7, para 2 of the OECD Model Treaty (para 16 et seq).
[22] The OECD agrees that this basic principle applies regardless of whether a tax administration has adopted the AOA as explicated in the 2010 Report on the Attribution of Profits to Permanent Establishments. *See* OECD, *Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7*, at 7 (2018), http://www.oecd.org/tax/transfer-pricing/additional-guidance-attribution-of-profits-to-permanent-establishments-BEPS-action-7.pdf [hereinafter "OECD Additional Guidance"].
[23] OECD, *2010 Report on The Attribution of Profits to Permanent Establishments*, ¶ 10 (July 22, 2010), http://www.oecd.org/tax/transfer-pricing/45689524.pdf.
[24] These changes primarily involved ensuring that commissionaire arrangements could not be used to avoid a PE and modifications to the rules on specific activity exemptions. The latter change was viewed by the OECD as being "particularly relevant in the case of digitalised businesses." *See, e.g.,* OECD Additional Guidance, *supra* note 22, at 7.

under some other rule under Article 7, distortions between structures involving PEs and structures involving subsidiaries would arise. As a result, the OECD Model Tax Convention attempts to apply the TPG and the arm's length principle as consistently as possible in both cases.[25]

Applying the AOA means that the PE and its head office are treated like independent enterprises. Note, however, that modern tax treaty permanent establishment tests are built to a significant degree on an underlying idea of dependence that differs from dependence/independence of ownership.[26] Thus, the AOA taxes a permanent establishment as if the PE and its head office are independent enterprises, but by definition a dependent agent PE requires dependence. This paradox is a product of the decision to have the transfer pricing rules trump the permanent establishment rules and make the arm's length standard the central organizing principle.[27] As a result, in our current legal construct, discussing the attribution of profits to a permanent establishment requires discussing which rules we wish to use to allocate MNE profits generally.

The alternative to the dependency criteria for establishing the existence of a PE is physical presence. Arguably, that mechanism for establishing a PE is just a proxy for meaningful presence in the economic life of a jurisdiction through dependent agents. Historically the physical presence rule was also a pragmatic administrative consideration. The physical presence of either an enterprise or a dependent agent of the enterprise was necessary in order to collect tax revenues from a taxpayer. Today, however, the pragmatic consideration is much less important in business-to-business transactions, given the development of reverse-charging type mechanisms and the ability to require a resident business to withhold from a non-resident. Moreover, in the internet era, it seems to me a losing argument to suggest that large digital firms do not have a meaningful global presence. So the principled debate with respect to jurisdiction to tax and attribution of profits to permanent establishments is just the debate about how to allocate the profits of an MNE among jurisdictions generally.[28]

IC. The Rise of International Tax Unilateralism and the Push to Tax Big Tech

[25] *See* Commentary to Article 7, para 2 of the OECD Model Treaty, para 16 ("the basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person… that faction corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for purposes of adjusting the profits of associated enterprises.")

[26] The PE concept of dependence has been with us since the PE test was first developed in the League of Nations, before the adoption of the arm's length standard. *See generally* Richard J. Vann, *Tax Treaties: The Secret Agent's Secrets*, 3 BTR 345 (2006).

[27] *Id.*

[28] I acknowledge that there are enforcement challenges associated with requiring smaller businesses without physical presence to pay tax in a jurisdiction, but I do not view that as a first-order issue.

Many jurisdictions decided quite quickly that they were not satisfied with the BEPS transfer pricing outcomes, at least with respect to specific companies or sectors where they wished to collect more revenue. The marquee actor in this story is the United Kingdom.

In 2015, before the BEPS project had ended, the United Kingdom imposed a 25% tax on profits deemed to be artificially diverted away from the UK. The Diverted Profit Tax ("DPT") targets instances where, under existing permanent establishment rules, an MNC legitimately avoids a UK taxable presence, despite the fact that the MNC is supplying goods or services to UK customers. The UK took the position that the DPT was not covered by the United Kingdom's income tax treaties, and therefore that the permanent establishment rules tax treaties specify as to when a state has jurisdiction to tax an enterprise based in another state did not apply to the DPT.

The primary justification for OECD countries recommending and the G-20 launching the BEPS project had been to develop rules-based multilateral reforms that would prevent unilateral actions by the countries participating in the BEPS project. The UK adopted the DPT at the same time that it was helping lead the BEPS project. The UK's decision both to lead a multilateral project that was supposed to set internationally agreed rules that would prevent inconsistent unilateral action, and at the same time unilaterally adopt the DPT, a tax that was not consistent with BEPS, was broadly perceived as a significant blow to tax multilateralism. The decision treated sovereignty as a license for organized hypocrisy. But for the DPT, one could imagine that a more cooperative international tax environment might have evolved out of the BEPS project.[29]

Under the DPT, Her Majesty's Revenue and Customs ("HMRC") can choose which companies it wishes to pursue and to what degree.[30] Thus, the DPT also struck a blow against non-discrimination principles in international taxation. Indeed, in press interviews UK government officials referred to the DPT simply as the "Google Tax."[31] The extent to which the DPT is an arbitrary levy on targets of interest to HMRC is well-illustrated by the twelve-fold increase in revenues raised by the DPT between 2015/2016 and 2017/2018.[32]

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[29] Note also the inclusion of a digital services tax (DST) in the UK budget of October 29, 2018. The DST represents another instance of UK unilateralism in the midst of a multilateral project in which it claims to be a fully committed participant. HM Treasury, Budget 2018 Digital Services Tax (Oct 29. 2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752172/DST_web.pdf

[30] Dan Neidle et al., *The UK Diverted Profits Tax: Final Legislation Published*, Clifford Chance, Mar. 25, 2015, http://www.cliffordchance.com/briefings/2015/03/the_uk_diverted_profitstaxfinallegislatio.html.

[31] It is still known by that moniker. Vanessa Houlder, *'Google tax' take swells to £281m as levy starts to bite*, Financial Times, Sept. 13, 2017, https://www.ft.com/content/4f7aed86-989f-11e7-a652-cde3f882dd7b.

[32] *See generally* HM Revenue & Customs [HMRC], *Transfer Pricing and Diverted Profits Tax statistics*, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/729876/Transfer_Pricing_and_Diverted_Profits_Tax_statistics.pdf (estimating an increase in the "DPT Yield" from £31m in 2015/16 to £388m in 2017/18). DPT charging notices raised 57% of the revenue HMRC attributed to the DPT in 2017/2018. The remainder was raised by what HMRC referred to as "behavioral change," the central element of which was "additional Corporation Tax paid as a result of HMRC intervention to ensure

Twelve-fold increases in revenue without a change in the rate or rules simply do not happen when tax law functions in the normal way.[33]

Following the UK's lead, by late 2017, countries as diverse as Australia, Argentina, Chile, France, India, Israel, Italy, Japan, Mexico, New Zealand, Poland, Spain, and Uruguay had taken unilateral actions not limited by or consistent with the BEPS agreements. These measures are generally designed to increase levels of inbound corporate income taxation. Many are structured so that, as a practical matter, they primarily affect US MNCs. Among other examples, in 2016 Australia enacted a DPT-like measure with a 40% tax rate (also publicly known as the "Google Tax"). India imposed a 6% "equalization levy" on outbound payments to nonresident companies for digital advertising services. India's legislation authorized extending the tax to all digital services by administrative action. The Israel Tax Authority announced an interpretation of Israeli law that significantly reduces the level of physical presence necessary for direct taxation of nonresident digital companies. The Korean government is considering amendments to the Korean Corporate Tax Act to override Korean tax treaties and treat "global information and communications technology companies" as having a digital Korean PE. Uruguay has enacted, and Argentina is considering, measures similar to those adopted in India. During this same time period the Directorate-General for Competition ("DG Comp") at the European Commission reconceptualized its "state aid" concept in the international tax context, notably by claiming that DG Comp was not limited by the OECD's arm's length standard in determining whether tax rulings were consistent with EU law.[34]

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that profits earned in the UK are taxed in the UK." That is to say, HMRC threatened to charge DPT and instead a company 'voluntarily' opted to pay more UK corporation tax.

[33] Officials from the OECD and the IMF, as well as the canonical Vogel treatise, generally define taxes as legally compulsory and unrequited payments to a government that do not provide a specific economic benefit. Moreover, to qualify as a tax under these definitions, the required payment must be a result of law of general applicability that is reasonably clear in its application. *See, e.g.*, Werner Haslehner et al., Klaus Vogel on Double Taxation Conventions Art. 2 at 26 (Ekkehart Reimer & Alexander Rust eds., 4th ed. 2015); Ken Messere et al., Tax Policy: Theory and Practice in OECD Countries 240 (2003); Ruud De Mooij & Michael Keen, *Taxing Principles: Making the best of a necessary evil*, Finance & Development, Dec. 2014, Vol. 51, No. 4. So, to ask a provocative question – does the DPT meet that test? Note that after France enacted a DPT-like tax, the French constitutional council struck the tax down on the basis that it gave the tax authority too much discretion to selectively target individual taxpayers, and therefore was not constitutional under French law. *See* Conseil constitutionnel [CC] [Constitutional Court] decision No. 2016-744 DC, Dec. 29, 2016 (Fr.), https://www.conseil-constitutionnel.fr/sites/default/files/as/root/bank_mm/decisions/2016744dc/2016744dc.pdf; *see also* Davide Anghileri, *France's diverted profits tax ruled unconstitutional*, MNE Tax (Jan. 4, 2017), https://mnetax.com/frances-diverted-profit-tax-ruled-unconstitutional-18873.

[34] In the Belgian state aid case, the Commission wrote that, "for any avoidance of doubt, the arm's length principle that the Commission applies in its state aid assessment is not that derived from Article 9 of the OECD Model Tax Convention and the OECD TP Guidelines, which are nonbinding instruments, but a general principle of equal treatment in taxation falling within the application of Article 107(1) of the Treaty, which binds the Member States and from whose scope the national tax rules are not excluded." Commission Decision of 11.1.2016 on the Excess Profit Exemption State Aid Scheme SA.37667 Implemented by Belgium, C(2015) 9837 final, para 150, http://ec.europa.eu/competition/state_aid/cases/256735/256735_1748545_185_2.pdf.

More recently, governments around the world have been proposing or enacting taxes targeted specifically at digital advertising and online platforms. India went first with its previously-mentioned tax on digital advertising. Then, in September 2017, the European Commission called for new international rules that would alter the application of permanent establishment and transfer pricing rules for the digital economy alone.[35] Moreover, the Commission argued that until such time as a digital-specific reform of the international tax system was agreed upon, an interim tax based on turnover, or a withholding mechanism, should be imposed on digital platform companies.[36] The UK followed up on the Commission's digital tax proposals with its own position paper on corporation tax and the digital economy.[37] On October 29, 2018, the UK announced the introduction of a "digital services tax" that is based on turnover and is explicitly ring-fenced to hit only large search engine, social media, and online marketplace businesses.[38] Other unilateral measures focusing on the digital economy have been taken by India (significant economic presence PE),[39] Israel (digital PE), and others. Like the earlier round of unilateral measures, some of these proposals have been described both in government documents and in the media as taxes targeting "GAFA:" Google, Apple, Facebook, and Amazon. However, the proposals generally are structured to have an impact beyond those four corporations.

Separately, in 2017 Germany adopted its "Act against Harmful Tax Practices with regard to Licensing of Rights." New section 4j of the German Income Tax Act restricts deductions for royalties and similar payments made to related parties if such payments are subject to a non-OECD compliant preferential tax regime and are taxed at an effective rate below 25%.[40] The provision also includes a conduit rule along the same general lines as US code provision section 7701(l).[41]

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[35] *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market*, at 9, COM (2017) 547 final (Sept. 21, 2017),
https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_taxation_digital_single_market_en.pdf.

[36] *Id.* at 10.

[37] That position paper was released after tax reform was introduced in the US House and US Senate, but before the 2017 Act passed.

[38] *See* HM Treasury, Budget 2018 Digital Services Tax (Oct 29.
2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752172/DST_web.pdf

[39] *See* PricewaterhouseCoopers LLP, India Budget 2018: Aiming for the Bullseye 28 (Feb. 2018), https://www.pwc.in/assets/pdfs/budget/2018/aiming_for_the_bullseye_pwc_union_budget_2018_booklet.pdf.

[40] *See* Einkommensteuergesetz [EStG] [German Income Tax Act], § 4j; *see also, e.g*., EY, German Parliament adopts legislation on limitation of tax deduction of royalties and tax exemption of restructuring gains (May 2, 2017).

[41] *Id.* ("If (i) the recipient of the payments or (ii) another party related to the German payer incurs expenses for license rights from which the rights derive that are licensed to the German payer, and the recipient of those payments benefits from an unqualified IP regime, then the deduction of the German licensee's payments are denied to the extent the ultimate payment recipient faces an effective rate below 25%.")

In 2017 the UK also opened consultations on a royalty withholding tax proposal, which is now scheduled to be enacted and in force from 6 April 2019.[42] This withholding tax would generally apply where a non-UK entity making sales in the UK does not have a taxable presence in the UK. Withholding is also extended to payments for the right to distribute goods or perform specified services in the UK. Since there is no UK entity making a payment, the proposal applies almost exclusively to cases where a non-UK company selling to UK customers pays a royalty to a 3rd country jurisdiction. HMT describes the proposal as a step to tax the digital economy, but acknowledges that it has application beyond the digital sector. For example imagine a Brazilian MNC has a subsidiary in Ireland making sales in the UK and paying a royalty to an entity in the Cayman Islands. Under these proposals, the UK would be trying to withhold from the royalty paid from Ireland to the Cayman Islands. The proposal thus raises the enforcement issues raised in the canonical *SDI Netherlands* case.

Realistically, more unilateral measures to increase source country taxation, market country taxation, or both are coming. These changes are likely to be somewhat uncoordinated, and sometimes unprincipled. Moreover, these moves toward source or market country taxation are likely to affect "old-line" businesses as well as the digital sector. Tax directors of multinationals in a wide range of industries already highlight that the label "BEPS" is used to justify a wide range of source-country tax adjustments that produce significant tax controversies.

Historically the multilateral international tax architecture was focused on residence country taxation. The international tax architecture around the world appears to be shifting towards more source-based or destination-based taxation, but that transition is turning out to be very messy. The strategic questions for the United States created by this unsettled state of international tax affairs featured prominently in the final round of discussions about US international tax reform.[43]

ID. US Tax Reform, the BEAT and the GILTI

By the time of the 2016 elections, there was widespread consensus that the United States needed to reform its aberrant international corporate tax system. Commentators called for a lower corporate tax rate, and a move away from a deferral system and towards the dividend exemption systems that had become an international norm. Other countries had been taking these steps for years, while also increasing their reliance on consumption taxes and decreasing their reliance on corporate income taxes.

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[42] See https://www.gov.uk/government/publications/offshore-receipts-from-intangible-property/income-tax-offshore-receipts-in-respect-of-intangible-property

[43] *International Tax Reform: Hearing Before the S. Fin. Comm.*, 115th Cong. (2017) (testimony of Itai Grinberg, Professor of Law, Georgetown University Law Center), https://www.finance.senate.gov/imo/media/doc/Grinberg%20October%202017%20SFC%20International%20Tax%20Testimony%20FINAL.PDF [hereinafter "Grinberg Senate Testimony"].

Nevertheless, at the outset of 2017, few commentators thought the US political system would successfully bring a tax reform package to fruition. Then, as we all know, the United States surprised the world by enacting tax reform. The international corporate component of the reform was labeled as a shift to a "territorial" regime. However, the law enacted actually moved the United States closer to a current worldwide tax system for outbound taxation, instantiated in a regime now known as the "GILTI." At the same time, the US followed the global trend in enacting unilateral measures intended to strengthen inbound taxation. The United States' did so by adopting the "base erosion anti-abuse tax" in new section 59A of the Code ("BEAT").

The GILTI is the main subject of Dana Trier's conference paper and the panel immediately preceding the presentation of this paper at the conference. Therefore I will not go to any great lengths to describe the GILTI here. Practitioners have also written about the various twists and turns of the BEAT, and I do not propose to reconstruct the full breadth of that discussion, either. Nevertheless, for the sake of completeness a brief background on these provisions is appropriate.

ID.1. GILTI

Section 951A requires each US shareholder of a controlled foreign corporation ("CFC") to include currently in its gross income its share of global intangible low-taxed income ("GILTI") for the year. In very general terms, GILTl refers to a US shareholder's share of a CFC's income above a 10 percent return on qualified business asset investment ("QBAI") with respect to everything other than five enumerated categories of CFC income. Those categories are effectively connected income, subpart F income, income that would be subpart F income but for the section 954(b)(4) high-tax kickout, certain intercompany dividends, and foreign oil and gas extraction income. A US shareholder of a CFC includes in income its GILTI in a manner similar to the inclusion mechanism for subpart F income. GILTI is eligible for a fifty percent deduction under section 250 (through 2025). Therefore, a minimum effective US tax rate of 10.5 percent applies to all GILTI earnings of CFCs of US shareholders. Special rules apply regarding foreign taxes associated with GILTI. Very generally, if a US shareholder that is a domestic corporation elects to take foreign tax credits for a taxable year, all of the foreign taxes associated with GILTI are included in its income as a deemed dividend under section 78. However, only 80 percent of these foreign taxes are allowed as deemed paid foreign tax credits in the new GILTI foreign tax credit basket.[44]

The New York State Bar Association ("NYSBA") observes that the GILTI can be understood conceptually as a hybrid between "a flat minimum domestic and foreign tax rate on a US shareholder's GILTI inclusions not associated with QBAI (the 'flat rate theory') and the imperfect adding of the GILTI regime onto the subpart F regime (the 'add-

[44] 26 USC. § 960(d)(1).

on theory')."[45] One's understanding of which theory should dominate can influence many regulatory decisions. But no matter how one thinks about the regime enacted in the statute (or how the regulations are written), the regime will generally produce at least a minimum 10.5% combined domestic and foreign tax on a US shareholder's GILTI not attributable to QBAI.[46] Moreover, given that the concerns in international tax policy are overwhelmingly intangible income-driven, and that the digital sector is "tangible asset light," ignoring QBAI constitutes a reasonable first-order simplification for purposes of this paper.

Finally, it should be noted that most of the complexity entailed by the international tax regulations now being issued by the United States Treasury in this area are the product of the QBAI concept, the foreign tax credit basketing system enacted for GILTI, and the legislative design decision to layer a shareholder level calculation on top of entity-level concepts. None of these features is inherent in or essential to enacting a flat rate minimum tax policy.[47]

ID.2. The Relationship between GILTI and the Digital Tax Debate

The consequences of GILTI for the international tax debate in the "digital" space should have been profound. When the BEPS project began, the digital economy was a special area of focus because it was considered an important case of so-called "stateless income."[48]

Following the 2017 legislation, the minimum tax rates on foreign earnings achievable for US-headquartered firms have changed. Speaking generally, an intangible driven US-parented multinational simply will not be able to achieve an effective tax rate on their foreign earnings that is below 10.5%. An effective rate of 10.5% for corporate shareholders

[45] New York State Bar Ass'n [NYSBA] Tax Section, Report No. 1394 on the GILTI Provisions of the Code 15 (May 4, 2018), http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2018/1394_Report.html.

[46] Given the FTC limitations imposed because of the GILTI FTC basket, in many situations the combined US and foreign tax rate on CFC income will be well in excess of 13.125%.

[47] Indeed, neither Camp "Option C," as eventually proposed in HR 1 2014 when Representative Camp (Republican from Michigan) was chairman of the House Ways and Means Committee, nor the "Option Y" and "Option Z" proposals released by Senator Baucus (Democrat from Montana) in 2013 when he was Chair of the Senate Finance Committee included a QBAI concept. Options Y and Z also used a partial exemption/partial full inclusion and foreign tax credit and expense disallowance mechanisms that may represent a more sensible and elegant way to address limitations on foreign tax credits and related expense allocation issues in a minimum tax regime than the mechanism ultimately adopted by the United States in 2017.

[48] OECD, *Addressing the Tax Challenges of the Digital Economy, BEPS Action 1: 2014 Deliverable*, 112 (Sept. 16, 2014) ("The comprehensiveness of the BEPS Action Plan will ensure that, once the different measures are implemented in a co-ordinated manner, taxation is more aligned with where economic activities take place… with the aim to put an end to the phenomenon of so-called stateless income."). In fact large US firms based in Silicon Valley were achieving very low rates of tax on their foreign earnings under the old US international tax regime. *See* European Commission, *Report of the Commission Expert Group on Taxation of the Digital Economy* (May 28, 2014). Consequently, European sovereigns took the position that special measures might be needed to solve this problem, unless the US acted and imposed tax on the relevant firms. At the same time, all the large developed economies said they had no interest in shifting the balance between source and residence. France, Germany and the United Kingdom were particularly strong on this point.

(after taking into account the 50% deduction described above) is comparatively unfavorable to the CFC regimes of most of the major trading partners of the United States, which typically tax CFC earnings in relatively limited circumstances. As a practical matter the consequence is that BEPS leading to stateless income – the original driver for the entire international tax reform debate – is now a phenomenon that exists only for non-US headquartered multinationals.

Google, Apple, Facebook, Amazon, the four companies specifically targeted in documents issued at various points by the Commission, the French government, and the German coalition agreement, each face a 10.5% minimum tax on their foreign earnings. Since every EU member state has a dividend exemption system that does not include a minimum tax, and instead provides a 0% tax rate on foreign earnings when repatriated, companies like Volkswagen, Allianz, Daimler, Siemens in Germany, or BNP Paribas and Carrefour in France do not face a minimum tax burden on their foreign earnings. They can, and in some circumstances still do, generate stateless income and achieve 0% tax on their foreign earnings. That is the reality of current US corporate tax law as compared with the current corporate tax law of the largest continuing members of the EU. Meanwhile, the UK's corporate tax reforms beginning in 2012 were explicitly designed to ensure the ability of UK-headquartered multinationals to achieve a zero rate of tax on foreign earnings by generally exempting those earnings from UK tax.

Therefore, when the Commission or HMT now propose a solution for the digital sector, that proposal is not about addressing low taxed income or leveling an unlevel playing field – the justifications given for rule changes in BEPS just a few years ago. Rather, the proposals are now clearly about a revenue shift to move tax revenue from jurisdictions of residence to the jurisdictions where digital companies have users.[49]

ID.3. BEAT

The BEAT was enacted to address legislative concerns that the former US international tax regime made foreign ownership of almost any asset or business more attractive than US ownership from a tax perspective, thereby creating tax-driven incentives for foreign takeovers of US firms and foreign acquisition of business units previously owned by US MNCs and financial pressures that encourage US MNCs to "invert" (move their headquarters abroad), produce abroad for the US market, and shift business income to low-tax jurisdictions abroad. Until recently, little policy attention was given to reining in the benefits that US law gives to inbound multinationals that make foreign status more attractive than domestic status. In this regard the US was a global outlier: in the rest of the world, governments have been focusing their policy efforts almost exclusively on inbound taxpayers that minimize their income in local jurisdictions since the onset of the

[49] For a balanced perspective on the broader question, *see* Wolfgang Schön, *Ten Questions about Why and How to Tax the Digitalized Economy,* 72 Bull. Intl. Taxn. 4/5, at 79-81 (2018).

financial crisis. With the BEAT, the US took a bold but highly imperfect step to join the global consensus that inbound must be addressed.

New section 59A of the Code imposes an additional tax equal to the "base erosion minimum tax amount" (the "BEAT tax") of "applicable taxpayers."[50] The BEAT tax generally means "the excess (if any) of an amount equal to 10 percent… of the modified taxable income of such taxpayer for the taxable year, over an amount equal to the regular tax liability… of the taxpayer for the taxable year, reduced (but not below zero) by [certain credits]."[51] In other words, the BEAT tax is calculated as the difference between the corporation's regular tax liability and an alternative calculation based on the corporation's modified taxable income.

Modified taxable income for BEAT tax purposes is generally defined as taxable income computed without regard to any deduction with respect to a payment to a foreign related party.[52] Certain exceptions (notably for certain payments for services) apply. Payments for cost of goods sold ("COGS") also have no effect on the calculation of modified taxable income because, as a technical matter, COGS are a reduction in gross receipts (rather than a deductible payment).[53] The characterization of payments, especially with respect to transactions involving bundled services and goods, can therefore affect whether a payment is within the scope of the BEAT provision. The BEAT's "modified taxable income" base is also determined without regard to the base erosion percentage of any net operating loss ("NOL") allowed for the tax year.

Only "applicable taxpayers" are subject to the BEAT at all. To be an applicable taxpayer, a US corporation and its affiliates[54] must meet certain criteria.[55] Notably, the US corporation generally must have a "base erosion percentage" of 3 percent or higher. This

[50] 26 USC. § 59A(a). Section 59A is effective for "base erosion payments" paid or accrued in taxable years beginning after December 31, 2017.
[51] § 59A(b)(1). Regular tax liability is defined in section 26(b). The applicable credits are: the excess of "the credits allowed under this chapter against such regular tax liability" over, the sum of those "allowed under section 38 for the taxable year which is properly allocable to the research credit determined under section 41(a)"; and "the portion of the applicable section 38 credits not in excess of 80 percent of the lesser of the amount of such credits. I.R.C. § 59A(b)(1)(B). Applicable section 38 credits are defined in section 59A(b)(4).
[52] § 59A(d). To be more precise, base erosion payments include any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable, any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer in connection with the acquisition by the taxpayer from such person of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation, reinsurance payments paid or accrued by the taxpayer to a foreign person which is a related party, and certain other payments to an expatriated entity which is a related party of the taxpayer which result in a reduction of the gross receipts of the taxpayer.
[53] An item included in COGS can qualify as a base erosion payment if it is paid to certain inverted corporations or members of an expanded affiliated group of an inverted corporation. *See* § 59A(d)(4).
[54] § 59A(e)(3) treats those persons classified as a single employer under section 52(a), with some modification, as a single taxpayer for the purposes of calculating gross receipts and base erosion percentage.
[55] Regulated investment companies, real estate investment trusts, and S corporations are also exempt from the BEAT.

base erosion percentage is generally determined by dividing the aggregate amount of a taxpayer's "base erosion tax benefits" for the taxable year, by the sum of the aggregate amount of the deductions allowable to the taxpayer, plus certain base erosion tax benefits allowable to the taxpayer.

The BEAT has been the subject of cogent critiques by the NYSBA and other commentators.[56] The key BEAT complications for purposes of this discussion relate to the treatment of foreign tax credits and the base erosion percentage concept. In my view, these two features of the BEAT should be removed.

Most tax credits are disregarded in determining regular tax liability for purposes of the BEAT calculation.[57] Most importantly, foreign tax credits are disregarded. The treatment of foreign tax credits under the BEAT disfavors foreign taxes paid by BEAT taxpayers relative to any other business expense. In other words, foreign taxes are in effect not even deductible for BEAT taxpayers. In various circumstances, the rule disregarding the value of foreign tax credits for purposes of measuring hypothetical regular tax liability increases the BEAT minimum tax dollar for dollar.[58] Foreign taxes paid by US MNCs are thus treated almost as if they were equivalent to bribes and payments made to entities in Iran and North Korea. This treatment is not justifiable. Moreover, disallowing foreign tax credits has no clear relationship to base erosion.

Second, if a taxpayer's "base erosion percentage" is 3% or less, they are not subject to the BEAT. The base erosion percentage is generally determined by dividing the aggregate amount of "base erosion tax benefits" of the taxpayer for the taxable year, by the sum of the aggregate amount of the deductions allowable to the taxpayer plus certain other tax benefits allowable to the taxpayer. Since both the numerator and denominator of the base erosion percentage fraction represent gross rather than net concepts, the rule is highly manipulable, and the cliff feature encourages manipulation.

Importantly, the BEAT includes a broad grant of regulatory authority to the Treasury. The provision includes specific authority to prescribe such regulations as may be necessary or

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[56] *See* NYSBA Tax Section, Report No. 1397 on Base Erosion and Anti-Abuse Tax 6 (July 16, 2018), http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2018/1397_Report.html. The report politely explains a number of the ways in which the BEAT as enacted functions poorly. Certain drafting errors associated with the current BEAT were deemed sufficiently problematic that the NYSBA felt compelled to write that "we believe that Treasury has authority to construe the provision logically in regulations to implement its legislative purpose, even in the absence of literal statutory support."

[57] Disregarded credits include foreign tax credits, 20 percent of low-income housing credits (section 42(a)), 20 percent of renewable energy production credits (section 45(a)), and 20 percent of section 46 investment credits allocable to the energy credit (section 48). Research and Experimentation credits are not disregarded for purposes of establishing the hypothetical regular tax amount against which BEAT liability is in effect compared.

[58] For examples and a formula, *see generally* Martin A. Sullivan, *Economic Analysis: The BEAT in a Diagram and an Easy-to-Use Spreadsheet*, Tax Notes (June 26, 2018), https://www.taxnotes.com/tax-reform/economic-analysis-beat-diagram-and-easy-use-spreadsheet.

appropriate. The BEAT also includes a number of specific grants of regulatory authority. These include providing "for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including through" the use of unrelated persons, conduit transactions, other intermediaries, or transactions designed in whole or in part to characterize payments otherwise subject to the BEAT as not subject to the BEAT, or (quite extraordinarily) even regulations preventing taxpayers from obtaining benefits from substituting payments not subject to the BEAT as drafted with payments that would normally not be subject to the BEAT.[59] The intent behind the scope of this remarkable grant of specific regulatory authority is not discussed in the legislative history. Nevertheless, the language is sufficiently expansive as to raise the question of whether Congress intended the BEAT to give Treasury authority to reconsider allocation of profits generally for minimum tax purposes.

Part II. Value Creation and User Participation[60]

Academic commentators of all ideological stripes have now explained in multiple articles that the international tax system is not now, and never has been, based on a value creation principle.[61] Moreover, as I suggested in Part IA, no one entirely knows or agrees on the precise meaning of "value creation." Finally, the consensus academic view is that any exercise to define specific sources of value creation is entirely subjective.[62]

Nevertheless, post-BEPS, various governments often repeat the mantra that "the international tax framework is based on a principle that the profits of a business should be taxed in the countries in which it creates value."[63] One proposal that features prominently among "value creationists" is known by the label "user participation." It purports to give appropriate credit to user participation in value creation in the digital economy. This idea originated from HMT, was then taken up by the European Commission, and is now being studied by the OECD.

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[59] Section 59A(i).

[60] Part II of this paper draws heavily from a piece I recently published in the British Tax Review. Itai Grinberg, *User Participation in Value Creation*, British Tax Review (forthcoming 2018).

[61] *See, e.g.*, Michael P. Devereux & John Vella, *Implications of Digitalization for International Corporate Tax Reform* (Oxford Univ. Centre for Business Taxation, Working Paper No. 17/07, 2017), https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_17/WP1707.pdf; Allison Christians, *Taxing According to Value Creation*, 90 Tax Notes Int'l 1379 (June 18, 2018); Joanna Hey, *"Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative*, 72 Bull. Intl. Taxn. 4/5 (2018).

[62] *Id.*

[63] *See, e.g.*, HM Treasury, Corporate Tax and The Digital Economy: Position Paper Update, ¶ 1.1 (Mar. 2018), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf [hereinafter "HMT Position Paper Update"]. A number of other reforms for the international tax system are also described by their advocates as reflecting the "value creation principle." One can best make sense of this development if one thinks of claiming the mantle of "value creation" as simply a claim that the reform being discussed should be the new multilateral norm.

HMT and the European Commission both maintain there is something distinctive about value creation in the digital economy. They focus on the example of a user uploading data on a social media platform to illustrate the importance of user participation in the digital space. The Commission argues that in this case user participation contributes to value creation because users' "data will later be used and monetised for targeted advertising. The profits are not necessarily taxed in the country of the user (and viewer of the advert), but rather in the country where the advertising algorithms has been developed, for example. This means that the user contribution to the profits is not taken into account when the company is taxed."[64]

HMT and the Commission also assert there is something special about online marketplaces and other "collaborative platforms," that "generates revenue through matching suppliers and purchasers of a good", or "charges a commission for bringing together supply and demand for assets and possessions owned by individuals. The success of those businesses is reliant on the active involvement of users on either side of the intermediated market and the expansion of that user base to allow the business to benefit from network effects, economies of scale and market power."[65] In contrast, HMT claims participation of users in non-digital businesses is generally "passive."

Two immediate questions arise with respect to the user participation theory put forth by HMT and the Commission. The first question is whether there is any reason to believe that users only meaningfully contribute to value creation in the context of certain digital platforms. The second is how, across the whole of the economy, one would determine when users contribute to value creation, and to what degree.

If user participation is a meaningful concept, it cannot be rationally limited to information communication technologies. Consider a clinical trial from a user participation perspective: such trials involve a corporation giving thousands of individuals free medicine over a period of years in exchange for those users providing deeply personal medical data, as well as a service to the company – the use of their bodies for purposes of experimentation. The resulting data is monetized by obtaining a patent and customizing products to specific diseases and patient populations. This user data is also required for regulatory approvals, without which the company may not sell anything at all.

The data provided by patients is deeply private biometric and health information. In this sense, the data users provide in exchange for free products in the medical economy is often substantially more extensive and personal than the data that a digital user provides. Moreover, their engagement with the providers of their treatment is often more sustained

[64] European Commission Memorandum MEMO/18/214, Questions and Answers on Fair and Efficient Tax System in the EU for the Digital Single Market (Mar. 21, 2018), http://europa.eu/rapid/press-release_MEMO-18-2141_en.htm.
[65] *See* HM Treasury, Corporate Tax and The Digital Economy: Position Paper, ¶ 3.18 (Nov. 2017), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661458/corporate_tax_and_the_digital_economy_position_paper.pdf.

than a digital user of a social media platform. After all, in some cases disengaging from the company (ceasing to supply data in exchange for treatment) might fundamentally impact a drug user's health. In sum, both active user participation and data contribution appear to be part of the medical economy.

The most meaningful objection to the above analogy between user participation in the digital economy and user participation in the medical economy relates to the fact that the medical economy generally does not benefit from either "multisided business models" or network effects. Indeed Commission, HMT, and OECD documents each often highlight these two economic phenomena in describing potential justifications for a special profit allocation for user participation in the digital economy. [66]

Neither multisided business models nor network effects are new economic phenomena, nor are those phenomena limited to the digital platform businesses affected by user participation proposals. Multisided platform businesses are generally defined as businesses that a) offer distinct products or services, b) to different groups of customers, c) whom a "platform" connects, c) in simultaneous transactions. In simpler terms, they are market makers – businesses that help unrelated parties get together to exchange value. Network effects refer to the phenomenon whereby a product or service gains additional value as more people use it.

Before the advent of the internet, the classic example of a multisided business model with network effects used in economics discussions involved financial intermediation. Credit card businesses represent one example. On one side of the business consumers are offered convenience and financing, and on the other side merchants obtain a mechanism to receive payment other than in cash. Moreover, the more merchants accept a credit card, the more attractive a credit card is to consumers, and the more consumers hold a credit card, the more willing merchants are to accept the card and its related interconnection fee. [67] Other "non-digital" multi-sided business models with network effects include newspapers, traditional broadcast television, video game consoles, financial exchanges, and even farmer's markets (which charge rent to sellers, and allow shoppers to enter the market for free).

Of course a farmer's market has network effects because it is more valuable to buyers and sellers respectively to the extent that there are more famers and more local shoppers participating. However, the magnitude of the network effect is much greater, and

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[66] *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market*, *supra* note 35, at 9; OECD, Tax Challenges Arising from Digitalisation – Interim Report 2018 (2018), *supra* note 3, para 47, page 28.

[67] These businesses all exhibit what economists call "indirect network effects." D. Evans & R. Schmalensee, Matchmakers: The New Economics of Multisided Platforms 667 (2016). Indirect network effects exist where the value of the two-sided platform to one group of participants depends on how many members of a different group participate. Evans & Schmalensee 25. Airbnb, Uber, and other businesses that intermediate transactions between groups of buyers of goods and services and groups of sellers of goods and services also share this feature that the value they provides increases as the number of participants on both sides of the platform increases.

potentially more salient for tax purposes, when the "platform" (the marketplace) involved can intermediate transactions globally. That issue of magnitude is presumably what HMT and the European Commission think is special – network effects and multi-sided business models combined with so-called "cross-jurisdictional scale without mass."

Focusing on the issue of large network effects combined with cross-jurisdictional scale without mass brings us to financial exchanges. Network effects are the key feature of successful financial market making, because for transactions to take place there must be both buyers and sellers. Specifically, market liquidity is an important feature in determining transaction costs and making a market attractive to participants, and the number of participants is what determines liquidity. As the number of buyers and sellers on a given exchange increase, liquidity increases, and costs fall. Without enough buyers and sellers, the market literally falls apart.

As an example, consider the Lloyd's insurance marketplace, based in the UK. The vast majority of Lloyd's business involves insuring non-UK risks, often without any physical presence in the jurisdictions where the covered risk exists on behalf of either Lloyd's or the underwriters and syndicates that form the Lloyd's marketplace.[68] Moreover, the vast majority of the capital in the Lloyd's market does not come from the UK.[69] But, as Lloyd's itself explains, the certainty provided by the marketplace as well as the network effects from Lloyd's global network of insurance companies, brokers, and coverholders "makes Lloyd's the world's leading (re)insurance platform."[70] The London stock exchange is another important financial marketplace, albeit one where at least some of the offerings are not as bespoke (and therefore require less data) than is customary at Lloyd's.

Do users somehow participate less "actively" in traditional financial marketplaces when they enter into transactions than they do in online sharing marketplaces? The key participation feature of online marketplaces are reviews and ratings of sellers and buyers. Much more complex user data is shared among the specialist syndicates, brokers, and coverholders participating in the Lloyd's insurance market than is shared by short term renters on a vacation rentals platform[71]. And these market participants interact in more complicated ways than do renters and owners. Moreover, Lloyd's has now created a mandate that syndicates enter into many of their contracts electronically over a digital platform.[72] So, using Lloyd's as an example, it becomes difficult to see the clear distinction between an insurance intermediation platform and, for instance, the accommodation

[68] *See* Lloyd's, Annual Report, at 3 (2017), https://www.lloydsbankinggroup.com/globalassets/documents/investors/2017/2017_lbg_annual_report_v3.pdf (approx. 85% of the risks insured by Lloyd's are non-UK risks).
[69] *See id.* (only 13% of the capital in the Lloyd's market comes from the UK insurance industry).
[70] Lloyd's, Lloyd's in the US, 2 (2016), https://www.lloyds.com/lloyds-around-the-world/americas/us-homepage/about-us.
[71] Or, as HMT puts it user participation in reviewing and rating "services provided by third parties is crucial in regulating what appears on the platform and establishing an important trust mechanism for other users." HMT Position Paper Update, *supra* note 63, ¶ 2.24.
[72] *See* Lloyd's, Market Bulletin Y5170: Electronic Placement Mandate (Mar. 20, 2018), https://www.lloyds.com/market-resources/requirements-and-standards/electronic-placement.

intermediation platform represented by Airbnb. It is true that historically one business (reinsurance) was globalized before the advent of the internet while the other (home rentals) was not. And historically underwriters sometimes exchanged views offline, while renters often found it hard to exchange views at all. However, now both businesses are globalized, users on both the buy side and the sell side share their views with one another in both industries, and one industry is fully digitalized while the other is working to move in that direction. It seems intellectually unsustainable to claim there is a relevant difference with respect to user participation between the accommodation traded on Airbnb and bespoke products traded electronically in financial markets.

The Internet of Things ("IoT") is likely to make the distinction between businesses with network effects and multisided business models and more 'traditional" business even harder to maintain. IoT refers to the network of physical objects embedded with sensors and network connectivity that allows the collection and exchange of data. Such sensors are becoming ubiquitous in the devices we encounter in our daily environment. A large number of IoT applications are being developed in various domains by start-ups, SMEs, and large MNCs alike.[73]

One widely discussed IoT example is the idea of the "connected car." Connected cars are likely to feature seats that face a windshield that is akin to a computer screen.[74] Trends in automotive research and development involve navigation and entertainment display screens built into the dashboard to offer internet-based information and media, as well as sensors intended to pick up information from roads and other networked cars. On one model of what constitutes "active user participation," a connected car would have all the components for user participation in place. The user would provide geo proximity data by driving, financial information by leasing, and be in a car that acts as a channel to deliver advertising to a "captive" recipient.

On another model, use of a connected car would not constitute "active user participation" because the user of a connected car would not be actively writing a message or rating a product or service. In that case, however, clicks on a social media platform would also seem to constitute "passive" user participation. It seems inconceivable that "going" to a website or "searching" virtually should be classified as active user participation but going somewhere physically should be classified as passive activity.

Some projections suggest that there will be more than thirty billion IoT devices in use by 2020.[75] In addition to connected cars, commercial and industrial applications, driven

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[73] *See, e.g.*, Thibault Degrande, Frederic Vannieuwenborg, Sofie Verbrugge & Didier Colle, "Multi-sided Platforms for the Internet of Things," 372-81 (2018).

[74] For high-level discussion, *see, e.g.,* PricewaterhouseCoopers, 2017 Automotive Industry Trends: The future depends on improving returns on capital (2017), https://www.strategyand.pwc.com/media/file/2017-Automotive-Industry-Trends.pdf.

[75] Chin-Lung Hsu & Judy Chuan-Chuan Lin, *An empirical examination of consumer adoption of Internet of Things services: Network externalities and concern for information privacy perspectives*, *in* 62 Computers

largely by building automation, industrial automation, and lighting, are projected to account for many of the new connected devices coming into use between 2018 and 2030.[76] If those projections come to pass, it is hard to imagine that user participation in historically non-digital sectors will not exceed any de minimis user participation threshold.

In sum, it does not seem intellectually defensible to suggest that users only meaningfully contribute to value creation in the context of certain digital platforms, or to think that the boundaries of the idea are clear enough to allow for anything approaching reasonable implementation. Indeed, as articulated thus far it is difficult to view the proposal as anything other than either a) ill-conceived or b) transparently instrumentalist and mercantilist.

But understanding the user participation perspective remains important. For one thing, the user participation proposal highlights the political angle much of Europe brings to the current digital tax debate. Even more importantly, HMT and the Commission have both suggested that when "active user participation" is present, "jurisdictions in which users are located should be entitled to tax a portion of those businesses' profits."[77] HMT wishes to achieve this result using what is in effect a formulary system.[78] The Commission proposes doing so based on a facts and circumstances arm's length analysis of the value of user participation.[79] Either way, these proposals seek to allocate some (although not all) of the excess return of a business to the destination jurisdiction. And that issue – destination-based income taxation – lies at the heart of the intellectual debate about the future of the corporate income tax as applied cross-border.

Indeed, the core of Part III is a discussion of a proposal for allocating excess returns through a reform of the international tax system that would create a hybrid between a destination-based income tax and the present residence-based system. Such a system would, like the user participation proposals, allocate a part of the excess return of a business to market ("user") jurisdictions. Thus, the second key question regarding a user participation proposal, namely, how, across the whole of the economy, one would determine to what degree users contribute to "value creation," is conceptually parallel to the question of how,

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in Human Behavior 516-27 (2016). Additional projections suggest that thirty billion IoT devices by the year 2020 may be a conservative estimate. Global information firms estimate that the number of IoT devices connected worldwide already exceeds the thirty billion threshold, *see* IHS Markit, IoT Trend Watch 2018, at 4 (2018), and industry professionals have proposed that the number of devices "could approach 100 billion by the end of 2040." *See* Kathryn Cave, *What will the internet look like in 2040?*, IDG Connect (Sept. 8, 2015), https://www.idgconnect.com/blog-abstract/10383/what-internet-look-2040.

[76] *Id.* IHS Markit, IoT Trend Watch 2018, at 4 (2018).

[77] *See* HMT Position Paper Update, *supra* note 63, ¶ 3.7.

[78] *See* HMT Position Paper Update, *supra* note 63, ¶¶ 3.62-3.75.

[79] European Commission, Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM(2018) 148 final (Mar. 21, 2018), https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_common_system_digital_services_tax_21032018_en.pdf. European Commission, Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM(2018) 147 final (Mar. 21, 2018), https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf.

across the whole of the economy, one would allocate a part of the excess return to market jurisdictions. That is the "bridge" between the user participation proposal and the "marketing intangibles" or "DBRMPA" proposal described in Part III. Importantly, this means that all of the technical and administrative issues that will be described in Part IIIB below also apply in equal measure to any user participation proposal.

The principled issue is whether, how, and to what degree, across the whole of the economy, law should allocate the excess return of a business to consumer/user/market jurisdictions for corporate income tax purposes. The key difference between the proposal described in Part III and the user participation theory is that the proposal in Part III does not attempt to ring-fence the digital economy. Rather, it tackles this allocation question generally, without resorting to unsustainable and unjustifiable distinctions in business models.

Part III. Where We Go from Here: Destination-Based Income Tax Reform?

This Part considers the "marketing intangibles" or DBRMPA idea that constitutes a compromise between the current transfer pricing system and a destination-basis income tax. This hybrid approach may be under consideration in some form or other at the OECD. My formulation of this approach may or may not be the same as what is under discussion at the OECD, as the proposal has not been publicly described in any detail. However, no matter how a marketing intangibles concept is formulated, certain key issues will have to be addressed. These include how to split excess returns between the current arm's length system and an allocation to market countries, and how to determine destination so as to split the amount allocated to market countries among such countries.

The DBRMPA described here is a compromise between the present transfer pricing system and a form of destination-based income tax known as a destination-based residual profit allocation ("DBRPA"). The DBRMPA proposal divides intangible returns between those generated by so-called "customer-based" or marketing intangibles and those generated by other (presumably usually "production-based") intangibles. Residual returns deemed attributable to customer-based or marketing intangibles would be allocated to the market – the jurisdictions where the customers reside. Residual returns deemed attributable to other intangibles would be allocated based on current transfer pricing rules (i.e., the BLTV). Importantly, in this sense the DBRMPA functions in the same way as user participation, but does so across the whole economy, instead of ring-fencing this change based on a cliff effect determined by whether a business is categorized as being "digitalized" or not.

IIIA. Background: The Destination-Based Residual Profit Allocation

The DBRPA proposal was developed by a group consisting of Alan Auerbach, Michael Devereaux, Michael Keen, Paul Oosterhuis, Wolfgang Schön, and John Vella. The idea is explained in the excellent paper authored by Joe Andrus and Paul Oosterhuis for this conference in 2016 entitled "*Transfer Pricing After BEPS: Where Are We and Where Should We Be Going*." Further details appear in a presentation given by Paul Oosterhuis

at Oxford University in 2016.[80] The proposal represents an attempt to move towards a destination-basis corporate income tax system by means that can at least be described as remaining consistent with some of the principles of the current "arm's length" transfer pricing architecture.

The DBRMPA is fundamentally a compromise between a destination-based residual profit allocation (DBRPA) and the current transfer pricing system. Thus, analyzing the DBRMPA first and foremost requires understanding the DBRPA.[81]

The DBRPA proposal is animated by the understanding that the location of consumers is less mobile than the location of booked profits, intellectual property, corporate assets, corporate employees, or any other element of value creation. In this sense it is similar to sales-based formulary apportionment. However, the DBRPA attempts to separate "excess" or "residual" returns from "routine returns," and provide a normal rate of return to productive functions. The first-order advantages of a DBRPA are supposed to be reduced incentives to shift income to low-tax jurisdictions, reduced complexity and reduced administrative burdens.

The core idea is to salvage the existing arm's length system with respect to routine returns, while using a sales-based system to allocate residual returns. How would it work? To allocate excess/residual returns, the DBRPA deems the country in which customer sales take place to be an "entrepreneurial" affiliate with respect to local market sales, and ascribes all "non-routine" profits to that affiliate.[82] Achieving this result would require MNCs to measure gross revenues by country and by product using some concept of "destination" or "place of supply." Global costs would need to be measured at a product line level, and then either traced or apportioned out to revenues from specific countries.

The DBRPA mechanism for allocating the residual share to the market is quite similar to a cost-sharing approach for allocating income attributed to intangibles. However, instead of allocating the residual profit to an "entrepreneurial risk-taker" in an MNC group defined

[80] *Id.* at 89. *See* Paul Oosterhuis, *Skadden Arps LLP, Residual Profit Allocation Proposal at Oxford University Summer Conference 2016* (June 27, 2016), available at https://www.youtube.com/watch?v=AjSxfUBMHnY&list=PLtXf43N26Zids6PowkWDV7oQo7HwoNspy &index=8&t=0s; *see also* Michael Devereux, *Residual Profit Allocation Proposal at Brookings / Tax Policy Center Conference* on "A Corporate Tax for the 21st Century" (July 14, 2016), available at https://www.taxpolicycenter.org/sites/default/files/residual-profit-allocation-proposal_2.pdf.

[81] Analyzing the DBRMPA is also easier if one is familiar with formulary apportionment, sales-based formulary apportionment, and residual formulary apportionment. Those ideas, as well as the DBRPA, were described in a paper for the 2016 iteration of this conference authored by Joe Andrus & Paul Oosterhuis entitled "*Transfer Pricing After BEPS: Where Are We and Where Should We Be Going*," available at https://www.skadden.com/-/media/files/publications/2017/03/transfer-pricing-afterbepswhereareweandwhereshould.pdf. Given the relative consistency of participation in the University of Chicago conference, in this Part I often assume familiarity with the excellent Andrus & Oosterhuis paper. Readers wishing to refresh their memory of formulary apportionment, RFA and DBRPA as well as some of the issues that arise with those proposals are directed to pages 96 to 104 of that paper.

[82] *See* Michael Devereux, *supra* note 80.

as the affiliate that owns the intangible property and takes on financial risk (as in contemporary cost-sharing models), the residual profit is instead allocated to affiliates in the respective market jurisdictions. The proposal in effect imposes deemed contractual arrangements to which traditional transfer pricing methods are then applied. As a result, the DBRPA allocates excess returns on a product line by product line basis rather than an entity by entity basis. In doing so it appropriately escapes the "formulary apportionment" label.

Comparison of DBRPA with Sales-Based Formulary Apportionment

The most important difference between a DBRPA and sales-based formulary apportionment ("FA") is that a DBRPA would modify transfer pricing methodologies so as to allocate only "excess" or "residual" profits to the jurisdiction of sale.[83] Sales-based formulary apportionment systems do not necessarily allocate any income to jurisdictions where corporate functions takes place. In the US, our status as a very large market obscures this concern that sales-based formulary apportionment raises. But consider a small jurisdiction; let's call it Denmark. Whatever the theoretical merits, it is probably hard for politicians to explain to Danish taxpayers that a Danish corporation which exploits a range of local benefits to make outputs that are wholly or almost wholly exported will pay no or almost no corporate income tax in Denmark. The cost-plus markup on productive functions in the DBRPA is somewhat responsive to the concern that sales-based formulary apportionment provides no revenue to jurisdictions where economic activity takes place. It solves the "Denmark problem" to some degree.

Although DBRPA is not a sales-based FA proposal, in many circumstances DBRPA could produce results that are similar to the *residual* sales-based formulary apportionment ("RFA") proposal put forth by Avi-Yonah, Clausing and Durst in 2011. RFA would allocate a fixed markup (7.5% in the Durst et al proposal) on costs to entities that undertake activity within an MNC.[84] All other profits would then be allocated to the destination/market country.

The key difference between DBRPA and RFA is that DBRPA imposes a destination-basis allocation for residual returns on a product line by product line and individualized country by country basis.[85] If percentage of gross sales revenue on the one hand and percentage of corporate profit on the other vary significantly by country, DBRPA and RFA would generate different results.[86] Similarly, if average profit levels vary by product line and some countries generate more revenue for an MNE from high-profit products while other

[83] *See* Michael Devereux, *supra* note 80.
[84] Michael C. Durst et al, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 Fla. Tax Rev. 498, at 540-41 (2009).
[85] In contrast, RFA results in a single allocation (or perhaps a QBU by QBU allocation) of the average global profits of an entire multinational group.
[86] Unlike RFA, DBRPA would also keep transfer pricing lawyers and economists productively employed.

countries generate more revenue for an MNE from low-profit products, DBRPA and RFA would generate different results.[87]

DBRPA requires determining where sales occur. Andrus and Oosterhuis correctly observe that using location of sales to allocate income "raises several particularly difficult issues,[81] including: the treatment of remote sales, the treatment of sales through intermediaries, the treatment of sales of raw materials, components and intermediate goods, the treatment of capital goods sales and the treatment of services."[88] At minimum, addressing these issues would require augmented information exchange and potentially some degree of collection assistance. These issues also have first-order ramifications for DBRMPA, and so are addressed further below. Another important issue discussed below is that, like both sales-based formulary apportionment and RFA, DBRPA likely requires countries to agree on rules that define the corporate income tax base.

Other technical questions also arise in thinking about DBRPA.[89] Such issues include the treatment of losses, the treatment of flow-through entities, the treatment of certain financial transactions, and the treatment of M&A. In addition, financial accounting treatment may be problematic, and there are important questions about the compatibility of these ideas with tax treaties and international trade commitments. These issues were outlined in the 2016 Andrus and Oosterhuis effort. I do not rehash that discussion below, although these concerns may be relevant to a DBRMPA as well.

IIIB. Destination-Based Residual Marketing Profit Allocation

A DBRMPA has the same starting point as a DBRPA: affiliates of an MNE are compensated for their functions on a cost plus or return on assets basis using arm's length principles. Unlike in the DBRPA, however, the "residual return" must then be divided between marketing or customer-based intangibles and other intangibles. This division is necessary in order to then allocate income deemed to arise from customer-based or marketing intangibles to the market of destination for the good or service, while allocating the remaining residual return under existing transfer pricing principles.

Going forward in this Part I will use the term "marketing intangibles." There may very well be a substantive distinction between marketing intangibles and customer-based intangibles. For example, in the US core deposits of a financial institution were historically thought of as a "customer-based" intangible, but might not be a marketing intangible. Similarly, the value of a "network effect" might be considered a "customer-based"

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[87] One industry where the difference between DBRPA and RFA could be important is pharmaceuticals. In that industry more than 40% of profits globally are generated in the United States, even though less than 40% of sales occur here.
[88] Andrus & Oosterhuis, *supra* note 81, at 89-99.
[89] *Cf.* Mitchell Kane, *Transfer Pricing, Integration, and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard*, 6 World Tax J. 282 (2014).

intangible but not a marketing intangible.[90] However, in this discussion I explicitly do **not** intend to invoke such substantive distinctions. I am simply choosing a single term (marketing intangibles) for ease of exposition.[91]

The conceptual motivation for the DBRMPA derives from at least two sources. First, some believe certain export-driven jurisdictions would adamantly reject a DBRPA. However, at least two of the most prominent of these jurisdictions, Germany and Japan, may believe that the intangible value held by their domestically-headquartered corporations derives primarily from production intangibles rather than from marketing intangibles. Thus, these jurisdictions (the theory presumably goes) might be willing to accept a DBRMPA. Second, some policymakers may believe that marketing intangibles are fundamentally "customer-based," and therefore more appropriately allocated to jurisdictions of destination ("the market") than is income attributable to other intangibles.

Both of these premises are subject to doubt. For purposes of this paper, however, I will set those two questions aside and limit myself to administrative and pragmatic issues associated with the DBRMPA. This drafting decision is not because I'm persuaded by the premises described above.

The DBRMPA raises three basic administrative concerns. First, it retains all of the problems of current transfer pricing law, because with respect to residual returns that are not allocated to the marketing intangibles current law applies. Second, the proposal imposes an inadministrable distinction between residual returns associated with marketing intangibles and other residual returns. Third, since a DBRMPA allocates residual returns associated with marketing intangibles to the market jurisdiction, all the challenges associated with any destination-basis income tax proposal are present in the DBRMPA.

The problems of current transfer pricing law are well-known, and were also discussed in Part IA. Part IIIB.1. discusses historical evidence suggesting that the distinction between marketing intangibles and other intangibles is not administrable, and also considers various potential solutions to that concern. Part IIIB.2. discusses the difficulties associated with determining destination for purposes of allocating revenues in a destination-basis income tax. There are two sub-issues. First, mechanisms used in the VAT to determine destination do not work in an income tax. Second, solutions to determine destination by building on existing income tax-based concepts are insufficiently robust. Part IIIB.3. describes the difficulties that arise because the DBRMPA relies on unitary tax principles for purposes of allocating costs, but not for purposes of determining revenues. Part IIIB.4. concludes that the DBRMPA, while it seems attractive as a political compromise at 100,000 feet, entails a level of complexity and embedded sources for further conflict as between sovereigns and

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[90] Oosterhuis & Parsons, *Destination-Based Income Taxation: Neither Principled nor Practical?*, 71 Tax. L. Rev. 515 (2018).

[91] Indeed the term "marketing intangible" seems like a bit of a misnomer to me; the term "market intangible" might be more appropriate. Nevertheless, to avoid any confusion I use the term "marketing intangible" because it is the one that has been used most often in the current debate.

as between sovereigns and multinationals that is problematic. It also would require a significant degree of international tax harmonization.

IIIB.1. Dividing a Residual Return Between Marketing-Based and Other Intangibles

The DBRMPA raises an important and likely technically irresolvable point of controversy: the extent to which residual returns are attributable to customer-based or other intangible assets.

A legislative definition of "marketing" or "customer-based" intangibles would presumably be required to operationalize a basic DBRMPA proposal. One could certainly imagine such definitions. For example, a statute might define income associated with patents, copyrights, trade secrets, and any other intangible clearly related to product function or composition as "production-based" intangible income, and specify that all other income not allocated to a routine return was "marketing intangible" income. Alternatively, a statute could define marketing intangibles to include trademarks, tradenames, and franchises as well as the value of installed customer bases, expectation of future business from that base, and goodwill and going concern value.

A working legislative definition does not solve the underlying valuation problem. Conceptually the DBRMPA requires valuation of all "marketing intangibles" as distinct from all other intangibles in order to produce a ratio via which all residual income could be divided between marketing intangible income (which in this usage can equivalently be called "customer-based intangible income") and other intangible income.

This issue – distinguishing between customer-based intangibles and other intangibles – is not new for US law. Prior to enactment of the Omnibus Budget Reconciliation Act of 1993, many categories of intangibles were eligible for income forecast depreciation, often on accelerated schedules.[92] As a result the value of customer-based intangibles as opposed to patents and other intangibles acquired in various transactions had to be determined. Amortization deductions before 1993 depended on the acquirer's ability to establish that an acquired intangible had a limited useful life that could be established with reasonable accuracy and an ascertainable value separate from goodwill, since goodwill was nonamortizable.[93] Amortizable intangibles were then amortized under various useful lives.

In contrast, section 197 spreads amortization over a 15-year straight line period, without regard to their "type." Section 197 obviates the need to ascertain individual valuations for different categories of intangibles, and greatly diminishes the incentive taxpayers once had

[92] *See, e.g.*, Rev. Rul. 79-285 (1979-2 C.B. 91).

[93] *See, e.g.*, Treas. Reg. § 1.167(a)-3 (1960); Gregory Beil, *Internal Revenue Code Section 197: A Cure for the Controversy over the Amortization of Acquired Intangible Assets*, 79 U. Miami L. Rev. 731 (1995) (providing discussion of prior law regulations and the surrounding case law).

to characterize acquired intangibles as assets distinguishable from goodwill and going concern value.

Fred Goldberg, a former Commissioner of the IRS, explained the administrative problem created by prior law to Congress in 1992, shortly after he left the job of Commissioner of the IRS and became the Assistant Secretary of the Treasury for Tax Policy. He testified that the need to allocate basis among purchased intangibles not only resulted in substantial uncertainty and dissimilar treatment of similarly situated taxpayers, but also imposed large wasteful transaction and administrative costs on taxpayers and the government. Before 1993, disputes over the amortization of customer-based or market-based intangibles, including but not limited to items such as core deposits held by financial institutions, insurance expirations, and newspaper and magazine subscription lists, produced many prominent, large dollar litigations.[94] As one author described the problem, "the governance of purchase price allocations to intangible assets [has become] an administrative quagmire and a judicial disaster."[95]

For tax years between 1979 and 1987, for all unresolved audit cases (on any issue) in examination, appeals, or litigation as of mid 1989, in fully 70 percent of those cases in which taxpayers claimed that an intangible assets had a determinable useful life over which amortization was available, the IRS proposed adjustments and claimed that the assets were in fact goodwill.[96] Moreover, for that same period, the single category of intangible assets over which this dispute arose most often were customer or market-based intangibles.[97] The debate before 1993 regarding acquired intangibles largely focused on distinguishing between customer-based intangibles and goodwill, the latter of which was not amortizable under pre-1993 law. But the core problem was allocating purchase price premia across intangible asset categories generally.

This same issue – whether an intangible is a customer or market-based intangible or some other intangible (goodwill or something else) would arise in a new guise in a regime that distinguishes between "marketing intangibles" and other intangibles. As long as one result is more favorable for the taxpayer on the one hand or the government on the other, or for one government or another, incentives for controversies regarding classification arise. But relative to pre-1993 US law, the difference would be that instead of being limited to cases where intangibles were acquired, the controversy would arise with respect to every single cross-border transaction in which a non-routine return existed. The intangible

[94] *See Tax Treatment on Intangible Assets: Hearing Before the Comm. on Fin., United States Senate, on S. 1245, H.R. 3035, and H.R. 4210*, 102d Cong., 2d Sess. 1, 3 (1992) (testimony of Hon. Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, Department of the Treasury and former IRS Commissioner) [hereinafter "Hearings"].
[95] Jon D. Kitchel, *A Tax Policy Analysis of Recent Legislative Proposals Regarding the Treatment of Goodwill*, 92 Tax Notes Today 252-89 (Dec. 18, 1992).
[96] US Gen. Acct. Off., Tax Policy: Issues and Policy Proposals Regarding the Tax Treatment of Intangible Assets 10 (1991) (report to the Joint Committee on Taxation).
[97] *Id.* It is difficult to understate how serious the intangible asset categorization problem was thought to be in the period before the adoption of section 197.

classification incentive of a foreign sovereign where any DEMPE functions took place and the incentives of the IRS would always be at cross-purposes. To paraphrase Fred Goldberg's 1992 congressional testimony regarding the analogous issue a generation ago, if we go down this path, "[n]o amount of after the fact enforcement and litigation can possibly remedy the situation."[98] We will have re-created a mess from a generation ago and compounded it exponentially.

IIIB.1.a. A "Two Sided" Valuation Solution?

Another key difficulty with a DBRMPA arises from the fact that, like the DBRPA, this is a transactional method. The DPRMPA therefore has the complexity associated with determining profit levels on a product line by product line and country-by-country basis.

However, the DBRMPA differs from the DBRPA in that it requires a profit split of the residual profit being allocated for each transaction between profits attributed to marketing intangibles and other residual profits. A methodology must be chosen to undertake this profit split.[99] In transfer pricing terms, on first impression a DBRMPA would seem to require application of the transactional profit split method to all transactions, even where only one party makes unique and valuable contributions.

We've spent years in transfer pricing trying to limit the use of the transactional profit split method. The OECD's recent guidance on the application of the transactional profit split explains why: "[a] weakness of the transactional profit split method relates to difficulties in its application."[100] As a result, the OECD perspective is that "where the accurate delineation of the transaction determines that one party to the transaction performs only simple functions, does not assume economically significant risks in relation to the transaction and does not otherwise make any contribution which is unique and valuable, a transactional profit split method typically would not be appropriate."[101] For the same reason, the OECD maintains that "a lack of comparables alone is insufficient to warrant the use of a transactional profit split."[102]

In various high-profile cases over the years, the application of the transactional profit split produced highly intractable disputes between taxpayers and governments and between

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[98] *See* Hearings, *supra* note 94.

[99] For the method to function effectively, the transactions associated with a product line will also need to be accurately delineated. Depending on policy choices and the facts as issue, the DBRMPA may more fully import all the complexity associated with determining the appropriate level of aggregation and accurately delineating the transactions to be covered that arises in the transactional profit split method of the current transfer pricing guidelines than would a pure DBRPA.

[100] OECD, *Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10, OECD/G20 Base Erosion and Profit Shifting Project*, ¶ 2.123 (2018), www.oecd.org/tax/beps/revised-guidance-on-the-application-of-the-transactional-profitsplit-method-beps-action-10.pdf [hereinafter "OECD Action 10"].

[101] *Id.* ¶ 2.127.

[102] *Id.* ¶ 2.148.

competent authorities in governments. One well-remembered example is the IRS transfer pricing dispute with Glaxo SmithKline Holdings (Americas) Inc. & Subsidiaries ("GSK") for the tax years 1989-2005.[103] The essence of the dispute was over the level of US profits reported by GSK after making intercompany payments that needed to take into account production intangibles developed by and trademarks owned by its UK parent, relative to the value of GSK's marketing intangibles in the US.[104]

The facts of the GSK case required coordination between the US and the UK with respect to what current OECD transfer pricing guidelines would describe as a two-sided transactional profit split. The public record suggests the UK government never acceded to the US assertion as to the share of the GSK profits that were attributable to US marketing intangibles rather than UK production intangibles.[105] The GSK case is particularly well-remembered, and the size of the dispute was unusual, but the basic setup is not unique.

Two-sided transactional profit splits lend themselves to requiring intergovernmental coordination through MAP to avoid double juridical taxation. Even after the BEPS project and the advent of the multilateral instrument, mandatory binding arbitration is still available only in a limited set of MAP cases, and the risk of failures of MAP coordination remains high in transactional profit splits. Sometimes, maybe this is just the way it has to be. But why would we want to adopt an international tax system that sets up this exact type of dispute between taxpayers and governments and as between national tax administrations in *every* case; including in the broad swath of cases where everyone previously agreed the transactional profit split method had no relevance?[106]

IIIB.1.b. A Relative "Capitalized Expenditure" Approach?

Another potential approach to splitting residual profit between profits being allocated to marketing intangibles and profits being allocated to other intangibles could involve specifying which expenditures contribute to developing marketing intangibles and which expenditures contribute to developing other intangibles. Governments would then presumably establish "useful lives" for various buckets of expenditure. The resulting relative "capitalized values" associated with marketing intangibles as compared to other

[103] Robert Guy Matthews & Jeanne Whalen, *Glaxo to Settle Tax Dispute with IRS Over US Unit for $3.4* Billion, Wall St. J. (Sept. 12, 2006), https://www.wsj.com/articles/SB115798715531459461. At the time it represented the largest tax dispute in the history of the Internal Revenue Service, and it ended when GSK made the largest settlement payment in history.
[104] News Release, Internal Revenue Serv., IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute (Sept. 11, 2006), https://www.irs.gov/newsroom/irs-accepts-settlement-offer-in-largest-transfer-pricing-dispute.
[105] *See, e.g.*, Gareth Green, *The U.K. Reaction to the Glaxo Case*, Tax Planning International Transfer Pricing, BNA (Nov. 2006).
[106] *Cf*. OECD Action 10, *supra* note 100, ¶ 2.127. ("[W]here the accurate delineation of the transaction determines that one party to the transaction performs only simple functions, does not assume economically significant risks in relation to the transaction and does not otherwise make any contribution which is unique and valuable, a transactional profit split method typically would not be appropriate since a share of profits… would be unlikely to represent an arm's length outcome for such contributions or risk assumption.")

intangibles would produce a ratio. The ratio would change each year as a result of both new expenditures by the MNC and the operation of whatever "amortization schedule" was adopted for the various buckets of expenditure. The "amortization schedule" would not produce actual deductions; it would simply establish the annual ratio of "marketing intangibles" to "other intangibles." That ratio (as it adjusted each year, presumably on a product line by product line basis), would provide the ratio of excess return to be allocated through the current arm's length system as opposed to being assigned to market jurisdictions for each specified product line.

Something akin to this approach is said to have been used in some advanced pricing agreements entered into by some multinationals both with the IRS and with foreign tax administrations. But generalizing this approach would be very resource intensive. Moreover, the approach transmutes the debate as to what constitutes a "marketing" or "customer-based" intangible as opposed to other intangibles into a debate as to what costs develop a "marketing intangible" and what costs develop other intangibles (e.g. production intangibles) and what the respective useful lives of such expenditures should be.[107] It is unclear to me that this represents a meaningful improvement on the basic two-sided DBRMPA method described in Part IIIB.1.a. above. It certainly highlights the relationship between the problem of relative valuation in a DBRMPA and the useful life issues section 197 was enacted to eliminate.

Finally, the relative capitalized expenditure approach is hard to translate into the context of the digital business models that are at the heart of this debate. Which expenditures can be attributed to creating "network effects," and thereby a form of "marketing intangible?" Considered *prima facie* as an intellectual matter, arguably few or none. But is that an answer that would be globally accepted?

IIIB.1.c. A "One-Sided" Valuation Solution?

The central problem described above in Parts IIIB.1.a. and IIIB.1.b. arises as a result of the attempt to put relative values on the intangibles associated with "marketing intangibles" as compared to other intangibles. Again, in IIIB.1.a. valuing "marketing intangibles" and "other intangibles" respectively is just a mechanism to create the ratio of excess return to be allocated through the current arm's length system as opposed to being assigned to market jurisdictions. IIIB.1.b., produces the same ratio through a relative "capitalized asset" approach.

Another alternative to resolve the relative valuation marketing intangible/other intangible allocation problem would be to value the excess return that should be ascribed to

[107] Moreover, as the OECD correctly observes in the context of cost-based profit splitting factors in a transactional profit split, this approach "can be very sensitive to differences and changes in accounting classification of costs. It is therefore necessary to clearly identify in advance what costs will be taken into account … and to determine the factor consistently among the parties." OECD Action 10, *supra* note 100, ¶ 2.182.

specifically listed production intangibles. The system could then allocate the residual – that is to say, the excess return remaining after subtracting the return given to non-routine production intangibles – to the "marketing bucket" and assign it to market jurisdictions on a destination-basis.

This one-sided DBRMPA method would avoid the problem described in Parts IIIB.1.a. and IIIB.1.b. with respect to dividing residual returns between marketing intangibles (the market) and other intangibles (the current transfer pricing system) using a ratio. Instead, one could imagine using a one-sided method by attempting to locate a comparable uncontrolled transaction for non-routine production intangibles,[108] or by applying a profit indicator, for example a return on costs associated with specified production intangibles (or some other net profit indicator).

This latter approach (a one-sided profit indicator approach) is similar to the OECD's "transactional net margin method" ("TNMM") (known in the US as a comparable profits method), but with one important difference. The OECD transfer pricing guidelines specify that a TNMM is only supposed to be applied when one of the two parties owns and controls all the relevant non-routine intangibles.

MNCs would be incentivized to adapt tax planning to a one-sided DBRMPA, which would value the return to "marketing intangibles" as a residual after a return is ascribed to non-routine production intangibles. In a one-sided DBRMPA world with DEMPE rules (i.e. the BLTV) for the allocation of the return ascribed to production intangibles, MNCs would seek to a) locate their production intangibles in low tax jurisdictions and b) maximize the valuations for their production intangibles. Nevertheless, because excess returns are so large for the world's leading companies, the one-sided methodology DBRMPA, which ascribes a specified return to production intangibles and gives everything else to the market, would likely allocate most (high) excess returns to the market/marketing intangibles.

A one-sided DBRMPA methodology that values only specified production intangibles is intellectually distinguishable from a DBRPA. However, as a practical matter the one-sided DBRMPA produces a result that asymptotically approaches the outcome in a DBRPA. It also has all the issues associated with determining destination in DBRPA, without achieving one of the DBRPA's virtues, which is eliminating the administrative problems associated with current transfer pricing law.

[108] The Tax Court resolved part of the recent Amazon transfer pricing dispute using a technique akin to the one-sided DBRMPA method I describe here using a comparable uncontrolled transaction. Unlike in a TNMM, in the Amazon case all parties agreed that non-routine intangibles were controlled by both related parties to the transaction. Nevertheless, Judge Lauber's opinion adopted a comparable uncontrolled transaction methodology for determining the return that should be attributed to Amazon's website technology – the intangibles that would presumably be considered "production intangibles," in a DBRMPA, and treated the remainder of the residual return as allocable to a non-US party.

It should also be noted that the reason the DBRPA is not currently under consideration internationally does not appear to be related to whether it is normatively defensible. Rather, the DBRPA is not part of the debate because it is politically unpalatable to a number of major jurisdictions and other constituencies that oppose allocating all or most of the residual return from intangible assets to market jurisdictions. The one-sided DBRMPA methodology could be politically unpalatable to those same jurisdictions and other constituencies.

Finally, one should note that the one-sided DBRMPA methodology described above is in some sense the inverse of the "digital investment" idea put forth by Wolfgang Schön.[109] Schön's idea treats "digital investment" as the functional equivalent of the "marketing intangible" in the DBRMPA. Schön suggests that market-specific digital investment should be measured, and the return associated with that investment should be valued using a TNMM-type approach and allocated to market jurisdictions. How that measurement would be accomplished is not entirely clear, but Schön's idea is quite interesting. It could be integrated into the current transfer pricing system more easily than any DBRMPA concept. And the digital investment concept certainly would not asymptotically approach a DBRPA. It is unclear whether the Schön's proposal is being considered as a mechanism to implement the marketing intangibles idea. However, the terminology used by Schön and the terminology that has been used publicly to date in the marketing intangibles discussion do not overlap.

IIIB.1.d. A "Formulary DBRMPA" Solution?

Some might acknowledge the problems of allocating between production intangibles and marketing intangibles based on either a "two-sided" or a "one-sided" transfer pricing method, and then suggest that the issue should simply be resolved by agreeing a percentage allocation to the market. For instance, governments could agree that distinguishing between market intangibles and other intangibles was not systematically administrable, and therefore the excess return should just be divided based on fixed percentages (50/50) between market jurisdictions and the existing arm's length standard (the BLTV). A formulary approach clearly does address the allocation problems described above with respect to the DBRMPA as between marketing intangibles and other intangibles. Moreover, it does so without asymptotically approaching a DBRPA.

However, formulary DBRMPA likely raises the issues traditional formulary apportionment raised in the United States. In other words, because activity is mobile, but sales are not, jurisdictions would be incentivized to abandon a 50/50 split and move in the direction of a 100% allocation to destination.

US states use a formulary apportionment system to determine their taxable share of US-source corporate profits. The basic mechanics of a formulary apportionment system, in

[109] Wolfgang Schön, *supra* note 49, at 79-81.

which intercompany transactions are generally ignored, are thus familiar to most US tax lawyers. A generation ago US state corporate tax apportionment formulas were based on a weighted average of the shares of sales, payroll, and assets in the state.[110] However, these formulas create an implicit excise tax on the factors used in the formula.[111] As a result, the three-factor formula discourages MNCs from investing in assets or generating employment in high-tax locations.

Over the years the states of the United States shifted (in inconsistent ways) away from three-factor apportionment towards sales-only apportionment factors to gain a competitive advantage in attracting tangible investment and jobs.[112] In the international setting, with higher tax rates than state income taxes and fewer coordination mechanisms to limit competition, most serious commentators agree that this dynamic would be more intense. Moreover, customers are much less mobile than employment in the cross-border setting, so economic theory would suggest that a sales-based apportionment should produce fewer economic distortions than an apportionment formula that took location of employment into account.[113]

Formulary DBRMPA would crystalize the problems of the BLTV. Research consistently shows that high skilled – DEMPE-capable – labor is the most mobile form of labor globally (certainly more mobile than the payroll and assets factors of traditional formulary apportionment). Meanwhile consumers are quite immobile. The dichotomy between an apportionment factor that is immobile and an apportionment factor that is highly mobile, with fixed percentages to each, creates an implicit excise tax on the mobile factor. That reality would likely push countries in the direction of unilaterally choosing a 100% allocation to the immobile factor (the location of the consumer), in order to eliminate the implicit excise tax on high-skilled jobs that the 50/50 split would create, just as US states over-weighted sales and abandoned the payroll factor to encourage job creation in their jurisdictions. Moreover, in the international system, even more than at the level of the US states, it is not clear what enforcement mechanisms exist to ensure that countries abide by an agreed 50/50 split. Bilateral tax treaties are not well-suited to enshrining such an approach.

The one potential solution I see to the pressures created by the formulary DBRMPA's implicit excise tax on DEMPE jobs in higher tax jurisdictions is to abandon the BLTV. Governments could decide to revert to pre-BEPS transfer pricing guidelines for the part of the excess return attributed to other intangibles and allocated under transfer pricing rules. In that world, contractual allocations of risk would be more fully respected and income

[110] The year 1978 was the high water mark for three factor apportionment at the state level in the United States. *See, e.g.*, Walter Hellerstein, *A US Subnational Perspective on the "Logic" of Taxing Income on a "Market" Basis*, 72 Bull. Intl. Taxn. 4/5 (2018).

[111] *See e.g.*, Charles E. McClure, Jr., *The State Corporate Income Tax: Lambs in Wolves' Clothing*, in THE ECONOMICS OF TAXATION (Henry Aaron & M. Boskin eds. 1980).

[112] *See* Hellerstein, *supra* note 110.

[113] For similar reasons, most academic observers agree that formulary apportionment employed internationally would probably be implemented (sooner or later) under a single factor sales-based formulary apportionment system.

shifting for the "other intangibles" portion of excess returns would be somewhat easier than under current law. But shifting income would not require shifting well-paying (and highly mobile) jobs out of higher tax jurisdictions. Reverting to the pre-BEPS transfer pricing guidelines therefore would reduce the otherwise inevitable pressure for countries to unilaterally move from a DBRMPA to a 100% allocation of the excess return to the market jurisdiction.

IIIB.2. Problems with Relying on Destination for Income Tax Purposes

In any system that allocates part of the return to the market (in other words, any "destination-basis" system) the tax burden is meant to rest in the jurisdiction of the final consumer, rather than the jurisdiction of residence of any intermediaries in the supply chain. The economic rationale for this result is that the final consumer is thought to be the least mobile factor. Thus, from a theoretical economics perspective, a destination-basis system is less economically distortive than other more mobile bases for assessing corporate tax.[114]

However, if the administrative mechanism for measuring the location of sales does not conform to the location of the final consumer, this justification for attempting to tax at destination is undermined. Importantly, multinationals can easily structure their transfer pricing arrangements to book sales income in a jurisdiction that is not the jurisdiction of residence of the final consumer and are incentivized to do so if they can lower their tax burden as a result.

The US international income tax system has been cognizant of this category of issue for decades; it is at the heart of both the 20th century understanding of section 482 and the 1962 foreign base company sales income rules.

For the same reason, every destination-basis income tax proposal relies on a concept of destination separate and apart from the contractual decision MNCs make about where to book sales. Andrus and Oosterhuis, as well as other commentators, in effect suggest that concepts for determining destination that have evolved outside the United States for purposes of implementing the value-added tax might be modified for purposes of administering a DBRMPA.[115] The VAT does effectively establish destination by means of proxies and administrative solutions in the consumption tax context in most cases. The

[114] *See, e.g.*, Alan Auerbach et al., *Destination-Based Cash Flow Taxation*, Oxford Univ. Ctr. For Bus. Taxation, Working Paper (Jan. 17, 2017), https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_17/WP1701b.pdf.

[115] *See, e.g.*, Andrus & Oosterhuis, *supra* note 81, at 99. ("These issues may be novel in the income tax context, but not in the value-added tax context; the evolving thinking on these issues in the latter context can thus be a useful guide.")

difficulty is that the mechanisms the VAT uses for this purpose simply are not amenable to implementation in an income tax.[116]

IIIB.2.a. Inapplicability of VAT Best Practices

The VAT generally resolves the issue of determining destination using the credit-invoice mechanism. Two of the most important features of the credit-invoice mechanism are taxation on gross amounts and imposition of tax on every transfer, both intra-firm and inter-firm.

An income tax cannot adopt the credit-invoice mechanism for one key reason: income taxes tax net income, rather than gross revenues. In an income tax cross-border business input purchases are generally deductible. In contrast, the VAT establishes destination in large measure by providing cross-border business input purchases a treatment that is the equivalent of non-deductibility.[117]

Destination of Goods

For tangible goods, VAT laws generally assess VAT using frontier or border controls.[118] Imported goods are in effect treated as having the destination of the jurisdiction where they clear customs. VAT is assessed on the full value of the good as it enters the jurisdiction. VAT laws then free exports of VAT through a combination of non-inclusion of proceeds and a refund mechanism for VAT previously paid. As a result, the VAT avoids the difficulties a destination-basis income tax would have with cross-border sales through third party intermediaries.

The reason third party cross-border intermediation does not obscure destination in the VAT is that the intermediary pays a full tax on its purchases, and has the full amount refunded

[116] In a credit-method VAT, registered businesses assess tax on taxable goods and services they sell each time they supply such a good or service to either a business or a consumer. Registered businesses are then permitted to reduce the amount of VAT they are liable to remit to the government by a credit equal to the amount of VAT paid to other registered businesses in purchasing business inputs (intermediate goods, services, plant and equipment, etc.). The credit eliminates the VAT on goods and services used by a registered business, but leaves in place the VAT on sales to final consumers. This mechanism ensures that the consumption of all goods and services subject to the VAT will be taxed once, but only once, generally at the consumer level. Imposing the VAT on a destination-basis requires a border adjustment. To eliminate the tax paid on an exported good by businesses at earlier stages in the production and distribution process, exporters receive a credit (and therefore perhaps a refund) for tax paid on their inputs in a credit-invoice method system, while no tax is assessed on their sales.

[117] The VAT mechanism works cross-border and is not equivalent to a tariff because the VAT credit mechanism then provides a credit to registered businesses (and not to consumers). The whole tax is passed on to consumers; businesses bear none of it. In contrast, in an income tax, businesses are intended to pay tax. As a result, the full credit mechanism is not an option in an income tax.

[118] VAT on imports is generally collected at the same time as customs duties, although in some countries collection is postponed until declared on the importer's next VAT return.

on re-export. Exports are not included in the tax base, and then a tax based on the sales price of the good is collected at the jurisdiction of (further) destination. A similar result applies with respect to importation of intermediate inputs (whether raw materials, components, or intermediate goods) that are subsequently exported as part of a different tangible good, and (thanks to expensing) even with respect to capital goods that are purchased to allow for the manufacture of other products for export.[119] In all cases the credit-input system thereby moves the tax burden to the final buyer.

This VAT system for ensuring that tax is collected at destination only works because the system taxes on a gross basis and refunds on every intra-firm and inter-firm transfer. An income tax cannot adopt this basic element of the credit-invoice mechanism as it operates in cross-border situations and remain a tax on net income. As a result, the VAT does not provide useful guidance for resolving problems of destination of goods in an income tax system.

Location of Services

Determining the destination of cross-border trade in services and intangibles more generally has been a key issue in reforming the VAT for the 21st century.[120] Since there are no customs controls to impose the VAT at the point of importation on services and intangibles, creating administrable proxies for the destination principle in services and intangibles is challenging. The OECD has developed special guidelines for determining the jurisdiction of taxation for international supplies of services and intangibles over the last decade that attempt to reflect the destination principle.

Determining the location of services raises especially difficult issues in the MNC context.[121] In many cases, MNC service recipients utilize the services of a service provider in multiple jurisdictions. The country that the services are billed to can become a mechanism for manipulation in a DBRMPA.

Charge-out mechanisms of the kind used in today's income tax system can and do conceptually resolve the problem of determining the destination of services an MNC recipient receives and uses in multiple locations in the VAT context.[122] However, the difficulty raised by this solution for tax administrations in the DBRMPA context is

[119] Of course, income taxes cannot provide expensing treatment in all cases while maintaining their status as income taxes.
[120] Walter Hellerstein & Michael Keen, *Interjurisdictional Issues in the Design of a VAT*, 63 Tax L. Rev. 359 (2010).
[121] See Julie Roin, *Can the Income Tax Be Saved? The Promised Pitfalls of Adopting Unitary Formulary Apportionment*, 61 Tax L. Rev. 169, at 208 (2008) and Hellerstein, *supra* note 110, at 9-12, for a discussion of these issues.
[122] Note also that to solve the problem of determining where globally-provided MNC to MNC services are "consumed," most VATs today generally follow the result achieved for purpose of corporate income tax chargeouts. It is obviously no answer to rely on the VAT to solve an income tax problem if the present law VAT solution is to rely on the income tax answer to solve that same problem.

different and should not be trivialized. Tax administrations would need to audit service recipients to determine whether charge-outs had been made appropriately in order to inform their audit of the service provider. While charge outs can be a subject of audit in today's income tax system, tax administrators never need to ask whether charge outs by an unrelated party change the tax result for a separate, unrelated taxpayer. The level of internal coordination such a system would require of government auditors simply does not exist today within tax administrations.

IIIB.2.b. Known Solutions Building on Income Tax Administrative Concepts Are Insufficiently Robust

As noted above, sales through third party distributors would raise substantial avoidance and/or enforcement issues for a DBRMPA. Since the administrative features of the VAT cannot help, other anti-abuse rules would be needed in a DBRMPA to address the tax incentive to structure operations to have customers purchase products through a third-party distributor in a low-tax jurisdiction. Most likely some type of look-through rule would be required.[123] However, making a look-through rule work would require reporting by third party distributing purchasers. Andrus and Oosterhuis imagine implementation of this sort of system in the context of single-factor sales apportionment.[124]

Getting buy-sell arrangements with third party distributors to be treated equivalently to related party distribution arrangements or third-party agency distribution arrangements would be challenging. In theory, a DBRMPA would also need similar look-through rules to allocate revenue from sales of intermediate inputs to third party manufacturers. Ideally these sales would be allocated on a look-through basis based on the country of sale of the end good into which intermediate goods are ultimately incorporated. However, because this structure is infeasible, Andrus and Oosterhuis recommend treating the place where the goods are incorporated into products of the purchaser as the location of sale.[125] The sale of capital goods raises a more extreme version of the same problem – these are in effect the sale of intermediary goods with a long useful life the value of which is then embedded in end consumer goods and services.

Andrus and Oosterhuis suggest that to prevent rampant abuse, we would need to distinguish between "real" manufacturing and mere re-importation or packaging (this would backstop the look-through rule for distributing purchasers). As they wrote "[t]he location, for example, of the final packaging or labeling of products can too easily be manipulated if a significant tax advantage results." They then suggest the contract manufacturing rules (which distinguish manufacturing from repackaging) might be used to address this concern.

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[123] Clausing & Avi-Yonah proposed a look-through rule for unrelated distributors in their single sales factor formulary apportionment proposal. Kim Clausing & Reuven Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, Brookings Inst., June 2007.
[124] Andrus & Oosterhuis, *supra* note 81, at 101.
[125] Andrus & Oosterhuis, *supra* note 81, at 100. *See also* Harry Grubert, *Destination-Based Income Taxes: A Mismatch Made in Heaven*, 69 Tax L. Rev. 43, at 55-56 (2015).

Those familiar with the difficulties in administering and unintended planning engendered by the contract manufacturing rules might be concerned about adopting a facts and circumstances test for all cross-border transactions, rather than the occasional instance of foreign base company sales income. However, the primary problem is a deeper one: in this case the jurisdiction in which a tax administration would need to audit the question of whether real manufacturing had occurred would often be a jurisdiction in which the MNC under audit has no physical presence. And, as with the location of service use discussed in IIIB.2.a., tax administrations would again be in the position of auditing one business to figure out where taxing rights lie for the profits of an unrelated corporation. Absent a radically improved and streamlined environment for both information exchange and international tax administrative assistance, how are the arising enforcement questions supposed to be addressed? Licensing arrangements and franchising structures raise parallel but – from an audit perspective – perhaps more complicated questions than those described above for 3rd party intermediary sales.[126]

IIIB.2.c. Other Methods of Identifying Destination

There may be mechanisms outside historic VAT or income tax practice to identify the destination of some goods and services. Two examples that come to mind are pharmaceutical products and technology that has an IP address. In the pharmaceutical industry for non-tax regulatory reasons businesses generally must keep track of the destination of their products even when those products are being distributed by third party distributors. An IP address can be used as a proxy for location, so a DBRMPA could potentially treat goods that have an IP address as having the destination associated with their IP address.

The question that then arises is whether destination can be determined using such non-tax proxies for most, some, or only a low percentage of goods and services that generate excess returns. The answer to this question is unclear. What is certain is that the destination of all goods that generate excess returns is not determinable based on piggybacking on non-tax regulatory rules or relying on IP addresses.

IIIB.2.d. Relationship Between FDII and any Destination-Based Allocation System

Interestingly, the IRS and the US Treasury are likely to put all the above-discussed concepts for determining destination to the test. New section 250 of the Code (“FDII”) in effect establishes a preferential tax rate for income derived by domestic corporations from serving foreign markets. The statutory rules require determining the foreign portion of deduction eligible income. This amount includes income derived from the sale of property to any foreign person for a foreign use. It also includes income derived in connection with services provided to any person not located within the United States, or with respect to property that is not located in the United States. Thus, the destination of both goods and services must be determined in order to implement the new FDII rules of section 250. The

[126] Some of these difficulties are discussed in Grubert, *supra* note 125, at 57.

IRS and the Treasury will need to write regulations describing how taxpayers should make these determinations in the coming twelve months in order to implement the FDII regime. Any multilateral organization or foreign sovereign evaluating a proposal for a DBRMPA would therefore be well-advised to evaluate the regulatory output of the IRS and the Treasury in this regard.

IIIB.3. Problems with Unitary Approach

As discussed earlier, a DBRMPA relies on the DBRPA with respect to the portion of the excess return of the MNC allocated to marketing intangibles. The DBRPA in turn is not a formulary system, because it measures returns at a product line level and provides jurisdictions "credit" for higher prices. However, escaping the formulary label does not equate to escaping the related "unitary" label. The DBRPA calculates most revenues at a country level, but it calculates costs on a global consolidated basis, just like the "unitary" aspect of formulary apportionment.

An important downside of global consolidation is that it requires a common measure of taxable income across jurisdictions. In other words, one needs a single measurement of apportionable income. That is the "unitary" aspect of formulary apportionment. DBRMPA may not require a common measure of gross income, but it would require common rules regarding costs. The most obvious category of costs that need common allocation rules are indirect costs. The problems of indirect cost allocation are familiar to US practitioners from the foreign tax credit system and our current debates about the GILTI. A DBRMPA would need globally agreed rules about analogous difficult issues.[127]

Moreover, for the DBRPA to work well, schedules for depreciation or amortization of tangible and intangible property, treatment of original issue discount – and perhaps even issues like the method used for inventorying costs or the treatment of fines and penalties – would ideally be standardized across jurisdictions. As Julie Roin explained a decade ago with respect to formulary apportionment, unitary systems become inadministrable if global costs must be measured for purposes of determining income in each jurisdiction, but each jurisdiction has its own rules with respect to when those global costs are taken into account.[128]

These issues with the "unitary" dimension of formulary apportionment are well-trodden ground. What observers may not appreciate is that the DBRMPA does not avoid those issues. Indeed, because the DBRMPA requires allocating indirect costs on a product line basis rather than a QBU basis, the unitary concerns that require tax harmonization to address may be more extensive than under formulary apportionment.

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[127] *Cf.* OECD Action 10, *supra* note 100, ¶¶ 2.154-2.157 (describing the importance of aligning accounting rules in transactional profit splits).

[128] Julie Roin, *Can the Income Tax Be Saved? The Promised Pitfalls of Adopting Unitary Formulary Apportionment*, 61 TAX L. REV. 169, 200 (2008).

IIIB.4. Conclusions re DBRMPA

The DBRMPA combines many of the administrative problems of a residual apportionment system and an arm's length system in an attempt to produce a political compromise. That political compromise allocates part but only part of the residual return to market jurisdictions. Replacing the current international tax rules with this system would entail substantial institutional transition costs in the US and elsewhere.[129]

Adopting a system that combines the issues of a residual apportionment system based on destination with the issues of an arm's length system reduces the stakes associated with the challenges of each part of the new combined system if and only if the relative share of the excess return allocated to each part of the new combined system is clear. In this regard, a relative valuation-based DBRMPA recreates the administrative quagmire we had in the US for valuing acquired intangibles prior to 1993, and expands it to every cross-border transaction involving an intangible.[130] In contrast, a "formulary DBRMPA" would resolve this issue by agreeing an arbitrary percentage split of excess returns so as to allocate a set percentage of the excess to market jurisdictions and the remainder to the current arm's length standard. However, the formulary DBRMPA may be subject to the same dynamic that manifested itself in connection with traditional 3-factor formulary apportionment in the United States. In other words, jurisdictions are likely to have economic incentives, revenue incentives, or both to abandon the agreed split and move towards a larger allocation to the market.

Separately, any DBRMPA method – whether "two-sided," "one-sided," or "formulary" – would face the same issues associated with international tax base harmonization that apply to unitary taxation systems, as well as the issues associated with determining destination without a credit-invoice system. Finally, all versions of the DBRMPA would maintain the problems of the current arm's length system for transfer pricing on the other intangibles side of the marketing intangibles vs other intangibles divide.

Part IV. Pairing Inbound and Outbound Minimum Taxes?

This section presents and evaluates a combination of inbound and outbound minimum taxes as a solution to the current debate over transfer pricing and the allocation of taxing rights as among jurisdictions. Minimum taxes include traditional CFC-based solutions, which rely on relative immutability of corporate residence, and newer ideas that combine outbound and inbound minimum taxes. Such ideas appear to have entered the OECD

[129] Roin's point was about formulary unitary taxation, but a close look reveals that most of the issues are related to unitary taxation rather than formulary approaches. Julie Roin, *Taxation Without Coordination*, 31 J. Legal Stud. S61, S78-84 (2002) (detailing institutional impediments to development of a common income tax base).

[130] A "one-sided" valuation method DBRMPA could avoid the problems created by a "two-sided" DBRMPA on the one hand and a "formulary" DBRMPA on the other, but in doing so approaches the result of a DBRPA. It does so with much more transfer pricing controversy embedded in order to get to that result.

debate. "Minimum effective taxation" is also an issue that Germany has recently raised at the most senior levels in European Union policy discussions.

Notably, the GILTI and the BEAT could respectively be described as an attempt to have outbound and inbound minimum taxes, or as an attempt to ensure minimum effective taxation. In this Part IV I will suggest that the GILTI and the BEAT can be reimagined to suggest a workable alternative for the medium-term future of the international tax system.

I expect the US will continue to describe the GILTI and the BEAT with our current acronyms. However, the reconceived system I describe below is perhaps better described as a combination of an outbound minimum tax and something like a "reverse CFC" rule.[131] The basic concept would be to pair some outbound minimum tax regime (a reformed GILTI) with defensive measures that would only be applied to multinationals parented in countries that do not impose a qualifying outbound minimum tax.

IVA. Outbound Minimum Taxes

The GILTI is now highly familiar for the participants at this conference. At the highest level, the GILTI requires a US shareholder of CFCs to pay a minimum aggregate US and foreign tax on its share of the earnings of its CFCs on a current basis. Unlike other dividend exemption systems, the structure of the regime imposes tax on most CFC income, but does so at a lower rate than domestic income.

As a practical matter the United States is likely to maintain some form of this outbound minimum tax regime over the medium term. At the present time the Republican party believes it has renewed American competitiveness with its corporate rate cut and hopes to protect the basic structure and rates. Meanwhile, Democrats are proposing to raise the corporate income tax rate and the GILTI rate along with it, but have not suggested altering the basic architecture of the regime. That political playing field is unsurprising given that at a 50,000 feet level one can describe the GILTI regime as the Obama Administration proposal to "Impose a 19 Percent Minimum Tax on Foreign Income,"[132] just enacted at Republican rather than Democratic rates.

Although the basic architecture of an outbound minimum tax is likely to be a stable feature of US international tax law, the technical details of that construct are subject to change. The 2017 legislation is legislatively unstable in the sense that various provisions expire by

[131] This idea also has some relationship to proposed special measure number five from the BEPS project's 2014 public discussion draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Actions 8, 9 and 10). OECD, *Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (Including risk, recharacterisation and special measures)* (2014), https://www.oecd.org/ctp/transfer-pricing/discussion-draft-actions-8-9-10-chapter-1-TP-Guidelines-risk-recharacterisation-special-measures.pdf.
[132] US Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals (2016).

their own terms between 2021 and 2025. It is politically vulnerable to revision, because it was enacted via a party line vote. Finally, it is technically unstable for reasons having to do both with how some provisions are difficult to administer and others may create unintended incentives.[133]

A few examples of political and technical instability of specific features of the current GILTI construct are worth mention. At the political level, Democrats are focusing on the QBAI regime, which exempts a small portion of CFC income from the minimum tax, as creating (unintended) incentives for offshoring tangible investment and related jobs.[134] Meanwhile, at the technical level, Dana Trier's paper correctly highlights the complexity created by the QBAI regime, as well as the problems created by the QBAI regime's interaction with the treatment of debt.[135] Separately, many commentators view the GILTI's reliance on the existing foreign tax credit and subpart F mechanics to be administratively inadvisable. There are likely more elegant ways to impose a minimum tax than building a system based on calculations at the shareholder level using rules written for entity level calculations.[136] It also is not clear why elements like foreign base company sales income, foreign base company services income, and section 956 are necessary components of a minimum tax regime.

I view the combination of a stable basic architecture (an outbound minimum tax regime) and flexibility as to features and technical/mechanical details of the regime as an opportunity for meaningful multilateralism.[137] From a US perspective, the pragmatic reality is that GILTI may be reformed to function more effectively, but the basic minimum tax concept seems unlikely to be repealed over the medium-term. From a non-US perspective, the key political fact is that the US was historically the biggest impediment to a floor to tax competition. Now the US has in effect embraced such a regime, without

[133] *See, e.g.*, Dana Trier, International Tax Reform in a Second Best World: the GILTI Rules (discussion draft for this conference).

[134] S. Comm. On Finance (minority), 115th Cong., Trump's Tax Law and International Tax: More Complexity, Loopholes and Incentives to Ship Jobs Offshore (2018). Note also that the articulated purpose of QBAI was to measure income from intangibles in an administratively simple way and exempt non-intangible returns from GILTI. A key motivating principle for the regime was that MNCs without high intangible returns should face an exemption system similar to those imposed by the countries of residence of most of their non-US competitors. This policy rationale is coherent, but it is inapposite in a multilateral minimum tax regime.

[135] Trier's paper also illustrates that a QBAI regime is not a natural fit with a German-style interest barrier of the type adopted by the United States in 2017. Trier's paper correctly treats this problem as a reason to question why the US has chosen to exempt a return measured as a percentage of QBAI from its minimum tax, rather than a reason to abandon the German-style interest barrier in favor of [describe Action 4 OECD proposal], which moved forward in the US in the 2017 legislative process as proposed code section 163(n). In the end, section 163(n) was excised from the US legislation as enacted.

[136] Treasury and the IRS will almost certainly smooth out many of the rough edges of the 2017 Act in regulations. But the statutory framework limits their ability to produce a clean system.

[137] Admittedly, as the thorough New York State Bar Report on the GILTI noted, the current GILTI regime contains elements of both a flat rate minimum tax on foreign income and an imperfect add-on to the prior-law subpart F regime. NYSBA Tax Section, Report No. 1394 on the GILTI Provisions of the Code (May 4, 2018), *supra* note 45. Determining whether Congress intended to enact a flat rate minimum tax or an add-on is probably unknowable. What is knowable is that the flat rate theory has a plausible rationale. In contrast, the GILTI as an imperfect add-on to the prior subpart F regime is normatively difficult to defend.

necessarily settling on the details in any permanent way. For countries that have wanted a floor on corporate tax competition and felt the US was an obstacle to such a result, the unsettled state of GILTI is an opportunity for meaningful and potentially efficacious dialogue.

Two non-American sovereigns that may find a minimum tax proposal attractive are Germany and Japan. It is important to understand why: these are export-driven economies. To the extent source becomes defined as destination, which is the trend we see in the other proposals discussed in this paper, these countries' national interest is to find an alternative to a destination-based income tax system. They and other export-driven economies might also find minimum tax systems attractive to the extent that they are concerned that the incidence of a destination-based income tax is more similar to that of a consumption tax than it is to a residence-based corporate income tax. The most viable alternative to a destination-based income tax is a multilaterally agreed inbound/outbound minimum tax regime that supports a version of the residence-based system.

A minimum tax regime that undergirds residence-based taxation is based on concepts that all currently exist in the law of multiple countries. Therefore, it should be easier to agree on and implement than a shift to destination-basis taxation. Moreover, such a regime is more objective than trying to ascribe relative value to different kinds of intangibles.

One important problem with any outbound minimum tax regime is that it applies only to tax-resident MNCs, and therefore creates incentives to redomicile. Outbound minimum taxes lower the benefits to a resident MNC eroding the domestic tax base. However, to the extent the United States, or any other country, imposes such a tax, and no other country does the same, the country or countries imposing the outbound minimum tax on resident MNCs discourage corporate tax residence and encourage foreign tax domiciliation for multinational enterprises. Senator Portman's Permanent Subcommittee on Investigations study entitled *Impact of the US Tax Code on the Market for Corporate Control and Jobs* persuasively showed that under prior US law "foreign acquirers that hail from more favorable tax jurisdictions are able to create value simply by restructuring the affairs of the US target companies to improve their tax profile."[138] The United States understandably does not want to be in that world, and other countries would not want to be, either. I testified to Congress about evidence that an important medium-term result of pressures for redomiciling MNCs out of the US by tax-driven acquisitions of US firms by foreign firms would be fewer high-quality jobs for US workers.[139] The same would hold true for any

[138] Majority Staff of Permanent Subcomm. On Investigations, S. Comm. On Homeland Security and Governmental Affrs., 114th Cong., Impact of the US Tax Code on the Market for Corporate Control and Jobs 2, (2015).

[139] Grinberg Senate Testimony, *supra* note 43. Importantly, the result appears to hold even with formerly US-tax resident corporations that have substantial presence in the United States but change their country of tax residency. Nirupama Rao (formerly part of the Obama Administration CEA) has shown that former US MNCs that undertake inversions subsequently develop higher shares of their employees and capital expenditures abroad after inversion, relative to similar firms that remain US tax resident. Nirupama Rao, *Corporate Inversions and Economic Performance*, 68 Nat'l Tax J. 1073 (2015). As Rao's paper highlights,

country that unilaterally adopted an outbound minimum tax without appropriate defensive measures.

Importantly, multiple countries adopting an outbound minimum tax for resident multinationals alone also would not in and of itself solve the problems associated with cross-border M&A to escape that taxpayer-unfavorable residence country tax net. Without a "defensive measure," all it takes is one viable corporate headquarters jurisdiction to defect and choose not to have an outbound minimum tax for the dynamic favoring acquisitions by tax-favored MNCs to take hold. For that reason, given the fungibility of tax residence for business units (which can be acquired), new businesses (which can incorporate initially abroad), and multinationals as a whole (which are routinely acquired in cross-border M&A transactions) simply differentiating tax burdens based on tax residence, without measures to discourage avoidance of a basic residence tax burden, is untenable as a policy option.

Relationship of Outbound Minimum Taxes to German Royalty Barrier

In 2017, Germany enacted the Act against Harmful Tax Practices with regard to Licensing of Rights (German EStG 4j). This provision of German law restricts the tax deduction of royalties and similar payments made to related parties if such payments are subject to a non-OECD-compliant preferential tax regime and are taxed at an effective rate below 25%.[140] This rule has a quite targeted scope, but it evolved from a more general German interest in proposals to encourage or ensure minimum effective taxation. The concept of encouraging minimum effective taxation at a general level, rather than on an item-by-item basis, continues to be of interest to German policymakers, including at the finance minister level.[141] Importantly, the German idea of minimum effective taxation as it has developed in EStG 4j would appear to reflect a country-by-country conception of minimum effective taxation.[142]

IVB. Inbound Minimum Taxes

The US Congress was cognizant of the problems associated with taxing resident multinationals in a harsher way than non-resident multinationals when it enacted the 2017 Act. The "Unified Framework for Fixing Our Broken Tax Code" discussed the importance

the changes in hiring and investment resulting from inversion are not attributable to the onetime effects on the data due to the inclusion of the foreign acquiring firm's existing workforce and investments. Rather, foreign shares of employment and investment are systematically higher two and more years after inversion, relative to the first year after inversion.

[140] *See* Einkommensteuergesetz [EStG] [German Income Tax Act], § 4j; *see also, e.g.*, EY, German Parliament adopts legislation on limitation of tax deduction of royalties and tax exemption of restructuring gains (May 2, 2017).

[141] *See* Elodie Lamer, *Germany Wants Progress on BEPS, Minimum Effective Taxation,* 91 Tax Notes Int'l 1246 (Sept. 17, 2018).

[142] *See* n.40-41 and accompanying text.

of "rules to level the playing field between US-headquartered parent companies and foreign-headquartered parent companies."[143] In reporting the BEAT to the Senate floor, the Senate Finance Committee explained that "the current U.S. international tax system makes foreign ownership of almost any asset or business more attractive than U.S. ownership… creating a tax-driven incentive for foreign takeovers of U.S. firms… [and] has created significant financial pressures for U.S. headquartered companies to re-domicile abroad and shift income to low-tax jurisdictions."[144] The Senate Finance Committee's explanation went on to explain that the BEAT was supposed to be an administrable way to meet the promise of the framework to level the playing field.

Unfortunately, the BEAT as enacted does not appear to have met this goal. However, the concept of using an inbound tax to defend residence-based taxation is quite rational. Importantly, the defense of an outbound minimum tax would work best if undertaken via multilateral coordination.

The BEAT that Could Be: A Reverse CFC Rule

Four high-level changes would be required to convert the BEAT into a useful inbound base erosion prevention mechanism that also encourages foreign sovereigns to adopt outbound minimum taxes. First, the BEAT would need to be amended so as not to apply to multinationals tax resident in a jurisdiction that imposed a qualifying minimum tax regime. The definition of a qualifying outbound minimum tax would presumably follow the contours of a multilateral agreement. Second, the reformed BEAT would need to be limited to actual base-eroding payments. Most importantly this would mean repealing the disallowance of foreign-tax credits and NOLs in present law BEAT. Third, the base erosion percentage limitation would need to be excised. Finally, the BEAT would need to be expanded to cover at least the value of intangible property embedded in goods, or perhaps to cover goods in their entirety. As explained below, the last of these is viable if the purpose of the reformed BEAT were to incentivize other jurisdictions to adopt qualifying outbound minimum taxes, rather than to raise revenue.

The inbound regime ("BEAT 2.0") described above could be accurately described as a "defensive measure." The base amount would still be determined by taking the taxpayer's taxable income increased by certain base-erosion items. As in the current regime, taxpayers would multiply the BEAT base amount by a given percent of the BEAT base. If that amount exceeded their otherwise-applicable US tax liability, they would pay the difference between the BEAT amount and their regular tax liability.

However, unlike the current BEAT, this regime would apply only to multinational groups that were not subject at the parent level to an (internationally-recognized) qualifying outbound minimum tax. As a result, countries whose multinationals operate extensively

[143] US Dep't of the Treasury, Unified Framework for Fixing Our Broken Tax Code 9 (2017).
[144] Senate Finance Committee, Explanation of the Bill, at 391, https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/11/tnf-sfc-explanation-of-bill-nov30-2017.pdf.

in the US market would have an incentive to adopt qualifying outbound minimum taxes. The incentives in this regard would be much stronger if the United States and the European Union and/or Japan were to take such steps in a coordinated fashion. In a multilaterally agreed minimum tax regime with coordinated defensive measures, multinational corporations would have strong incentives to remain headquartered in key jurisdictions that had qualifying outbound minimum taxes and were thus part of the new international consensus.

Various criticisms of this approach are available. Let me address just three. First, this approach would require some degree of agreement with respect to the acceptable outer boundaries of outbound minimum tax regimes. Minimum standards with respect to an outbound minimum tax regime represent a certain degree of tax harmonization. Some might fear this would represent a slippery slope towards even further tax harmonization, and that such constraints on tax competition are inappropriate. However, I would suggest to such critics that tax sovereignty is a basic interest of national sovereigns, and that a small step in the direction of coordinated rules may not in this case be a particularly slippery slope.

Moreover, note that the minimum tax regime likely requires much less tax harmonization than the DBRMPA. Inbound minimum taxes used as defensive measures to backstop the outbound minimum tax regime require determining some effective tax rate for the outbound regimes of jurisdictions that formally impose an outbound minimum tax. Otherwise countries could adopt an outbound minimum tax at the appropriate rate on a very narrowly defined base.

But note that the harmonized base definition issues are actually less extensive than in the DBRMPA. Unlike in a DBRMPA (or user participation), in the minimum tax structure the national rules that determine the base from which the effective tax rate is measured only matters with respect to the question of whether a national defensive measure is imposed. As a result, the pressures for countries to agree on a shared definition of the appropriate tax base are low. In the minimum effective taxation regime, the base only matters for the purpose of measuring the effective tax rate imposed in another jurisdiction, rather than for purposes of actually splitting up the tax base. As a result, inconsistent national definitions are fine within some wide margins. In contrast, in the DBRMPA and under user participation, the absence of base harmonization can have consequences in every case, because both of those approaches are unitary tax systems. Consistent definitions are needed to split up a base and therefore avoid double taxation. As a result, the pressures to harmonize are higher.

Second, Part IIIB.1. highlights why it is difficult to write regulations that separate embedded intangibles from the overall value of a tangible good in an administrable way. Sales of products containing embedded intangibles present a challenge for any inbound base protection rule that is meant to be WTO-compliant while raising revenue; rather than

acting as an incentive for other countries to adopt a regime that is exempt from the inbound base protection rule/defensive measure.[145]

In contrast, if the inbound base erosion/defensive measure rule applies only to multinationals that are not subject to a qualifying outbound minimum tax regime, and if (for example) the United States, the European Union, and perhaps Japan have all adopted such regimes, then "rough justice" that erred on the side of inclusion in destination country tax bases would not be a problem.[146] Indeed, onerous rough justice would help ensure widespread adoption of qualifying outbound minimum taxes. As more jurisdictions adopted qualifying outbound minimum taxes, the treatment of COGS in cross-border transactions with corporations' whose parent entity was tax resident in a jurisdiction without a minimum tax would become ever less important.[147]

Third, some might suggest that the minimum tax solution would not stop some sovereigns from separately enacting unilateral measures to ring-fence and tax large US tech firms participating in the digital economy. I have sympathy for this critique. We are living through a mercantilist and politically charged moment in international economic law (and the US is not exempt from this characterization). In the current environment, some sovereigns do seem to want a shift of the "digital" tax base, rather than to ensure a single level of tax on corporate income. The minimum tax proposal does not affect a shift of the tax base from residence to destination, and does not serve a mercantilist end in the digital sector. Thus, some sovereigns might take unilateral measures to accomplish their desired ends with respect to the digital sector on top of a minimum tax. Indeed, this concern may motivate the marketing intangibles proposal.

However, given that the United States already has a GILTI and is unlikely to repeal it in the medium term, I do not believe the "but it won't stop other countries' digital proposals" critique substantially changes the US policy calculus. Rather, if other sovereigns see redeeming features in the basic outlines of the American status quo, that outcome is in the national interest of the United States. This conclusion does not change if it turns out that multilateral agreement on a minimum effective taxation regime does not also completely stop unilateral efforts by some sovereigns to target the US tech sector. No proposal

[145] In an inbound base erosion regime intended to raise revenue, disaggregation of embedded intangibles could be required for cross-border payments associated with the supply in the United States of any good or service. Huge pressure would then exist for regulations attempting such a disaggregation to avoid overbreadth.

[146] It may be that such an agreement could not be reached with the EU in advance of March 29, 2019, the date for which Brexit is scheduled. Note also that from a US perspective what would be important would be for an agreed defensive measure to be applied by all EU member states at the external EU border. If freedom of establishment constraints prevented application of a defensive measure by EU sovereigns in regard of payments to other EU member states, that limitation would not raise any fundamental US policy concern.

[147] Importantly, so long as the inbound minimum tax is intended as a defensive measure rather than a meaningful revenue raiser, principled answers with respect to the currently intractable problems raised by embedded intangibles and foreign corporations with no taxable nexus under current standards are simply not necessary. Given the technical challenges raised by these two issues, the ability to avoid them is a significant advantage.

(including the marketing intangibles proposal) can fully stop such efforts in any case; the political reality abroad that views the US tech sector with distrust is simply too strong. What is important is that an agreement to implement a minimum tax block a multilateral agreement on a digital-only proposal, and also that the foreign countries most interested in a minimum tax outcome commit (including on a bilateral basis) not to pursue digital-only measures.[148] In other words, although the tech sector is an important US national interest, it is clearly not the only US national interest in the field of international taxation. Rather, our broadest interest should be to stabilize the international tax system generally, ensure that its architecture remains principled, provide certainty for all of our businesses, and bring our new international tax system more closely into alignment with international norms.

Although a multilateral agreement on a minimum effective taxation regime would not necessarily stop every foreign sovereign from enacting tech-specific tax proposals, it would likely discourage many sovereigns from doing so. To provide a simple example, if the German government were to agree to a minimum tax proposal as a solution to the digital tax question, and commit not to enact a digital-only proposal, it seems unlikely they would renege over the medium term. In my judgment the diplomatic and technocratic political culture of Germany is not such that it would agree to a solution to the digital issue that involved a minimum tax multilaterally, and then shortly thereafter enact a digitally-focused tax. A similar observation might be made about many governments (consider Japan for example). If the European Commission were to sign on to a minimum effective taxation agreement to settle the digital tax debate, it is also unlikely that the letter of the agreement would be abandoned. In that particular case, from a US perspective having both EU member states and the Commission commit to an agreement is important. The US should insist at the OECD that the Commission be an independent party to any agreement.

To address any concerns about individual countries behaving perfidiously, the United States should consider including a punitive measure in its reformed inbound minimum tax (BEAT 2.0) to discourage the imposition of particularly destructive taxes. For example, in my view today's gross basis turnover taxes on digital business represent a relatively transparent mercantilist effort to target US firms. US law could be structured so as to apply the reformed BEAT to jurisdictions that imposed taxes targeted at US MNCs, even if they adopted a minimum tax regime. As a statutory matter one could use section 891 as a model in this respect. Such a tool would be perceived to have legitimacy internationally if it were tied to a multilateral agreement on minimum taxation. International legitimacy (even if not complete acceptance) should be an important consideration for those of us concerned with reestablishing stability in the broader international economic law environment.[149]

Finally, one might be concerned that the United States itself might want to abandon the minimum tax at a future date. The US could unilaterally overcome its fiscal challenges

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[148] In the case of Germany, an important question also arises as to whether there should be a commitment to block EU-level digital-only solutions.

[149] More generally, the points above about coordination as to minimum standards for an outbound minimum tax regime would not require agreement as to all the details of the inbound minimum taxes (defensive measures) enacted by individual countries that are intended to backstop the outbound minimum tax regime.

and obtain fiscal leeway to lessen its reliance on our economically inefficient corporate double tax by adopting a new revenue source, such as a VAT. At that juncture a multilateral minimum tax regime would function as an unwelcome constraint. However, a new revenue source is not in the offing at this time in the United States. Moreover, it seems unlikely that the political process will soon sanction reducing corporate tax rates by increasing individual income taxes. As a result, anti-base erosion measures will probably continue to be needed over the medium term.

Conclusion

The international tax system that emerged after World War II had the important advantage of being nestled within a broader world order that, in Henry Kissinger's classic formulation, "had the advantage of uniform perceptions."[150] Countries accepted that the United States led the post-war international economic order of the free world. Almost as a minor corollary, countries generally accepted that the United States led the development of the transfer pricing regime, too.

In contrast, few observers would claim that today's international economic climate features uniform perceptions. The current state of international tax affairs reflects the broader disarray.

One important goal in this difficult environment should be to reestablish some stability to the international tax regime. Among other things, doing so could contribute to the broader goal of stabilizing our system of international economic law more generally.

If medium-term international tax stability is a goal, any answer to the questions raised by the digital economy cannot be limited to any definition of the digital economy, because no corporate international tax problem is unique to the digital economy. Moreover, the features of the digital economy that proponents of a digital-only solution might point to are gradually expanding to encompass the bulk of the economy.

However, the digitization of the economy does force policymakers to confront a basic choice between destination-based corporate income taxation and residence-based corporate income taxation. A shift from our residence-based system to a destination-based corporate income tax, if agreed to by the major economies, is certainly a viable option. But moving to a DBRPA would require significantly higher levels of information exchange and

[150] Henry Kissinger, Diplomacy 27 (1994). Not only was the United States the only country with the economic might to organize the international tax system of the capitalist world – its capacity to dictate international tax rules was part of a broader reality in which, in the Cold War period, the US in effect organized most aspects of the economic and military structure of the noncommunist developed world. US tax leadership, like US political and economic leadership more broadly, was accepted in large part because of a threat the developed noncommunist world perceived; namely that without US leadership the world might fall under Soviet domination.

collection assistance than currently exist. More fundamentally, a shift all the way to a destination-based corporate income tax presently seems politically implausible.

Indeed, the current debate internationally does not include a full move to destination-based corporate income taxation as an alternative. Instead there are two proposals that in effect split the baby between destination-based corporate income taxation and residence-based corporate income taxation. These are the user participation theory and the DBRMPA.

The latter "compromise" proposal, the DBRMPA, is principled and, at the 100,000 foot level, may appear politically attractive. It does change the balance of allocation of taxing rights. However, the DBRMPA creates a new set of administrative challenges for which we may not have solutions, while leaving the problems of the current transfer pricing system in place, and adding a new source of fundamental controversy – the appropriate split of excess returns between the market and the current transfer pricing system. These issues could play out as between governments and between governments and MNCs with respect to every cross-border transaction. What analyzing the DBRMPA highlights is that compromise between a destination-based income tax and a residence-based corporate income tax, even principled compromise, is hard to administer. Splitting the baby is probably unwise. If policymakers wish for a destination-based income tax, they should really try to go all the way there.

That said, if policymakers consider the compromise that is the DBRMPA, they should abandon the notion of measuring the relative value of marketing and non-marketing intangibles and accept a simple formulary split between the two residual return categories. It seems to me that in a DBRMPA system, a formulary approach, ideally backstopped by mandatory binding arbitration, is the only way to control the extent of tax controversy. Note, however, that there is currently no international law mechanism that would easily ensure that countries would respect an agreement to a specific allocation of the excess return between marketing intangibles and other intangibles. Bilateral tax treaties are not well-suited to enshrining such an approach; a multilateral treaty (not the MLI of the BEPS project) might be needed.

In contrast to destination-basis corporate income taxation, a minimum tax regime that undergirds residence-based taxation is based on concepts that all currently exist in the law of multiple countries. Therefore, it should be easier to agree on and implement than the DBRMPA, because it does not require tackling all the issues involved in a shift to destination-basis corporate income taxation. A minimum tax regime also (perhaps counterintuitively) requires less extensive international coordination than a DBRMPA. Finally, in a multilaterally agreed regime that included both outbound and inbound minimum taxes, multinational corporations would have strong incentives to remain headquartered in key jurisdictions that had qualifying outbound minimum taxes. Thus, the weakest point of a residence-based system – redomiciliation and tax-driven cross-border M&A – would be addressed. Compared to a partial move to destination-basis corporate income taxation, undergirding the residence-based regime with outbound and inbound minimum taxes seems both less disruptive and more administrable.

What is the mechanism for getting there? Success will require discussions around both substance and process to take place at the OECD. Americans must be aware that it will not be the sort of discussion the United States tended to have at the OECD a generation or two ago. The United States no longer is the uncontested leader of the capitalist world, and it does not have an uncontested leadership position in international tax, either. Rather, the best hope in the 21st century is to use the OECD in international tax the way Metternich used the Congress of Vienna in European military affairs in the 19th century – as a mechanism to overcome quite significant differences in perspective via a balance of power, and in the process (re)build legitimacy, shared values, and a stable equilibrium.

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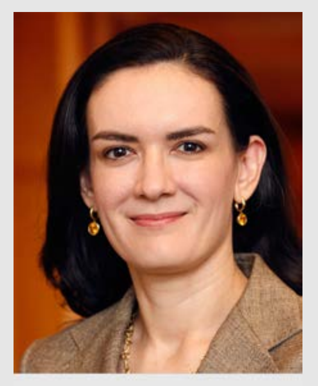
Digital Battlefront in the Tax Wars

by Ruth Mason and Leopoldo Parada



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In this article, the authors argue that the high revenue triggers in proposed digital taxes — including the recent Franco-German proposal for a digital advertising tax — may violate state aid law and prohibitions on nationality discrimination in the Treaty on the Functioning of the European Union.

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We live in an era characterized by widespread, if not total, agreement that our 1920s-vintage international tax system is not fit for our modern digital economy.[1] Failure to secure multilateral agreement on how to tax the digital economy has led countries to consider unilateral solutions ranging from alternative applications of the traditional permanent establishment threshold to specific regimes targeting large multinational enterprises, including withholding and turnover taxes.[2]

The European Commission proposed both short- and long-term solutions to the digital tax problem.[3] These proposals face the high bar of member state unanimity to pass, along with a host of questions about whether the Treaty on the Functioning of the European Union even gives the EU the power to adopt them.[4] The long-term solution involves a fundamental expansion to the PE concept to include a "significant digital presence" that would allow a source state to tax nonresident companies with substantial business activities in the state, even absent a physical presence or dependent agent. The commission's

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[1] *See, e.g.*, Yariv Brauner and Pasquale Pistone, "Adapting Current International Taxation to New Business Models: Two Proposals for the European Union," 71(12) *Bull. Int'l Tax'n* (2017); Georg Kofler, Gunter Mayr, and Christoph Schlager, "Taxation of the Digital Economy: 'Quick Fixes' or Long-Term Solution?" 57(12) *Eur. Tax'n* (2017); Kofler, Mayr, and Schlager, "Taxation of the Digital Economy: A Pragmatic Approach to Short-Term Measures," 58(4) *Eur. Tax'n* (2018); and Wolfgang Schön, "Ten Questions about Why and How to Tax the Digitalized Economy," 72(4/5) *Bull. Int'l Tax'n* (2018).

[2] OECD, "Tax Challenges Arising From Digitalization — Interim Report 2018: Inclusive Framework on BEPS" (2018), at 134 (OECD, "Tax Challenges").

[3] Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services, COM(2018) 148 final (Mar. 3, 2018) (EU DST proposal).

[4] Scholars have raised questions about the EU's capacity to enact, via TFEU articles 113 and 115, antiabuse legislation. *See, e.g.*, Maria C. Barreiro Carril, "Does the Anti-Tax Avoidance Directive Involve a Positive Step Towards the Completion of the Internal Market? Some Reflections in the Light of Linking Rules Addressing Hybrid Mismatches," in *European Tax Integration: Law, Policy and Politics* (forthcoming 2018); Ivan Lazarov and Sriram Govind, *Carpet-Bombing Tax Avoidance in Europe: Examining the Validity of the ATAD Under EU Law* (forthcoming). *See also* Consolidated Version of the Treaty on the Functioning of the European Union, 2012 O.J. C 326/01, articles 113 and 115.

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short-term solution, the digital services tax (DST), involves a tax on turnover associated with specific types of digital services, for example, revenue from selling online advertisements.

Although the DST did not gain the necessary unanimous Council vote at the ECOFIN meeting earlier this month, France and Germany have proposed modifying the terms of the DST to tax only digital advertisement revenue earned by large companies. France and Germany propose EU Council adoption of the modified DST by March 2019.[5]

The EU's DST has been roundly and justly criticized.[6] Commentators claim that digital taxes would inefficiently discriminate against particular sectors and countries,[7] operate as a tariff,[8] result in double taxation, be passed on to consumers, and invite retaliation.[9] The DST was designed as an unapologetic stopgap, a less-than-ideal proposal that would apply until the EU can work out a better solution to the challenges of taxing an increasingly digitized economy. Such a stopgap could inhibit lasting reform.[10]

This article makes two arguments: (1) unilateral digital taxes may violate state aid rules; and (2) both digital taxes adopted by particular member states and digital taxes as an EU directive may violate EU laws against nationality discrimination. Those arguments depend critically on two features of the proposed digital taxes: (a) their high revenue triggers, which ensure that only very large, and therefore disproportionately foreign, companies pay digital taxes; and (b) their narrow scope, which ensures that only companies operating in specific disfavored sectors face taxation.

To the extent that any modified EU digital tax proposal ends up sharing these features, it would face the same challenges.

If those flaws were corrected, digital taxes would be less discriminatory, but also less politically palatable.

I. Problematic Features of Digital Taxes

A. EU Digital Tax Proposals

At the time this article went to press, it appeared the European Commission's DST proposal lacked the political support it would need to pass. Nevertheless, because several member states have based their unilateral DST proposals on the commission's DST, we describe it in detail.

The EU's proposed interim DST is a 3 percent turnover tax that would apply to some revenue earned by large companies or members of large groups. Specifically, it would apply only to entities that either themselves, or as part of a consolidated group, have worldwide annual revenues in excess of €750 million and EU annual taxable revenues in excess of €50 million.[11]

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[5] Franco-German joint declaration on the taxation of digital companies and minimum taxation (Dec. 4, 2018).

[6] *See, e.g.*, Letter from Sens. Orrin Hatch and Ron Wyden to President Donald Tusk and President Jean-Claude Juncker (Oct. 18, 2018) (urging the EU to abandon its DST proposal because it was "designed to discriminate against US companies" and because it would "undermine the international tax treaty system," create trade barriers, lead to double taxation, and possibly violate the WTO).

[7] Many have proposed meaningful reform to address, among other issues, the digitalization of the economy. *See, e.g.*, Andrés Báez and Yariv Brauner, *Policy Options Regarding Tax Challenges of the Digitalized Economy: Making a Case for Withholding Taxes* (forthcoming) (expansion of withholding taxation); European Commission, Proposal for a Council Directive Laying Down the Rules Relating to the Corporate Taxation of a Significant Digital Presence, COM(2018) 147 Final (Mar. 21, 2018) (proposing changes to the definition of a PE in tax treaties to accommodate a nonphysical, but significant, digital presence); Alan J. Auerbach, Michael P. Devereux, Michael Keen, and John Vella, "Destination-Based Cash Flow Taxation," Oxford University Centre for Business WP 17/01 (2017) (detailing DBCFT); Bret Wells and Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source Is the Linchpin," 65 *Tax L. Rev.* 535 (2012) (proposing base-erosion tax); *and* Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," 9 *Fla. Tax Rev.* 497 (2009) (proposing profit splits in lieu of arm's-length separate accounting). At least some of these proposals would seem to address the concern that actually seems to motivate the commission — the inability of the market state to capture taxes under the current system.

[8] Daniel Bunn, "A Summary of Criticisms of the EU Digital Tax," Tax Foundation (Oct. 22, 2018).

[9] Brady Statement on U.K. Tax on Digital Services (Oct. 31, 2018) ("if the United Kingdom or other countries proceed, that will prompt a review of our U.S. tax and regulatory approach to determine what actions are appropriate to ensure a level playing field in global markets").

[10] *See* Hatch-Wyden Letter, *supra* note 6, at 1 ("the EU claims that the EU DST proposal is an interim measure; however, the proposal contains no end date and could conceivably last indefinitely"). *See also* Ruth Mason, "Implications of *Wayfair*," 46 *Int'l Tax Rev.* 810 (2018) (noting that, in the United States, the supposedly temporary solution to tax challenges created by remote sellers that lacked physical presence in the U.S. states lasted 50 years).

[11] EU DST proposal, *supra* note 3, article 4(1) (revenue trigger), article 4(6) (revenue trigger applies on a consolidated basis if entity is part of a group); article 2 (defining entities and consolidated groups).

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In addition to applying to only a small subset of entities, the first version of the DST would have applied only to some kinds of revenue, those resulting from:

> (a) the placing on a digital interface of advertising targeted at users of that interface;
>
> (b) the making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users;
>
> (c) the transmission of data collected about users and generated from users' activities on digital interfaces.[12]

The first version of the DST thus would have hit online ad sales, revenue from providing online marketplaces like Airbnb where both buyers and sellers are users, and sales of user data. After the EU Council effectively rejected the first formulation of the DST earlier this month, France and Germany asked the commission to modify it to tax only digital ad revenue. France and Germany did not ask the commission to remove the DST's revenue triggers.[13] To reflect that, our argument applies to any taxes with high revenue triggers and a narrow base, we refer collectively to all of the first EU DST, the Franco-German proposed amendments to the EU DST, and the various unilateral member state proposals as "digital taxes."

Taxpayers would remit digital taxes to the member states according to complicated rules for determining the location of a business's users (as measured by IP address, geolocation, or similar technologies).[14] Digital taxes may or may not be deductible from member state corporate income taxes.[15]

B. Member State Digital Taxes

Several states — including Spain, the United Kingdom, and most recently France — have considered or vowed to implement unilateral digital taxes if the European Commission's proposal does not go through.[16] Those unilateral member state proposals mirror the commission's approach[17] — importantly, they apply only to companies with very large global turnovers and only to specific types of revenue.

C. Our Argument, Briefly

The very large revenue triggers in the various digital tax proposals guarantee — as they were meant to — that digital taxes will fall disproportionately on U.S.-headquartered companies. The revenue triggers are facially neutral; they formally burden neither nationality nor familiar proxies for nationality, such as tax

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[12] EU DST proposal, *supra* note 3, article 3.

[13] Franco-German joint declaration, *supra* note 5 ("We invite the EU Commission and the Council: first to amend and focus its draft directive for a digital services tax on a tax base referring to advertisement, on the basis of a 3 [percent] tax on turnover, and second to submit proposals in due course on taxing the digital economy and minimum taxation in line with the work of the OECD").

[14] For criticism of user-based allocations, see, for example, Chartered Institute of Taxation, "Response to EU Commission Recommendation Relating to the Corporate Taxation of a Significant Digital Presence" (May 16, 2018), at 3 ("it is not agreed by all businesses that users do contribute significant value; but if it is accepted that users do contribute value, the amount of value that they do contribute will inevitably vary from business to business"); and PwC, "European Commission Proposals for Directives Regarding Fair Taxation of the Digital Economy ('Digital Tax Package')" (May 16, 2018) ("revenue is allocated according to where a user is when she views an ad, whereas viewing the ad may not be the source of her contribution to value. As others have pointed out, not only does the allocation proposal not prevent double-counting of users, but it has only a tenuous relationship with user value-creation, the ostensible justification for the tax.").

[15] EU DST proposal, *supra* note 3, article 20.

[16] "UK Could Go It Alone on Digital Services Tax: Finance Minister," Reuters (Oct. 1, 2018) (quoting British Chancellor of the Exchequer Philip Hammond as saying, "The time for talking is coming to an end and the stalling has to stop . . . . If we cannot reach agreement, the UK will go it alone with a Digital Services Tax of its own."); Document Subject to Public Information Procedure (Oct. 23, 2018), Blueprint of the Law No. XX/2018 on Specific Digital Services Tax (translation by the authors) (Spanish DST). The proposed Spanish DST is pending final approval at the Spanish Congress.

[17] The proposed U.K. DST provides for a lower tax rate (2 percent rather than the 3 percent in the EU and Spanish proposals, it establishes a safe harbor for companies with losses or low profits, it will be evaluated in 2025 to determine if it should be extended, and it does not specify how the revenues generated by companies providing digital services will be linked to U.K. users. *See generally* HM Revenue & Customs, "Digital Services Tax: Consultation" (Nov. 2018) (U.K. DST proposal). The EU and Spanish DST proposals specifically provide for the use of IP addresses and other geolocation methods. EU DST proposal, *supra* note 3, article 5(5); Spanish DST, *supra* note 16, article 7(4). The Spanish DST even provides monetary sanctions against users who attempt to fake or hide their IP addresses. Spanish DST, *supra* note 16, article 15.

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residence. Nevertheless, they are so high that the taxable population is very likely to be mostly foreign when viewed from the perspective of any one member state applying the digital tax. Domestic companies liable for digital taxes are likely to be foreign-parented, rather than domestic-parented.[18] As we explain, that effect might violate EU law as nationality discrimination.

Likewise, selective features of unilateral digital taxes may violate the state aid rules.

II. Preliminary Concerns

A. Who Can Bring a Claim?

1. Fundamental Freedoms

The principal target of European digital tax proposals is *U.S.-headquartered multinationals* doing business in Europe. But discriminating against U.S. companies is not illegal under the fundamental freedoms.[19] Thus, to challenge digital taxes under the fundamental freedoms, you would need an *EU plaintiff*. Because the U.S. companies that are the target of digital taxes typically operate in Europe through at least one subsidiary, and because those subsidiaries have standing to bring fundamental freedoms challenges,[20] standing should not be an insurmountable issue, at least when challenging *unilateral* digital taxes. For example, while U.S.-incorporated Apple Inc. would lack standing to bring a claim against, say, France for discrimination, one of its Irish subsidiaries with activities in France that are taxable under a unilateral French digital tax would have standing to bring a nationality discrimination claim against France.

Challenging a digital tax adopted as *an EU directive* under the fundamental freedoms raises interesting standing questions because it is unclear at what level you would test whether there has been a violation of a fundamental freedom. Is the relevant question whether the EU directive in aggregate, as assessed by all the member states, results in a violation of the fundamental freedoms (for example, because it disproportionately burdens multinationals and cross-border provision of services as compared with domestic companies and domestic provision of services)? Or do you test at the member-state level, such that there would be discrimination if, say, Malta applied the directive exclusively or nearly exclusively to taxpayers resident in other EU member states? As with finding an EU plaintiff, those obstacles do not seem insurmountable because you can make out a discrimination claim at either level.

While we mostly direct our fundamental freedoms arguments in this article to unilateral digital taxes, readers should keep in mind that the same arguments may be valid against EU directives on digital taxation if they contain similar revenue triggers. For this purpose, it would not matter whether the tax base included all of online ad sales, revenue from providing two-sided marketplaces, and sales of user data — as described in the original DST proposal — or whether the tax base was limited to only digital ad revenue, as proposed this month by France and Germany.

2. State Aid

a. Deutsche Bahn Immunity. EU directives[21] are immune from state aid review under the *Deutsche*

[18] Although the Spanish government did not publish an empirical analysis of the expected effects of the tax, it concluded that it would "mainly . . . affect multinational companies." Memorandum of the Regulatory Impact Analysis of the Law XX/2018, of XX of XX, on the Digital Service Tax (translation by the authors), at 21 (Spanish DST impact analysis).

[19] U.S. companies receive protection under the freedom of movement of capital, but not under the freedom of establishment. It is worth noting, however, that in its article 110 jurisprudence, the CJEU typically divides the universe of goods into domestic and foreign, rather than into domestic and *other-EU*.

[20] Subsidiaries claiming against their own member state would argue that the state discriminates against them by virtue of their foreign parentage. Subsidiaries claiming against other member states (for example, for taxes against turnover earned by branches) would have direct nationality discrimination claims.

[21] Tax directives require member state unanimity to pass at the EU level. After passage, each state transposes the directive into domestic law.

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Bahn doctrine.[22] Immunity of EU actions from state aid scrutiny has a textualist grounding: Because the TFEU bans only "aid granted by a Member State," it does not constrain aid granted by the EU itself.[23] So a directive could not be challenged as state aid, but unilateral digital taxes could. However, only the commission has standing to bring state aid investigations, and a principal obstacle to a state aid challenge may be the commission's reluctance to challenge unilateral member state rules modeled on the commission's own DST legislative proposal.

b. Brexit. It is likely that some sort of state aid prohibition will continue to apply to the United Kingdom as part of the Brexit deal.[24] The draft deal says that enforcement would switch from the European Commission to the U.K.'s competition authority after four years,[25] but U.K. authorities and courts would still be required to follow EU case law.[26] U.K. courts would enforce state aid in the United Kingdom, and EU courts in the EU.[27]

The United Kingdom has a long history of supporting EU state aid rules and has been among the EU's lowest granters of state aid.[28] Retention of state aid appears to be one of the less contentious issues at stake in the Brexit deal. Even in a no-deal scenario, the U.K. government prepared a national state-aid framework to replicate the existing EU regime. Accordingly, in the beginning of 2019, the U.K. competition authority is expected to publish its guidance on what new U.K. state aid regulations would be.[29]

B. Deference to Directives

We said that EU directives are immune from state aid scrutiny under the *Deutsche Bahn* doctrine. It is unclear whether directives are similarly immune from fundamental freedoms scrutiny. At least one case suggests that the Court of Justice of the European Union will not review EU directives for compatibility with the fundamental freedoms, even if a directive contains a blatantly discriminatory provision.[30] On the other hand, the CJEU closely reviews member state transpositions of directives to ensure that they do not violate fundamental freedoms. For example, if the directive provides options, member states must exercise those options consistently with EU law.[31]

While resolving questions of directive immunity is beyond the scope of this article, there are reasons to think that directives are not wholly immune from fundamental freedoms scrutiny, including that as TFEU provisions, the fundamental freedoms are legally superior to directives.[32] Even so, the CJEU may review directives more leniently under the fundamental

[22] *See Deutsche Bahn AG v. European Commission*, T-351/02 (European Court of the First Instance 2006) (holding that an allegedly discriminatory German tax exemption could not be analyzed as state aid when it derived from an EU directive because the exemption was imputable to the EU, not to Germany). *See* Andrés Báez, "El requisito de la imputabilidad de las ayudas de Estado y su aplicación a los impuestos armonizados: a propósito de la exención del combustible utilizado como carburante en la navegación aérea recogido en la Directiva de la Energía," 324 *Noticias de la Unión Europea* 99-107 (2012) (arguing that *Deustche Bahn* undermines the purpose of state aid rules, which is the defense of competition within the EU).

[23] TFEU, *supra* note 4, article 107 ("aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall in so far as it affects trade between Member States, be incompatible with the internal market").

[24] Ilze Jozepa, "EU State Aid Rules and WTO Subsidies Agreement," Commons Briefing Paper No. 06775 (Nov. 7, 2018), at 20.

[25] Draft agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, as agreed at negotiators' level on Nov. 14, 2018, articles 92 and 93.

[26] Jozepa, *supra* note 24, at 23.

[27] HM Government, White Paper on The Future Relationship between the United Kingdom and the European Union, Cm 9593 (July 12, 2018), at section 4.4.2.

[28] In 2016 the United Kingdom gave 0.36 percent of GDP as state aid, half the EU average of 0.7 percent. European Commission, "State Aid Scoreboard 2017" (accessed Nov. 14, 2018).

[29] U.K. Department for Business, Energy & Industrial Strategy, "State Aid if There's No Brexit Deal" (Aug. 23, 2018).

[30] *Commission v. Greece*, C-475/01 (CJEU 2004) (upholding Greece's entitlement to assess the Greek liquor ouzo at a lower VAT rate than other liquors; permission for the low rate had been expressly provided in the directive). *But see* Kofler, "The Relationship between the Fundamental Freedoms and Directives in the Area of Direct Taxation," 6(2) *Diritto e Pratica Tributaria Internazionale* 471, at 482-483 (2009) (criticizing the court's reasoning and noting that the case suffered from a number of procedural infirmities that made it impossible to directly challenge its compatibility with the fundamental freedoms).

[31] Directives usually provide the language to be transposed, but they sometimes allow member states flexibility (for example, they can choose the credit method or exemption method to relieve double tax, and so forth). *See* Kofler, *supra* note 30, at 472 and 501-504 (discussing member state transposition of EU tax directives in, among other cases, *Bosal* and *Keller Holding*).

[32] Good arguments can be made for and against. *See* Mason, "A Political-Process Defense of Deutsche Bahn Deference," Virginia Law and Economics Research Paper No. 2018-17 (Nov. 14, 2018) (distinguishing state aid deference from fundamental freedoms deference). While views on deference may diverge, most commentators would agree that a directive of the form "all Member States may double their tax rates on Irish nationals" would violate the fundamental freedoms, even if Ireland voted for the directive in exchange for compensation from the other states.

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freedoms than it would unilateral member state legislation.[33] Although the doctrine is not clear on this issue, either, in at least some cases, the Court has taken a deferential attitude toward directives, particularly when they represent a temporary stage on the way to more thorough harmonization.[34] Because the EU's interim digital tax proposals are meant to sunset on adoption of more comprehensive reform, the CJEU may regard them deferentially under its "harmonization in stages" doctrine.[35]

This article does not address the wisdom of lighter judicial review for EU actions than member state actions.[36] Instead, we assume that even if the Court reviews EU actions less stringently than it does member state actions, it will still — as it has in past cases[37] — meaningfully review EU actions to preclude nationality discrimination. However, if directives receive deference, it would be strategically advantageous for litigants to challenge a unilateral digital tax, like the Spanish DST, before attempting to challenge the EU directive. A holding against a member state that turnover-size thresholds constitute nationality discrimination would make it harder for the CJEU to uphold an identical or substantially similar rule in an EU directive. At a minimum, it would require the Court — for the first time — to state explicitly that directives receive deference or immunity from fundamental freedoms scrutiny.

C. Bottom Line

In sum, if the CJEU adheres to the *Deutsche Bahn* doctrine (which was established by the EU's lower court), then no one can challenge an EU directive as state aid. If individual member states pass digital taxes, then only the commission would have standing to bring a state aid investigation, but it is unclear whether the commission would do so.[38]

Any EU taxpayer liable for the digital tax would be able to challenge it under the fundamental freedoms, but because the CJEU affords directives deference, a taxpayer is more likely to be successful when challenging national digital taxes than when challenging EU directives.

III. Fundamental Freedom Violations

The fundamental freedoms forbid nationality discrimination, including not only facial discrimination that overtly uses nationality to deny tax benefits, but also other classifications that disproportionately tax nonnationals.[39] There are a few different fundamental freedoms arguments that challengers could use against digital taxes whether adopted as an EU directive or as a unilateral member state rule. Challengers' cases typically would be stronger against unilateral rules, because of both judicial deference to directives and the challenges of articulating *within EU* discrimination under a directive.

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[33] Karoline Spies, "Fundamental Freedoms and VAT: An Analysis Based on the *Credit Lyonnais* Case," 6 *World J. VAT/GST* 100 (2017) (pointing to a recent case in which the CJEU accepted apparent nationality discrimination embedded in the VAT Directive). *See id.* at 108 (concluding that "when looking at the few cases it has considered so far, the CJEU seems to apply a less strict standard when analysing whether the EU legislature has infringed the fundamental freedoms as compared to the standard it applies when domestic legislatures are alleged to have infringed them"). *See id.* at 109 (noting that the Court has never invalidated a mandatory provision of a directive as a fundamental freedoms violation). *See also Crédit Lyonnais*, C-388/11 (CJEU 2013) (holding that member states must calculate the VAT recovery ratios of domestic head offices on a territorial, not worldwide basis, which excludes consideration of foreign, but not domestic, branches). *See also* Michael Lang, "ECJ Case Law on Cross-Border Dividend Taxation: Recent Developments," 2008 *EC Tax Rev.* 67, 73 ("Analyzing the case law of the Court, one gets the impression that fundamental freedoms play a smaller role the more the Community legislator has taken action."). *See also* Rita Szudoczky, "The Sources of EU Law and Their Relationships: Lessons for the Field of Taxation," IBFD Doctoral Series, Vol. 32 (2014, at section 8.3.5.3 at 450-456 (concluding that "Union acts are measured by a lower standard of proportionality than national measures when they are reviewed for their compatibility with primary law").

[34] This deference described by Spies may be particularly relevant when the measure, like the proposed DST, is meant to be a stage in a larger plan of harmonization. *See generally* Spies, *supra* note 33 (describing the Court's tolerant attitude toward "harmonization in stages").

[35] Szudoczky, *supra* note 33, at 448 (concluding that "the 'harmonization-in-stages' reasoning is sometimes used by the Court to shield clearly and blatantly discriminatory provisions laid down in secondary law and/or national law based on the mere fact that such provisions are transitional in nature").

[36] *See* Mason, "A Political-Process Defense," *supra* note 32.

[37] *Rewe-Zentral*, C-37/83 (CJEU 1984), para. 18 (noting that although treaty rules prohibiting measures that have an equivalent effect to quantitative trade restrictions "apply primarily to unilateral measures adopted by the Member States, the Community institutions themselves must also have due regard to freedom of trade within the Community, which is a fundamental principle of the common market").

[38] *See* Ruth Mason, "Tax Rulings as State Aid FAQ," *Tax Notes*, Jan. 23, 2017, p. 451 (explaining that the commission choses its state aid cases non-transparently and that those choices are unreviewable).

[39] *Id.*

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A. Groups

The current formulation of the European Commission's DST (and unilateral digital taxes modeled on it) treats corporate groups worse than stand-alone companies, and groups are more likely than stand-alone companies to be engaged in cross-border provision of services, an activity protected by the fundamental freedoms.

Under the commission's current DST proposal and similar national proposals, if an entity is a part of a group, the *group's global revenue* would determine whether the entity will be liable for the DST.[40] In contrast, for a stand-alone company, only its own revenue counts toward the revenue trigger. France and Germany have not recommended changing this feature in the revised DST proposal.

This difference in treatment between groups and standalone companies raises EU law issues. In *Hervis*, a recent fundamental freedoms case, the CJEU held that similar methods for aggregating turnover across group members to determine tax rates could result in nationality discrimination.[41]

B. Foreign-Parented Companies

We've known at least since *Metallgesellschaft* that member states can violate the fundamental freedoms by discriminating against domestic companies with parents in other member states (for example, French companies with Irish parents).[42] Thus, if member states apply their unilateral digital taxes disproportionately to domestic subsidiaries that are parented by companies resident in fellow EU states, that could constitute nationality discrimination. That argument would be unavailable when challenging an EU directive, because discrimination against *non-EU parents* does not violate the fundamental freedoms (except in cases not relevant here).

C. Big Companies

In a forthcoming academic paper, we argue that size thresholds could constitute what the EU courts call "covert" nationality discrimination.[43] If — as our review of the doctrine suggests[44] — establishing covert discrimination is a simple matter of showing that more than half the taxable population resides in (or is parented in) another EU state, then some member states will almost surely discriminate by applying digital taxes with high revenue thresholds. Member states will discriminate because they will have few or no domestic companies that would meet those thresholds. Those countries would impose digital taxes exclusively or nearly exclusively on companies resident in other states. Our doctrinal analysis unsurprisingly reveals that taxes that exclusively burden nonresident companies while exempting domestic companies present the strongest case for covert nationality discrimination.[45]

Some member states might not meet the disproportionate-impact threshold.[46] For

[40] EU DST proposal, *supra* note 3, article 4(6).

[41] *Hervis Sport*, C-385/12 (CJEU 2014), para. 8 (holding that it was a matter for the national court to determine whether a rule that required the turnover of related nonresident companies to be aggregated for purposes of determining the tax rate applicable to domestic members of the group disproportionately adversely affected foreign-parented companies; if it did, the rule constituted nationality discrimination). Two pending cases before the Court raise similar questions. *See Request for a preliminary ruling from the Fővárosi Közigazgatási és Munkaügyi Bíróság (Hungary) lodged on 6 February 2018 — Vodafone Magyarország Mobil Távközlési Zrt. v. Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatósága*, C-75/18 (asking whether a member state's legislation that as applied burdens mainly foreign-owned taxable persons could be considered indirectly discriminatory). *See also Request for a preliminary ruling from the Fővárosi Közigazgatási és Munkaügyi Bíróság (Hungary) lodged on 16 May 2018 — Tesco-Global Áruházak Zrt. v. Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatósága*, C-323/18 (asking whether discrimination results when the portion of the total tax collected paid by foreign-owned companies is substantially higher than that paid by domestically owned companies).

[42] *Metallgesellschaft Ltd. v. Commissioners of Inland Revenue*, joined cases C-397/98 and C-410/98 (CJEU 2001) (holding that limiting group-filing election to groups with British parents violated the freedom of establishment). *See also* Advocate General Juliane Kokott's discussion of covert discrimination on the basis of the nationality a company's parent in *Hervis Sport*. *Hervis Sport*, C-385/12 (CJEU 2013) (opinion of Advocate General Kokott), paras. 32-42.

[43] Ruth Mason and Leopoldo Parada, *Discriminatory Impact and Discriminatory Intent in EU Law: Size Matters* (forthcoming).

[44] *Id.*

[45] *Id.*

[46] Johannes Voget, "Relocation of Headquarters and International Taxation," 95 *J. Pub. Econ.* 1067, 1069 (2011) (showing large differences among states as to the proportion of their companies that are multinationals); Fabrice Defever, "Functional Fragmentation and the Location of Multinational Firms in the Enlarged Europe," 36 *Reg. Sci. & Urban Econ.* 658, 666 (2006) (describing gaps in Europe between, among other things, the countries where companies are headquartered and the places where they conduct sales and marketing).

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Trade-Off Between Potential Revenue and Number of Companies

Share of Entities in the EU	Corresponding Share of Turnover	Share of Groups Active Only Domestically Compared to Total Number of Groups in This Bracket[a]	Share of Entities With Global Ultimate Owner Located in the EU-28	
Less than or equal to €50 million	92.8%	19.9%	95.2%	88.0%
More than €50 million	7.2%	81.1%	51.0%	79.6%
More than €500 million	4.8%	68.6%	24.5%	78.4%
More than €750 million	2.0%	64.2%	19.2%	74.2%

Source: European Commission Staff Working Document Impact Assessment, COM(2018) 147 final (Mar. 21, 2018), Table (10) at 68.

[a]This ratio has been computed for groups that have their global ultimate owner (GUO) in the EU. In other words, groups active in the EU but with a GUO outside the EU are not reflected in this ratio. This ratio therefore gives an upper estimate of the share of purely domestic groups.

example, an Irish or Luxembourgian digital tax might fall mostly on domestic companies, notwithstanding the high revenue triggers (although many of those companies could have U.S. parents). In the present formulation of the EU DST, revenue triggers are not tailored by state. And member states with concrete unilateral digital tax proposals have used the same (or nearly the same) revenue triggers as those in the commission's proposal. So the proportion of each state's taxable population that will be foreign will vary depending on the composition of the state's companies. It is no mere coincidence that countries that oppose digital taxes have the best chance of applying them without engaging in de facto nationality discrimination.

Big often means foreign, and our doctrinal study reveals that the commission and the CJEU are increasingly aware of member states' use of size as a proxy for nationality.[47] The revenue thresholds in the commission's DST proposal and national proposals based on it are really big. So big, in fact, that the EU DST proposal would tax only a few companies and raise only €5 billion annually. We reproduce below a table from the European Commission's impact assessment, in which the commission considered how various revenue thresholds would affect the composition of the taxable populations.

As the revenue threshold rises, the share of taxable entities whose ultimate parent is outside the EU rises, and presumably the taxable population becomes more foreign to the taxing state.

While the commission did not publish statistics showing the expected taxable population by EU taxing state, it estimated that more than half of all the payers of the DST would be parented outside the EU, and we assume that for most member states applying digital taxes based on similar revenue triggers, most liable companies would be foreign and nearly all would be foreign-parented. If those foreign taxpayers (or their parents) reside in fellow EU states, their taxation may violate the fundamental freedoms.

IV. State Aid Violations

Unilateral digital taxes, including the Spanish DST, are susceptible to state aid challenges because they are selective on the basis of size, nationality, and sector, each of which generally

[47]Mason and Parada, *supra* note 43.

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suffices for a successful state aid claim.[48] A selective tax on big companies earning certain types of income can be understood as a selective subsidy to their competitors.[49]

In an earlier *Tax Notes* article, one of us explained the EU's approach to state aid,[50] which is similar to tiered review under the U.S. equal protection clause. Under the tiered model, the more problematic the classification drawn by the state, the stricter the judicial scrutiny. Race is a suspect class under equal protection, so classifications based on race are struck down unless supported by a compelling government interest. Similarly, although it does not acknowledge adopting a tiered-scrutiny approach, the commission and CJEU give heightened scrutiny to classifications that rely on company size; sector; region; nationality; engagement in cross-border commerce; and to measures that provide so-called individual aid, or aid to a particular company. Those classifications are suspect because states tend to use them to provide the kinds of subsidies that the state aid rules forbid — namely, those that are protectionist or designed to poach productive factors (or tax base) from fellow EU states.[51]

In contrast, other non-suspect classifications that have nothing to do with protectionism — such as those based on ability to pay — receive only what Americans would call rational-basis review.[52]

A. Selective by Size, Sector, or Nationality

The proposed member state digital taxes invoke suspect classes. They select straightforwardly based on size (revenue trigger) and sector (only digital services are taxed), and they select indirectly based on nationality (only very high-revenue companies are taxable, and those tend to be foreign).

Lest readers think the commission would ignore the obvious link between revenue thresholds and nationality discrimination, we offer a recent Polish state aid case, in which a company's tax rate depended not on its net income, but rather on its turnover. The commission concluded that the Polish rule was "specifically designed to favour smaller retailers over larger ones by . . . subjecting undertakings with lower turnover to a lower average effective tax rate than undertakings with a higher turnover, which also tend to be foreign-owned."[53] Thus, the commission concluded that the challenged graduated turnover taxes hit companies based on their *size*, rather than on their profitability, ability to pay, or other justification offered by Poland.[54] The commission concluded that this size classification was meant to capture companies' nationality and constituted state aid.[55]

[48] The Spanish DST "selects," at a minimum, on the basis of size, sector, and engagement in cross-border activities, each of which is a suspect class under state aid doctrine. On the types of selection that matter for state aid purposes, see Ruth Mason, "An American View of State Aid," *Tax Notes*, Oct. 30, 2017, p. 645. For criticism of the commission's recent transfer pricing state aid decisions, see Ruth Mason, "A New Era of State Aid," SSRN (June 5, 2018).

[49] In *Aer Lingus*, the commission held that Ireland conferred state aid by charging selective airline taxes. On appeal, the airlines ordered to pay the state aid recovery argued that the commission should have reduced the recovery to account for the fact that the higher fee (charged on disfavored flights that did not receive state aid) was a violation of the fundamental freedoms that would have to be refunded by Ireland to the airlines. *Aer Lingus*, joined cases C-164/15 P and C-165/15 P (CJEU 2016), paras. 54, 61-65. In response, the CJEU noted that the national court had the responsibility to ensure that any subsequent compensation under the fundamental freedoms to the airlines for paying the higher tax "does not give rise to new aid . . . to the benefit of the undertakings receiving such reimbursement." *Id.* at para. 119. Thus, the tax could equally be conceived as state aid to those that paid too little or as a fundamental freedoms violation for those who paid too much (but not both), and it was up to the national courts to work out the recoveries and rewards so that there was no duplication.

[50] Mason, "An American View of State Aid," *supra* note 48.

[51] *Id.*

[52] *Id.*

[53] State Aid SA. 44351(2016/C) (ex 2016/NN), Polish Tax on the Retail Sector (June 30, 2017) C(2017) 4449 final (Polish turnover tax decision). Poland never collected the tax because the commission suspended it, but under it, companies with turnover under €4.02 million would be exempt from the monthly turnover tax; those with turnover between €4.02 million and €40.2 million would pay 0.8 percent; and those with turnover over €40.2 million would pay 1.4 percent. *Id.* at paras. 22–23. Appeals are pending: *Poland v. Commission*, T-836/16; and *Poland v. Commission*, T-624/17.

[54] *See also* pending case *Vodafone*, C-75/18, *supra* note 41 (asking whether a member state's legislation imposing graduated turnover taxes was state aid when it disproportionately burdened foreign-owned taxpayers). *See also* pending case *Tesco-Global*, C-323/18, *supra* note 41 (asking whether substantially disproportionately foreign composition of taxpaying population raised state aid concerns).

[55] Polish turnover tax decision, *supra* note 53, at paras. 51, 57-59 (noting that of the approximately 200,000 retailers operating in Poland, only 109 submitted retail tax declarations in September 2016). Polish turnover tax decision, *supra*, at para. 51. The commission did not indicate which portions of the taxpayers were foreign and which portions Polish.

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B. Selective by Group Status

In addition to potentially violating the state aid rules by selecting based on size, sector, and nationality, the proposed unilateral digital taxes favor stand-alone companies over companies that are members of groups. In recent state aid cases involving, among others, Apple, Starbucks, McDonald's, and Amazon, one of the commission's central claims was that favorable tax rulings constituted state aid because they improperly favored group companies over stand-alone companies.[56] Although the normative groundings for the state aid rules are not well articulated, presumably, favoritism of stand-alone companies over groups is no better than the reverse.

C. Reservation: Purposes of State Aid

While we argue that unilateral digital taxes constitute sectoral state aid to smaller, domestic competitors of large multinationals that would be liable for digital taxes, the commission has never been particularly clear in tax cases what the state aid provision is meant to do. If it exists to prevent protectionism by member states (an interpretation we think the case law supports), then the commission should regard unilateral digital taxes as state aid because they are blatantly protectionist.

V. Relevance of Intent

While the CJEU typically ignores questions of intent in fundamental freedoms cases, it regularly takes intent into consideration in state aid cases.[57]

Far from hiding the protectionist goals underlying their digital tax proposals, officials in Spain and the United Kingdom touted them.

According to the Spanish Ministry of Finance's official release launching the digital tax, the proposal was directed at "*big international undertakings* in Spain based on certain digital activities that escape the current tax framework"[58] (emphasis added). Confirming the intention to protect smaller (typically domestic) businesses, the release noted that the revenue "thresholds help guarantee that only *big undertakings are affected and not SMEs*"[59] (emphasis added). The draft law similarly noted that the tax would apply only to large companies, or those with "a solid position in the market."[60] The government's memorandum of regulatory impact predicted that the tax would affect mainly big multinationals that provide digital services.[61]

The U.K. finance minister's 2018 budget speech also reflects protectionist intent. Chancellor of the Exchequer Philip Hammond promised that the tax "will be carefully designed to ensure it is established tech giants — rather than *our* tech start-ups — that shoulder the burden"[62] (emphasis added). Hammond went on to say that "it is only right that these global giants, with profitable businesses in the U.K., pay their fair share towards supporting our public services."[63] Neither the Spanish nor U.K. government made any secret of their goal to target foreign companies while exempting domestic competitors.

Similarly, the commission's 161-page DST impact assessment strongly suggests that the proposed €750 million and €50 million thresholds were chosen precisely to affect the nationality composition of the tax base.[64] The commission assumed that if the tax fell entirely on non-EU

[56] *See* Ruth Mason, "Part 6 — Arm's Length on Appeal," *Tax Notes*, Feb. 5, 2018, p. 771.

[57] *Gibraltar*, joined cases C-106/09 P and C-107/09 P (CJEU 2011) (emphasizing the legislature's intent to favor offshore companies through tax-base design decisions). *See id.* at para. 106 ("it should be observed that the fact that offshore companies are not taxed is not a random consequence of the regime at issue, but the inevitable consequence of the fact that the bases of assessment are specifically designed so that offshore companies, which by their nature have no employees and do not occupy business premises, have no tax base under the bases of assessment adopted in the proposed tax reform").

[58] Spanish Minister of Finance, Council of Ministers release, "The Government Presents the Blueprint of the Law Against Fiscal Fraud to Combat the New Form of Tax Evasion" (Oct. 18, 2018) (translated by the authors).

[59] *Id.* (translated by the authors).

[60] Spanish Minister of Finance, "Blueprint of the Law on Specific Digital Services Tax, Explanatory Memorandum," *supra* note 16, para. V at 3.

[61] Spanish DST impact analysis, *supra* note 18, at 21.

[62] Philip Hammond, "U.K. Budget 2018" (Oct. 29, 2018).

[63] *Id.*

[64] In our forthcoming academic paper, we give reasons why the Court should consider evidence of intent in fundamental freedoms cases. Mason and Parada, *supra* note 43.

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companies, it "would not be allowed from a legal perspective."[65] According to the impact statement:

> [It] seems safe to conclude that for all the general revenue thresholds considered here, a sizeable share of EU entities would be captured by the measure. However, data on the biggest global companies with sizeable revenues from the relevant digital services suggests that a specific threshold above EUR 50 million could risk a de-facto discrimination. From the subset of 112 companies examined in this impact assessment, less than a quarter would have their main business activity falling under the scope of the new tax and have revenues in the EU exceeding EUR 50 million. Generally, the determination of the specific revenue threshold within the range of EUR 10-50 million should balance the risk of discrimination against the risk of damaging digitalisation of the EU economy.[66]

The commission's proposal also cherry-picked taxable revenue streams to reach business models used by U.S. digital giants (and their EU subsidiaries), while leaving aside those associated with EU-parented digital companies. As Gary Hufbauer and Lucy Lu of the Peterson Institute for International Economics put it:

> "Taxable revenues" include digital advertising (Google and Facebook), digital platforms and marketplaces to sell goods and services (Amazon, eBay, Uber, and Airbnb), and transmission of users' data to other users (Facebook and Twitter). . . . However, "taxable revenues" exclude subscription fees (the main revenue of Spotify, based in Sweden) and in-app purchases of digital wares (the main revenue of Supercell, based in Finland). "Taxable revenues" also exclude revenue from platforms that facilitate financial trades (all the EU banks and stock exchanges) and platforms that facilitate payments (PayPal is the US example, Skrill is the U.K. example).[67]

Arguably, the desire to discriminate against *non-EU* companies should not count against the DST or revised digital tax proposals because discrimination against third countries is (mostly) not forbidden under the fundamental freedoms.[68] Although the commission's impact statement evinces a clear goal to fine-tune the national incidence of the digital tax, the most obvious goal was to get the EU and non-EU mix correct. What was intended to be EU-wide discrimination against U.S. companies merely has the unintended collateral consequence of within-EU discrimination by particular states applying the tax. There is no evidence in the impact statement that the commission's goal was to discriminate *among* EU companies depending on their state of establishment. However, presence of actual discriminatory intent — even against U.S., rather than EU, companies — may make it harder to justify the *within Europe* discriminatory impact of the DST or a similar tax, even if the Court is inclined to defer to directives. The impact statement repeatedly makes the DST's protectionist goals clear by emphasizing the desire to limit the tax's impact on budding EU companies.

VI. Comparability and Justifications

Both the fundamental freedoms and state aid have doctrines of comparability and justification.[69]

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[65] *See* European Commission staff working document impact assessment, COM(2018) 147 final (Mar. 21, 2018), at 69 (European Commission impact assessment). As the analysis in the next part shows, it might actually be better under EU law for digital taxes to fall only on non-EU companies, rather than falling disproportionately on EU-to-EU cross-border provisions of services, since third-country-to-EU provisions of services receive no protection under the fundamental freedoms. Such discrimination against non-EU companies could, however, raise other legal problems (for example, under tax treaties or WTO law).

[66] *Id.*

[67] Gary Clyde Hufbauer and Zhiyao (Lucy) Lu, "The European Union's Proposed Digital Services Tax: A De Facto Tariff," Peterson Institute for International Economics Policy Brief 18-15 (June 2018).

[68] If the goal of nondiscrimination is to prevent protectionism and retentionism, there is no good reason to exclude third countries from its scope. On the other hand, if the goal is to increase European social cohesion or to improve the efficiency of factor location only within Europe, then denial of protection to third countries under the nondiscrimination principle makes sense. Although the freedom of capital movement applies to third countries, the DST would not seem to implicate it, given the Court's tendency to conclude that capital movement and establishment essentially are mutually exclusive. *See, e.g., De Baeck v. Belgium*, C-268/03 (CJEU 2004).

[69] While state aid does not have a formal doctrine of justification, selectivity analysis may fail in cases when states have good reasons for taxing one group favorably compared with another.

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Those concepts are embedded in the state aid notion of selectivity and in the fundamental freedoms notion of discrimination. In this section, we broadly canvas arguments that sound in comparability or justification without attempting to disentangle the two.[70] This section is not meant to be comprehensive; rather, we try to anticipate what the commission or member states might offer as defenses to digital taxes.

A. Size Discrimination in General

If the CJEU were to accept that classifications by company size could illegally discriminate based on nationality, it is still possible that treating taxpayers differently based on size could be consistent with EU law. For example, public policy goals, such as taxation based on the ability to pay, could justify differences in tax that derive from differences in companies' net income, which would tend to correlate with size. Thus, the desire to engage in progressive taxation could justify size-based classifications, but the classifications would actually have to relate to progressivity and would have to capture ability to pay. Thus, net income thresholds would fare better under our analysis than would turnover thresholds because while both discriminate by size, only the former measures ability to pay.

Likewise, the need for administrability would seem to justify many size-based tax thresholds, perhaps including those in the country-by-country reporting and common consolidated corporate tax base.

The CJEU has accepted other justifications for discrimination, including the need to maintain fiscal cohesion (essentially, an anti-whipsaw justification) and prevent fraud.[71] It has accepted the need for a balanced allocation of taxing rights, which helps justify states' adherence to customary international tax laws, and in particular, allocation rules in tax treaties that are designed to prevent double taxation.[72]

Whatever the proffered justification (or, equivalently, argument against comparability), to survive judicial review, the state's rule must be what the Europeans call "proportionate" and what Americans call "narrowly tailored" — it must be no more discriminatory than necessary to achieve legitimate state interests.

B. Size Discrimination in Revenue Triggers

It's hard to see how member states or the commission can justify the current forms of proposed digital taxes.

Michael Devereux accurately captured the realpolitik of DST proposals when he recounted the famous story of Willie Sutton, who, when asked why he robbed banks, retorted, "That's where the money is."[73] The CJEU, however, has consistently rejected revenue-based justifications for taxes that discriminate on the basis of nationality.[74]

The commission's impact statement contains many unsupported claims meant to defend the application of additional taxation on large companies. For example, the commission states that "only companies of a certain scale provide digital services for which user contributions play a central role."[75] By itself, no such bald assertion could justify exempting from the DST or similar digital taxes all companies with global revenues under €750 million.

The commission supports the threshold with several other arguments, which could be offered as justifications for disproportionate effects on nonresident companies. For example, the commission cited protecting the integrity of the single market, preventing tax base erosion, leveling competition, and combatting aggressive tax planning as reasons for the DST.[76] Even if those were generally acceptable justifications, it is unlikely that member states could carry their

[70] One of us believes (and the other is undecided) that there is no principled distinction between the two concepts and so trying to disentangle them is fruitless.

[71] *See* Mason, *Primer on Direct Taxation in the European Union* 93-108 (2005).

[72] *See, e.g.*, *Marks & Spencer PLC v. Halsey*, C-446/03 (CJEU 2005).

[73] Devereux, "The Digital Services 'Sutton' Tax," Oxford Said School of Business, Centre for Business Taxation Blog (Oct. 23, 2018).

[74] *See, e.g.*, *Svensson & Gustavsson v. Ministre du Logement et de l'Urbanisme*, C-484/93 (CJEU 1995); and *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt*, C-307/97 (CJEU 1999), para. 50. And anyway the DST hardly raises any revenue.

[75] European Commission impact assessment, *supra* note 65, at 67.

[76] *Id.*, at 66 (arguing that larger companies are better able to avoid income taxation through tax planning, and larger companies receive more benefits from network effects).

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burden to show that the DST (or similar digital taxes) is proportional to those aims.[77]

Proportionality is about the fit between the degree of discrimination and the public policy reason that justifies the discrimination. If digital taxation were defended as an antiabuse rule, the problem would be establishing the proportionality of the measure under the CJEU's stringent *Cadbury Schweppes* standard. Under *Cadbury Schweppes*, antiabuse measures that distinguish between resident and nonresident taxpayers (or foreign and domestic income) are invalid unless they capture *only* wholly artificial arrangements.[78] The DST and similar structures cannot meet that stringent standard.

The commission's proposal claimed that the €750 million threshold ensured that the DST would reach companies that "have established strong market positions that allow them to benefit relatively more from network effects and exploitation of big data and thus build their business models around user participation."[79] But nothing about the threshold directly or indirectly measures a company's network effects, exploitation of big data, or amount of user input. The poor fit between the justification for the tax and its actual features makes the DST (and taxes with similar features) less likely to pass proportionality review.

On any of the cited public policy justifications, member states would be in the unenviable position of having to argue that there was no less discriminatory provision that could have served the public policy than a flat 3 percent turnover tax that applies to companies with worldwide revenues over €750 million and EU revenues over €50 million (or, for example, Spanish revenues over €3 million).[80] The amount of the tax, its gross basis, and the revenue thresholds would all face close scrutiny. None of those is well explained by the commission or any individual member state. Indeed, the commission's impact statement strongly suggests that the revenue thresholds are best explained by the desire to control the nationality composition of the tax base, itself a warning sign of nationality discrimination.

Suppose the justification offered for a unilateral digital tax were the importance of taxing value created by users. A flat 3 percent tax on only some kinds of revenue is not well tailored to the goal of taxing value created by users. Users contribute differently and add differing amounts of value to different kinds of digital platforms, as well as to non-digital platforms, but current member state DST proposals, because they are modeled on the commission proposal, tax certain digital platforms of large companies, while exempting similar platforms of small companies and exempting all non-digital platforms, however dependent on user input. Therefore, current digital tax proposals do not seem to be narrowly tailored to tax user-created value.

In the same vein, it is unlikely that the traditional justifications accepted by the CJEU in tax cases would be available to defend revenue-triggered digital taxes. Take fiscal coherence, the anti-whipsaw principle. Unlike in *Bachmann*, where Belgium paired a deduction denial for nonresidents with an exclusion of related income (when residents received a deduction but had to include the related income), there is no fiscal coherence argument that favors digital taxation. Digital taxation is not an inclusion for foreigners meant to bookend a deduction that only foreigners enjoy. On the contrary, digital taxation

[77] *See, e.g., Marks & Spencer*, C-446/03 (CJEU 2005), para. 35 (to justify the discrimination or restriction, "it is further necessary . . . that its application be appropriate to ensuring the attainment of the objective thus pursued and not go beyond what is necessary to attain it").

[78] *Cadbury Schweppes PLC v. Commissioners of Inland Revenue*, C-196/04 (CJEU 2006) (holding that a resident company's tax base cannot be determined including profits made by a "controlled foreign company" in another member state, even if tax motives exist, unless the controlled foreign companies are part of "wholly artificial arrangements" made purely for tax reasons and no genuine economic activity occurs).

[79] EU DST proposal, *supra* note 3, at 10.

[80] In its proposal, the commission simply asserted that the measure was proportionate "to meet the objectives of the Treaties, in particular the smooth functioning of the Single Market." EU DST proposal, *supra* note 3, at 5. *See also* European Commission impact assessment, *supra* note 65, at section 9.4.2.

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may result in unrelieved double taxation.[81] Nor is there a convincing argument that the size triggers serve an ability-to-pay purpose. After all, if ability to pay were a concern, the tax would account for a company's expenses in earning the taxable income.

We said earlier that many size-based triggers in the tax law could probably be justified on administrability grounds, even if they disproportionately affect nonnationals. But here, too, proportionality would be the problem. It would be difficult for a member state to convince the Court that it could enforce a DST (or other digital tax with a similar revenue threshold) against companies that have €750 million in revenue but not against companies with €500 million in revenue. Or that it would be easier for states to collect the tax from a foreign company with €751 million in global revenue, of which €51 million was from the EU, than from a domestic company with €749 million in global revenue all earned domestically. The €750 million DST threshold was not motivated by administrative concerns. Rather, it was motivated by the hope that the tax burden could be exported outside the EU.

What about a balanced allocation of taxing rights, the idea that states possess some flexibility in determining how to tax cross-border income so as to avoid double taxation and double nontaxation? The CJEU has proven increasingly willing to accept balanced allocation justifications for tax measures that discriminate based on nationality.[82] The purpose of digital taxes is to collect tax revenue from companies that do substantial business in states where they have no physical presence and therefore are not susceptible to source-based income taxation under current law. It should come as no surprise, the argument would run, that such taxes fall disproportionately on nonresident companies.

The problem with citing balanced allocation as a justification for digital taxes is that rather than adhering to internationally accepted allocation rules memorialized in tax treaties, the member states want to use digital taxes to *undo* the results of their tax treaties. They essentially want to use turnover taxes to reallocate to themselves income over which they ceded jurisdiction in their tax treaties.

No one can expect states to live forever with the consequences of bad bargains struck in old treaties that no longer fit the modern economy. But nor should we expect the CJEU to uphold an end-run around tax treaties as an instance of a balanced allocation of taxing rights. However sympathetic we may be to the idea that international tax rules need a fundamental rethink, engaging in nationality discrimination as a way to align tax with perceptions of value creation does not match up to one of the Court's preexisting justifications for nationality discrimination.

Finally, while one could imagine the CJEU accepting the desire to protect start-ups or particular segments of the economy as a justification for nationality discrimination,[83] such blatantly protectionist justifications would be at odds with preexisting fundamental freedoms and state aid doctrines.

VII. Can We Save Digital Taxes?

Can digital taxes be saved from state aid scrutiny? Yes, but states would have to either avoid discriminating against the biggest companies (unlikely, because that would not serve the political goal to tax (only) big tech) or the digital tax would have to be passed as an EU directive, which would confer immunity from state aid scrutiny. But even unilateral measures may not face state aid scrutiny because only the

[81] *See, e.g.*, Roland Ismer and Christoph Jescheck, "Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model," 46(6/7) *Int'l Tax Rev.* (2018) (stressing particularly the issues of legal certainty created by turnover taxes, double tax relief, and tax treaties); and Adolfo M. Jiménez, "BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties," 46(8/9) *Int'l Tax Rev.* (2018) (generally arguing that equalization levies, such as the EU proposal, can cause treaty override). Similarly, the U.K. DST proposal recognizes that "given the DST will not be within the scope of the UK's double tax treaties, it will not be creditable against UK Corporate Tax." U.K. DST proposal, *supra* note 17, at 17.

[82] *Marks & Spencer*, C-446/03 (CJEU 2005); *SGI*, C-311/08 (CJEU 2010), para. 60 ("justification may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory").

[83] European Commission impact assessment, *supra* note 65, at 69 (suggesting that a purpose of the DST was to protect infant domestic — that is, EU — high-tech companies while taxing more established, out-of-state competitors).

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commission can initiate state aid investigations, a power it exercises with broad discretion.

Unlike with state aid, taxpayers have standing to challenge fundamental freedoms violations. To increase the likelihood of surviving that kind of challenge, the EU and its individual members could lower the revenue thresholds in their digital taxes. If the thresholds were low enough, those taxes would no longer disproportionately affect foreign companies. If the threshold cannot be lowered enough to avoid disproportionate impact, then defenders of the thresholds should be prepared to justify them as narrowly tailored to meet legitimate policy interests (and neither revenue nor protectionism — including protecting start-ups — would be a legitimate policy goal for that purpose).[84]

What about alternatives for taxing tech giants? If revenue thresholds discriminate, countries will have to find nondiscriminatory tax triggers.[85] The EU's digital PE proposal suffers the same potential defects as its digital tax proposal, because it too uses size to trigger tax. Other options include rules for controlled foreign corporations and minimum taxes like that the United States imposed on global intangible low-taxed income. While those rules do not raise size discrimination questions, they may have their own EU law problems.[86] Of course, CFC rules and minimum taxes award the tax to the parent's residence state, not the users' state, and thus would not satisfy countries that argue that the market state ought to get a larger share of tax. Proposals to increase the market state's share include modifications to the PE concept that would not violate EU law, assigning appropriate returns to marketing intangibles, and increased use of withholding taxes or regimes like the U.S. base erosion and antiabuse tax.[87]

VIII. Conclusion

In the current environment of unilateral and uncoordinated solutions, equalization taxes, and the BEAT, the OECD has struggled to convince countries that cooperation is superior to unilateralism. Outside the auspices of the OECD, the European Commission has proposed both short- and long-term solutions to the digital tax problem, and member states have proposed similar unilateral solutions.[88] In this article, we argued that revenue thresholds in current digital tax proposals are vulnerable to nationality discrimination claims because they are intended to — and as applied by individual member states, likely would — burden mostly nonresident companies. Ring-fenced digital taxes also may confer state aid when enacted unilaterally. More generally, as EU states consider their approaches to taxing the digital economy, and regardless of whether those approaches would be unilateral, European, or global, they must account for limitations imposed by EU law, and in particular its prohibition on nationality discrimination. Adherence to EU law may foreclose some types of tax triggers, including very high revenue triggers, that disproportionately tax EU companies that reside outside the taxing state. ■

[84] Interestingly, the U.S. Supreme Court recently accepted size thresholds in *Wayfair*, but, reflecting the defending state's desire to tax outsiders and insiders similarly (rather than dissimilarly as is the goal in the DST), the thresholds in the U.S. case were much lower. *See South Dakota v. Wayfair Inc.*, 585 U.S. (2018)(accepting, as a trigger to force a remote seller to collect retail sales tax, a threshold of 200 sales or $100,000 in sales in a year). *See also* Mason, *supra* note 10 (discussing implications of *Wayfair* for DSTs).

[85] EU law considerations have a significant impact on the formulation of BEPS recommendations. *See* Lilian V. Faulhaber, "The Luxembourg Effect: Patent Boxes and the Limits of International Cooperation," 101 *Minn. L. Rev.* 1641 (2017).

[86] Although minimum taxes apply to foreign subsidiaries, their scope is appropriate to their antiabuse rationale, and therefore arguably proportionate under EU law.

[87] *See* OECD, "Tax Challenges," *supra* note 2, at 133-165 (reviewing unilateral actions).

[88] EU DST proposal, *supra* note 3.

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OECD/G20 Base Erosion and Profit Shifting Project

Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note

As approved by the Inclusive Framework on BEPS on 23 January 2019

Addressing the Tax Challenges of the Digitalisation of the Economy

1.1. Background

The tax challenges of the digitalisation of the economy were identified as one of the main areas of focus of the Base Erosion and Profit Shifting (BEPS) Action Plan, leading to the 2015 BEPS Action 1 Report (the Action 1 Report). The Action 1 Report found that the whole economy was digitalizing and, as a result, it would be difficult, if not impossible, to ring-fence the digital economy. The Action 1 Report also observed that, beyond BEPS, the digitalisation of the economy raised a number of broader direct tax challenges chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.

Following a mandate by G20 Finance Ministers in March 2017, the Inclusive Framework, working through its Task Force on the Digital Economy (TFDE) delivered an Interim Report in March 2018, *Tax Challenges Arising from Digitalisation – Interim Report 2018* (the Interim Report). The Interim Report provided an in-depth analysis of value creation across new and changing business models in the context of digitalisation and the tax challenges they presented.[1] These challenges included risks remaining after BEPS for highly mobile income producing factors which still can be shifted into low-tax environments. While members of the Inclusive Framework did not converge on the conclusions to be drawn from this analysis, they committed to continue working together towards a final report in 2020 aimed at providing a consensus-based long-term solution, with an update in 2019.

Conscious of the G20 time frame and the significance of the issue, the TFDE further intensified its work since the delivery of the Interim Report. Drawing on the analysis included in the Action 1 Report as well as the Interim Report, and informed by recent discussions at the July and December meetings of the TFDE on a "without prejudice" basis, a number of proposals have been made. These proposals, together with the recent discussions and comments from members of the Inclusive Framework, lay the grounds for the Inclusive Framework to come to an agreement on the way forward.

1.2. Proposed way forward

Consistent with the analytical framework of both the Action 1 Report and the Interim Report, there is agreement to examine proposals involving two pillars which could form the basis for consensus. One pillar addresses the broader challenges of the digitalised economy[2] and focuses on the allocation of taxing rights, and a second pillar addresses remaining BEPS issues. A two pillar approach would recognise that the digitalisation of the economy is pervasive, raises broader issues, and is most evident in, but not limited to, highly digitalised businesses. It raises questions of where tax should be paid and if so in what amount in a world where enterprises can effectively be heavily involved in the economic life of different jurisdictions without any significant physical presence and where new and often intangible value drivers more and more come to the fore. At the same time, the features of the digitalising economy exacerbate BEPS risks, and enable structures that shift profits to entities that escape taxation or are taxed at only very low rates. A solution would therefore require comprehensive work that covers the overall allocation of taxing rights through revised profit allocation rules and revised nexus rules, as well as anti-BEPS rules.

[1] See Chapter 2 "Digitalisation, business models and value creation" of the Interim Report.

[2] As described in the Action 1 Report and the Interim Report.

Under the first pillar, focused on the allocation of taxing rights including nexus issues, several proposals have been made that would allocate more taxing rights to market or user jurisdictions in situations where value is created by a business activity through participation in the user or market jurisdiction that is not recognised in the framework for allocating profits. The Inclusive Framework agreed to explore these proposals on a without prejudice basis. The Inclusive Framework recognises that the implications of these proposals may reach into fundamental aspects of the current international tax architecture. Some of the proposals would require reconsidering the current transfer pricing rules as they relate to non-routine returns, and other proposals would entail modifications potentially going beyond non-routine returns. In all cases, these proposals would lead to solutions that go beyond the arm's length principle. They also go beyond the limitations on taxing rights determined by reference to a physical presence generally accepted as another corner stone of the current rules. The Inclusive Framework agreed that issues of profit attribution and nexus would need to be developed contemporaneously with each playing a key role in any solution ultimately adopted, noting that they may require changes to tax treaties. On nexus, the Inclusive Framework agreed to explore different concepts, including changes to the permanent establishment threshold, such as the concept of "significant economic presence" which was discussed in the Action 1 Report or the concept of "significant digital presence", as well as special treaty rules.

The work of the Inclusive Framework will be driven by finding the right balance between accuracy and simplicity. This means that any solution needs to be administrable by tax administrations and taxpayers alike and take account of the different levels of development and capacity of members. The Inclusive Framework is open to exploring solutions, administrative simplifications and collection mechanisms, which should all be principle-based and could include withholding taxes where they do not result in double taxation.

The Inclusive Framework recognises that what is proposed may affect not only a small group of highly digitalised businesses but could affect a much wider group of enterprises with cross border business operations, for instance those with marketing intangible profits but limited risk distribution structures in market jurisdictions. Further technical work on the design considerations of the proposals would be required, taking into consideration potential scope limitations, business line segmentation, profit determination and allocation, as well as nexus and treaty considerations.

Under the second pillar, the Inclusive Framework agreed to explore on a "without prejudice" basis taxing rights that would strengthen the ability of jurisdictions to tax profits where the other jurisdiction with taxing rights applies a low effective rate of tax to those profits. These proposals recognise that in part the tax challenges of the digitalisation of the economy form part of the larger landscape relating to remaining BEPS challenges and further reflect more recent developments such as US tax reform.

The proposal under this pillar would be designed to address the continued risk of profit shifting to entities subject to no or very low taxation through the development of two inter- related rules, i.e. an income inclusion rule and a tax on base eroding payments.

The proposal under this pillar does not change the fact that countries or jurisdictions remain free to set their own tax rates or not to have a corporate income tax system at all. Instead, the proposal considers that in the absence of multilateral action there is a risk of un-coordinated, unilateral action, both to attract more tax base and to protect the existing tax base, with adverse consequences for all countries, large and small, developed and developing.

Members of the Inclusive Framework discussed these innovative proposals, stressing the need for more in-depth analysis of each proposal and their interlinkages, and noting the importance of the assessment of revenue, economic and behavioural implications before decisions can be taken. They are cognisant that taking on these challenges, together, and on a co-ordinated, multilateral basis could ease the growing tension within the international tax architecture with a number of countries having taken unilateral measures over recent years.

Members of the Inclusive Framework also agreed that any new rules to be developed should not result in taxation when there is no economic profit nor should they result in double taxation. They stressed the importance of tax certainty and the need for effective dispute prevention and dispute resolution tools. The members were mindful of the need to ensure a level playing field between all jurisdictions; large or small, developed or developing. Also mindful of compliance and administrative burdens, members will strive to make any rules as simple as the tax policy context permits, including through the exploration of simplification measures.

In light of the novelty of the approaches and significant development work required, members of the Inclusive Framework have agreed that this work would be conducted on a "without prejudice basis." Furthermore, given the interlinked nature of the issues to be discussed, the challenging time frame, and the fundamental nature of the changes proposed, the Inclusive Framework decided to mandate the Steering Group to elaborate a detailed programme of work together with detailed instructions to subsidiary bodies to which the Inclusive Framework could agree at its May meeting, with a view to reporting progress to the G20 Finance Ministers in June 2019 and deliver the solution in 2020.

NEW YORK UNIVERSITY SCHOOL OF LAW

TAX LAW REVIEW

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NYU/UCLA TAX POLICY SYMPOSIUM
NEW APPROACHES TO CALCULATION AND ALLOCATION OF THE INTERNATIONAL TAX BASE

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Destination-Based Income Taxation: Neither Principled Nor Practical?

PAUL OOSTERHUIS*
AMANDA PARSONS**

Many market countries, of course, would like to extract some of the rents earned on highly profitable products developed elsewhere. In the context of imports, this is the equivalent of a tariff even though it is denominated as an income tax.[1]

I. Introduction

The problems of existing international source rules, taxable presence rules, and transfer pricing rules in allocating income among countries have been well documented in recent years.[2] Commentators have emphasized the ability of multinationals to allocate income on a residence basis to entities in tax-favored jurisdictions, giving rise to terms of art such as "stateless income"[3] and "homeless income."[4] In response, the Organisation for Economic Cooperation and Development ("OECD"), in cooperation with G-20 nonmember countries, spent three years updating its transfer pricing guidelines and its model

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1 Harry Grubert, Destination-Based Income Taxes: A Mismatch Made in Heaven, 69 Tax L. Rev. 43, 48 (2015). Harry Grubert's article included a critical analysis of an early version of ideas expressed herein. This Article was originally motivated in part as a continuation of that discussion. Unfortunately, with his passing last August, we will not have the benefit of his further thoughts. It is one of the many ways in which we will miss him.

2 See, e.g., Carol Dunahoo, Source Country Taxation of Foreign Corporations: Evolving Permanent Establishment Concepts, 86 Tax Mag. 37 (2008) (discussing concerns with the concept of "permanent establishments"); Harry Grubert & Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax, 66 Nat'l Tax J. 671, 675-76 (2013) (summarizing issues caused by our current international tax system, including income-shifting and lockout effect); Edward D. Kleinbard, Stateless Income, 11 Fla. Tax Rev. 699, 703-05 (2011) (discussing how transfer pricing and source rules lead to base erosion); Lawrence Lokken, What Is This Thing Called Source?, 37 Int'l Tax J. 21, 23-25 (discussing lack of consistency in source rules and resulting issues); Bret Wells & Cym Lowell, Tax Base Erosion and Homeless Income: Collection at Source Is the Linchpin, 65 Tax L. Rev. 535 (2012) (exploring the development and flaws of international tax policy).

3 See Kleinbard, note 2.

4 See Wells & Lowell, note 2.

treaty permanent establishment ("PE") provisions,[5] with a result that many have criticized.[6] By emphasizing "value creation," which focuses on the need to conduct activities and functions in tax-favored jurisdictions in order to justify income allocations, the revised guidelines further encourage business enterprises to migrate jobs and capital investments to such jurisdictions.[7] The potential result is increased tax competition among governments.

These problems have led some commentators to consider various forms of formulary apportionment as an alternative to the current transfer pricing rules (and to some extent an alternative to current source and taxable presence rules).[8] The practical problems with any apportionment based on assets and employment (or compensation) have also been well-documented.[9] Like the OECD's emphasis on value creation, both measures encourage the migration of functions and activities to tax-favored jurisdictions.[10] Additionally and more importantly, both are subject to widespread manipulation through the use of independent contractors, outsourcing, and other similar business arrangements that are increasingly available in today's business world.[11]

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[5] OECD, Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project (2015), www.oecd.org/tax/beps-explanatory-statement-2015.pdf [hereinafter BEPS].

[6] See, e.g., Joe Andrus & Paul Oosterhuis, Transfer Pricing After BEPS: Where Are We and Where Should We Be Going, 95 Tax Mag. 89 (2017); Michael Devereux & John Vella, Are We Heading Towards a Corporate Tax System Fit for the 21st Century?, 35 Fiscal Stud. 449 (2014).

[7] See Andrus & Oosterhuis, note 6, at 95-96.

[8] See, e.g., Grubert & Altshuler, note 2; Reuven Avi-Yonah & Kimberly Clausing, Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment, Brookings Inst. (June 1, 2007), https://www.brookings.edu/research/reforming-corporate-taxation-in-a-global-economy-a-proposal-to-adopt-formulary-apportionment/.

[9] See, e.g., J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?, 36 Mich. J. Int'l L. 1 (2014); Julie Roin, Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment, 61 Tax Law Rev. 169 (2008).

In contrast, Michael Durst questions whether apportionment based on assets actually results in shifting of property to lower-tax jurisdictions while noting that fear of such property shifting has "contributed to the near-demise of the property factor in the United States." Michael Durst, A Formulary System for Dividing Income Among Taxing Jurisdictions, 6938 Tax Mgmt. Portfolio (BNA), at V.D.2 (2015). Durst also describes apportionment based on compensation as having "significant appeal" and includes compensation as part of his proposed method of apportionment despite the potential impact of tax competition. Id. at V.D.3, V.B.

[10] See Roin, note 9, at 203 ("Formulary taxation does not provide an antidote for tax competition . . . . Taxpayers operating under formulary apportionment regimes can reduce their tax liability by relocating the identified tax factors from high-tax to low-tax jurisdictions. Such relocations can be 'actual' or 'virtual.'").

[11] See id. at 205.

In its recently enacted income tax reform legislation,[12] the United States adopted a different approach: limiting deductions for so-called "base erosion payments." Such payments are disallowed for purposes of a new 10% minimum tax, payable to the extent it exceeds a corporate taxpayer's regular corporate tax.[13] Disallowed related-party payments include all deductible payments if not included in cost of goods sold (which are treated as a reduction of revenues to determine gross income.)[14] Thus, many related-party payments that have the potential for base erosion, including payments for the purchase of inventory and payments of royalties and other expenses allocable to inventories,[15] are not limited under the tax. Rather, besides interest expense, the disallowance primarily affects payments for related-party sales, marketing, and general and administrative (G&A) expenses of multinationals that sell inventoried products, plus payments for all related-party expenses for companies that do not maintain inventories. Ironically, the extensive literature on base erosion planning techniques provides little evidence that the services-type payments disallowed as deductions are the cause of a substantial portion of base erosion.[16]

The provisions do disallow related-party interest expense for purposes of the minimum tax, which expense clearly can be tied to base erosion planning.[17] But such planning can readily be limited by other proposals that focus directly on interest expense, including the proposals in both the House and Senate bills, but dropped in conference, to limit interest expense to the taxpayer's pro rata share of global group interest expense based on relative assets or EBITDA in the United States.[18] Moreover, much of the revenue raised by the tax results not from disallowing "base erosion" payments but from disallowing foreign tax credits for purposes of the minimum tax. For example, the tax can apply to a U.S.-based multinational with modest related-party services payments but with extensive and profitable foreign operations subject to relatively high rates of foreign tax. Most of that foreign income will be included in taxable income in the United States under the Act's "global intangible low-taxed income" ("GILTI") pro-

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[12] Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[13] IRC § 59A(b)(1).

[14] IRC § 59A(d).

[15] See IRC § 263A and accompanying regulations for an overview of the capitalization and inclusion of certain expenses in inventory costs.

[16] See, e.g., Kleinbard, note 2, at 761 (identifying services businesses as an industry that has not been able to benefit from base erosion techniques).

[17] IRC § 59A(c).

[18] Tax Cuts and Jobs Act, H.R. 1, 115th Cong., § 4302 (2017); Tax Cuts and Jobs Act, S. 1, 115th Cong., § 14221 (2017). That proposal could have readily been limited to inbound related-party lending if the intended target is inbound related-party base erosion.

visions.[19] It also will be included in income for purposes of the 10% minimum tax, but without a foreign tax credit to offset that minimum tax.

Congress thus seems to have missed the mark in terms of effective base erosion legislation. Rather, it has enacted a tax that could be described as a form of excise tax or tariff on a specified universe of related-party payments for taxpayers subject to its provisions. It is not a model for other countries to follow. Instead, alternative forms of base erosion legislation should be considered. In particular, proposals that alter transfer pricing, taxable presence, and source rules with a focus on the jurisdiction of ultimate sale to a customer should be evaluated not only as a way of effectively mitigating base erosion, but more broadly as a more stable basis for allocating income among jurisdictions.

The jurisdiction of the ultimate customer is said to be relatively immobile,[20] which is certainly almost always true with respect to consumer transactions and is often but not always true with respect to business transactions.[21] But, even if a destination base is less mobile, subject to less manipulation, and, thus, preferable as a practical matter (although there are many implementation issues, some of which are discussed below), it is difficult to conclude that some form of destination base should be adopted solely for that reason. As Grubert articulated well, a "tariff" imposed in the guise of an income tax is still a "tariff."[22] Thus, the question is raised: Are there concepts or principles underlying a coherent set of source, transfer pricing, and taxable presence rules that can help form a more principled grounding for some form of destination-based income tax? This question has been little explored. Yet any answers could help inform an appropriate structure for a destination base in a system that remains truly a tax on income.

Rather than taking a purely normative approach to addressing this question, we explore the history and development of current and past

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[19] IRC § 951A. The GILTI provisions impose a minimum tax on global intangible low-taxed income ("GILTI"). U.S. shareholders are required to include the amount of their GILTI in their gross income, using a method similar to inclusions for subpart F income. GILTI is the excess of the U.S. shareholder's net tested income over such shareholder's deemed tangible income return. The purpose of the GILTI provisions is to reduce the incentives for U.S. taxpayers to locate intangible income in low- or zero-tax jurisdictions.

[20] See Alan J. Auerbach & Michael P. Devereux, Consumption and Cash-Flow Taxes in an International Setting 3 (Nat'l Bureau of Econ. Research, Working Paper No. 19579, 2013), http://www.nber.org/papers/w19579.pdf.

[21] Grubert, note 1, at 55-56 (noting tax planning opportunities for multinational corporations in a destination-based system by breaking the value chain through business-to-business transactions with respect to intangibles).

[22] Id. at 48.

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source, transfer pricing, and taxable presence rules. We analyze some of the core principles that underlie current and past source, transfer pricing, and taxable presence rules and some of the decisions made in our laws and treaties to see how they are or can be made more consistent with a destination income tax base in today's economy.

In a coherent system for taxing international income, source, transfer pricing, and taxable presence rules must be integrated; changing one has implications that require rethinking the others. Various commentators have discussed changes in transfer pricing, for example, with little thought to necessary changes in source and taxable presence rules to accomplish those changes.[23] These three components must be discussed in tandem in order to maintain a sound international tax system. Because they involve complex questions of justification for taxing income, it is most logical to start with the source rules as a foundation for establishing a principled basis to determine where different types of income are appropriately taxed. Once these source rules are established, a discussion of developments in transfer pricing rules and how they could be applied to shape a destination-based system can be productive. Finally, it is necessary to determine what can or must constitute a taxable presence in a country in order to effectuate a result for third-party transactions consistent with those source and transfer pricing rules. This Article discusses each of these areas in sequence and then applies the resulting considerations to three alternative approaches to a destination-based income tax—residual profit formulary apportionment, residual profit allocation, and two-sided transfer pricing.

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[23] See, e.g., Yariv Brauner, Formula Based Transfer Pricing 42 Intertax 615, 616 (2014) (discussing the benefits of arm's-length-based transfer pricing regimes versus formula-based regimes while not addressing the question of changing our current source-based regime); Bret Wells & Cym Lowell, Tax Base Erosion: Reformation of Section 482's Arm's Length Standard, 15 Fla. Tax Rev. 737, 794-97 (2014) (advocating for a shift to two-sided transfer pricing methodology and the addition of a base-protecting surtax without addressing the source and taxable presence rule changes needed to accomplish such reform). The OECD BEPS project has also suffered from too narrow a focus on transfer pricing and permanent establishment rules and lack of engagement with necessary source rule changes. This approach is demonstrated by the statement of U.S. Treasury Department Assistant Secretary for International Tax Affairs Robert Stack at an OECD conference that the BEPS project is "not a project that is about fundamental reexamination of residence and source country taxation." Kristen A. Parillo, Days of Double Nontaxation Are Over, Stack Says, 139 Tax Notes 1217, 1217 (June 10, 2013).

II. Current Regime for Taxing Multinational Corporations

A. *Source Rules*

The coherence or incoherence of the concept of or particular determination of source rules from an economic perspective is beyond the scope of this Article.[24] But, regardless of the outcome of that economic inquiry, the need to have legal mechanisms to coordinate the division of income among jurisdictions is obvious.[25] And granting the primary right to tax business income to the jurisdiction to which business activity in some way relates is fully consistent with a principled allocation of taxing rights from both a conceptual perspective (based on governmental benefits)[26] and an historical perspective (in the United States going back to the writings of T.S. Adams and others).[27]

The historical development of the full universe of source rules under U.S. laws or internationally is beyond the scope of this Article. But the development of the most important source rules for our purposes—the rules for use of intangible property and for the sale of inventory property—is worth some exploration.[28]

1. *Determining the Source of Intangible Income*

Under U.S. law there is no statutory or regulatory rule that comprehensively determines the source of income from the use of intangible property. The closest is the source rule for rents and royalties. Section 861(a)(4) defines as U.S. source income:

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[24] For discussions of source rules from an economic perspective, see generally Hugh J. Ault & David P. Bradford, Taxing International Income: An Analysis of the U.S. System and Its Economic Premises, in Taxation in the Global Economy 11, 30 (Assaf Razin & Joel Slemrod eds., 1990); Mitchell A. Kane, A Defense of Source Rules in International Taxation, 32 Yale J. on Reg. 311 (2015); Kleinbard, note 2.

[25] See Kane, note 24, at 321 ("[A] proper understanding of the conceptual basis of source rules remains essential.").

[26] See id. at 315 (noting the weaknesses of benefits theory as a justification for source-based taxation but ultimately concluding, "[I]t would seem that source-based taxation must ultimately rest on some sort of benefits rationale, if only because there is no plausible alternative justifying the widely accepted source-based rules"); Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, "What's Source Got To Do with It?" Source Rules and U.S. International Taxation, 56 Tax L. Rev. 81, 92 (2003) (justifying source-based taxation based on the government granting businesses access to markets).

[27] See Michael J. Graetz, The "Original Intent" of U.S. International Taxation, in Follow the Money: Essays on International Taxation 2, 11-16 (2016); Bret Wells & Cym H. Lowell, Income Tax Treaty Policy in the 21st Century: Residence vs. Source, 5 Colum. J. Tax L. 1, 5-10 (2013).

[28] We recognize that services are a large part of today's economy and require extensive discussion (hopefully which can follow in another paper) once inventory property and intangibles are analyzed.

> Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property.

The Code treats royalties for the use of intangible property as sourced to the jurisdiction whose laws protect that property, not the jurisdiction where the activities that created the property took place or the jurisdiction where the property is owned. This provision has been part of our source rules going back to the Revenue Act of 1921 and has not been revised since that time.[29] Legislation prior to 1921 did not address the sourcing of rents and royalties. The Revenue Act of 1916 did not address sourcing at all,[30] and the Revenue Act of 1918 only stipulated that income from within the United States included interests from obligations of residents, dividends from resident corporations, and profits from the manufacture or disposition of goods within the United States.[31]

There is relatively little discussion in the available historical materials of the rationale for this rule or of alternatives that were considered but rejected. This approach may have been selected because source-based taxation is grounded in part on the benefits provided by governments, and sourcing royalty income to the place of use acknowledges the benefits that the government of the country of use provides in protecting such intangible property.[32] That notion makes sense as applied to legally protected intangible property because the protection of such property is dependent on local law in the jurisdiction of use and not the laws of the jurisdiction where the property is owned or was created.

This source rule as applied to cross-border royalties is clearly impractical and for that reason has never had a major impact on the allocation of income among countries. In most cases the earner of the income is not a local resident and thus not subject to local tax on a net income basis; only gross income withholding taxes can be imposed to carry out the source-based allocation of income. Given that the costs of creating or acquiring any intangible can be substantial and can be incurred in tax periods prior to the period in which the royalty in

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[29] See Revenue Act of 1921, Pub. L. No. 67-98, § 217(a)(4), 42 Stat. 227, 243.

[30] See Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756.

[31] Revenue Act of 1918, Pub. L. 65-254, § 213(c), 40 Stat. 1057, 1066.

[32] John J. Cross III, Taxation of Intellectual Property in International Transactions, 8 Va. Tax Rev. 553, 572-73 (1989); Lawrence Lokken, The Sources of Income from International Uses and Disposition of Intellectual Property, 36 Tax L. Rev. 233, 242 (1981).

question is paid, a gross income withholding tax can never be crafted to be a reasonable proxy for a net income tax on intangible income. Thus, it is not surprising that tax treaties from their early days have strived to allocate taxing jurisdiction to the residence of the royalty recipient rather than the jurisdiction that provides the legal protection for that payment.[33]

But that is a practical, not a principled, reason for allocating income to the residence rather than the source country. For example, if it otherwise were appropriate and practical to treat the royalty recipient as having a taxable presence in the country of use, attributing the net income of the royalty recipient to that taxable presence would not be inconsistent with the principles of taxing income based on source. As long as the expenses in creating or acquiring the intangible property are properly accounted for, attributing the resulting net income to the jurisdiction where the intangible property is used would seem to be consistent with a tax on income. Admittedly, as discussed later, properly accounting for intangible development expenses is often difficult but must be dealt with;[34] a tax on intangible profits that does not properly account for such expenses is not consistent with an income tax.[35]

A source rule that allocates income from intangible property to the jurisdiction protecting that property is potentially coherent for legally

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[33] For examples allocating taxing jurisdiction based on the residence of the royalty recipient, see Report to the Council on the Fourth Session of the Committee, League of Nations Doc., C.399M204 1933 II.A. (1933); Convention and Protocol Concerning Double Taxation, Fr.-U.S., Apr. 27, 1932, 49 Stat. 3145, 3149; Convention and Protocol Respecting Double Taxation, Swed.-U.S., Mar. 23, 1939, 54 Stat. 1759, 1762; and Convention Respecting Double Taxation and Taxes on Income and Protocol, U.K.-U.S., Apr. 16, 1945, 60 Stat. 1377, 1382. See Ke Chin Wang, International Double Taxation of Income: Relief Through International Agreement 1921-1945, 59 Harv. L. Rev. 73, 94-95, 107-08, 110-11 (1945). While more common, this approach was not universal. For example, the League of Nations Model Bilateral Convention of 1943 taxed royalties received as consideration for the right to use a patent, a secret process or formula, a trademark, or other analogous right at source rather than residence. Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion, League of Nations Doc. C.2.M.2 1945 II.A. (1945); Wang, supra, at 96-97.

[34] Mitchell Kane correctly notes that this issue of properly allocating expenses to intangible assets is not unique to the cross-border context but also exists in the context of a closed economy through, for example, incentives to allocate intangible development costs to assets with quicker depreciation or amortization schedules. See Kane, note 24, at 342. However, we argue that these problems of proper allocation of expenses are greater in the cross-border context because of the broader universe of planning opportunities available when operating across multiple jurisdictions.

[35] See Boris I. Bittker, A "Comprehensive Tax Base" As a Goal of Income Tax Reform, 80 Harv. L. Rev. 925, 929 (1967) ("[T]axable income in most cases should correspond to commonly accepted business measures of net income . . . .").

protected intangibles.[36] There also exist very valuable forms of intangibles that are not legally protected: largely, goodwill, but also going-concern value, customer-based intangibles, and supplier-based intangibles.[37] In the United States, tax lawyers were very familiar with going-concern value, customer-based intangibles, and supplier-based intangibles prior to the enactment of § 197 in 1993 because, unlike goodwill, they could be amortized.[38] They have largely ignored them since the enactment given the parallel treatment of all such intangibles under that provision. The pre-§ 197 law establishes that these assets can be treated as separate items of property for U.S. tax purposes but are often difficult to transfer to another party in the absence of transferring a broader trade or business. Perhaps for that reason, Code drafters have not seen a need to draft a source rule that applies to the separate sale or license of these intangibles.

It would seem a strong argument could be made that the jurisdiction where the base of customers or a network exists is a natural source for goodwill and customer-based intangibles. Under the common law tradition and case law prior to § 197, goodwill is defined as the expectancy of continued customer patronage, and the drafters of the regulations adopted this same definition.[39] Little in the law today discusses the geography to which that asset is attributable. But where the element of future business to be measured reflects customers in a particular jurisdiction, it makes sense to ascribe the value of that asset to the jurisdiction where the customers reside. Similarly, customer-based intangibles include assets such as established customer bases or relations (for example, core deposits and subscribers)[40] and expanding opportunities within a market (for example, expanding demand for cable television services),[41] which can appropriately be sourced based on the physical location of the customers or of the market.

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[36] See Kane, note 24, at 341 ("[I]t is possible to give geographic coherence to intangible assets so long as we consider the category to cover assets that have some legal basis or protection . . . . [I]t is possible to associate the income from the intangible asset with the territorial basis of the associated rights generating the income."); Lokken, note 32, at 239-41.

[37] For an overview of the characteristics and tax treatment of these categories of intangibles, see Philip F. Postlewaite, David L. Cameron & Thomas Kittle-Kamp, Federal Income Taxation of Intellectual Properties and Intangible Assets ¶ 11.01 (2017).

[38] See IRC § 167(a); Newark Morning Ledger Co. v. United States, 507 U.S. 546, 566 (1993).

[39] Reg. § 1.197-2(b)(1); Commissioner v. Killian, 314 F.2d 852, 855 (5th Cir. 1963) (goodwill is the "reasonable expectation that the old customers will resort to the old place"); Boe v. Commissioner, 307 F.2d 339, 343 (9th Cir. 1962) (goodwill is "the expectancy of continued patronage").

[40] Reg. § 1.197-2(b)(6).

[41] Internal Revenue Service, Coordinated Issue Paper, Amortization of Market Based Intangibles (Feb. 19, 1996), https://www.taxnotes.com/federal-research-library/settlement-

It is not as obvious that going-concern value or supplier-based intangibles should be sourced to the jurisdiction of the ultimate customer. Supplier-based intangibles constitute the value stemming from the future purchase of goods or services from existing suppliers.[42] Therefore, it arguably would be more appropriate to source these intangibles to the place of production. Going-concern value includes the value attributable to the ability of a trade or business to continue functioning and generating income without interruption;[43] workforce in place is often a key element of going-concern value. The appropriate source would likely vary based on the nature of the particular business but often would not be tied to the location of the ultimate customer. Thus, a destination-based allocation of these types of intangible income may not be appropriate. But, as is discussed in detail below, a destination-based system need not allocate all intangible profits to the location of the customer; there may be alternatives that give proper recognition to the geography of these intangibles.

2. *Sourcing Income from the Sale of Inventory*

The second source rule we explore is the rule for income from the sale of inventory property. Section 861(a)(6) includes as U.S. source income: "Gains, profits and income derived from the purchase of inventory property (within the meaning of section 865(i)(1)) without the United States (other than within a possession of the United States) and its sale or exchange within the United States."

This rule has been little changed as a statutory matter since 1921. But what constitutes a sale within the United States has shifted between emphasizing where selling activities take place and where the actual transfer of ownership of the goods occurs. While a number of Treasury rulings between 1921 and 1928 held that place of sale was the place where title and beneficial ownership was passed,[44] subsequent regulations in effect from 1933 to 1957 provided: "Income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which sold . . . . The 'country in which sold' ordinarily means the place where the property is marketed."[45]

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guidelines-isp/amortization-market-based-intangibles/1r3z4?highlight=%22amortization%20of%20market%20based%20intangibles%22.

[42] IRC § 197(d)(1)(C)(v), (d)(3).

[43] Reg. § 1.197-2(b)(2).

[44] See O.D. 1100, 5 Cum. Bull. 118 (1921); I.T. 1569, II-1 Cum. Bull. 126 (1923); I.T. 2068, III-2 Cum. Bull. 164 (1924); G.C.M. 2467, VII-2 Cum. Bull. 188 (1928); see also Johannes R. Krahmer, Federal Income Tax Treatment of International Sales of Goods: A Reevaluation of the Title-Passage Test, 17 Tax L. Rev. 235, 237 (1962).

[45] See Reg. § 39.119-8 (1939); Reg. § 39.119(a)-6 (1953).

Thus, the regulation would seem to focus on the location of the purchaser of goods, which is where the marketing activity typically would take place. The case law, however, focused not on the location of marketing but on the location of the mechanics of the sale itself, leading to a rule largely based on the "substance of the sale," which was often reduced to the location of title passage.[46]

The weaknesses of the title passage test were acknowledged in judicial review. However, most courts ultimately chose to follow the title passage test because they believed that the alternatives would not be administrable and would not provide adequate certainty for taxpayers. For example, the Second Circuit in *United States v. Balanovski* explained:

> Although the "passage of title" rule may be subject to criticism on the grounds that it may impose inequitable tax burdens upon taxpayers engaged in substantially similar transactions, such as upon exporters whose customers require that property in the goods pass in the United States, no suitable substitute test providing an adequate degree of certainty for taxpayers has been proposed. Vague "contacts" or "substance of the transaction" criteria would make it more difficult for corporations engaged in Western Hemisphere trade to plan their operations . . . .[47]

The Courts also recognized a disconnect between the title passage test and the earning of income. The U.S. Court of Claims admitted that the title passage rules had "little or no bearing on the question of where income is earned and how it should be apportioned among the various countries in which business is conducted."[48]

The 1952 ALI Income Tax Project likewise recognized the formalistic nature of the title passage test and considered but rejected a more destination-based approach to the place of sale rules. As Stanley Surrey and William Warren explained in a summary of the project:

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[46] See, e.g., East Coast Oil Co., 31 B.T.A. 558, 560 (1934), aff'd, Commissioner v. East Coast Oil Co., 85 F.2d 322 (5th Cir. 1936)

> Of course, the place of contract, the place of delivery and of payment, the terms of the agreement, and extraneous circumstances may each have a bearing. But the ultimate goal of the examination of all such considerations is to ascertain when and where the title to the goods passes from the seller to the buyer. It is then and there a sale is consummated—when and where property in the goods passes, when and where the incidents of ownership vest in the vendee.

[47] United States v. Balanovski, 236 F.2d 298, 306 (2d Cir. 1956) (citation omitted); see also A.P. Green Export Co. v. United States, 284 F.2d 383, 387 (Ct. Cl. 1960).

[48] *A.P. Green Export Co.*, 284 F.2d at 387.

> Because of these objections to the title passage rule, careful study was given to possible alternatives. A test for tangible personality was considered which would depend upon the destination of the property sold. Upon careful analysis, however, it was found that such a test, when used with the special Western Hemisphere provisions and the foreign tax credit, would encourage exports and discourage imports by benefiting taxpayers who export goods from the United States while operating to the disadvantage of taxpayers who sell foreign goods in the United States. Furthermore, the destination test would be subject to manipulation and would prove difficult in administration . . . . After considering all the various possible alternatives and their inherent difficulties, the present title passage test was retained.[49]

Thus, the title passage rule was retained not because of any inherent principles of income taxation, but because of economic policy concerns regarding imports and exports and administrability issues. The title passage rule for exported inventory property survived the broad rewrite of the source rule for gain on sale of property in the Tax Reform Act of 1986[50] (again, for economic policy reasons—to maintain competitiveness of U.S. companies in international commerce[51]).

The administrability issues of any substantial gain on sale of inventory rule is real where sellers have no substantial presence in the country of purchase. But where such a presence is treated as existing, at least, there is no reason why a jurisdiction cannot assert taxing authority over gain on the sale of inventory to customers located in that jurisdiction. Indeed, the United States exercises that authority for imported goods today under § 865(e)(2), which overrides the general title passage rule for imported products sold through a foreign taxpayer's "office or other fixed place of business" in the United States. Congress asserted taxing authority under § 865(e)(2) to prevent base erosion. The Senate Finance Committee explained that many foreign corporations and some nonresident individuals were en-

[49] Stanley S. Surrey & William C. Warren, The Income Tax Project of the American Law Institute: Partnerships, Corporations, Sale of a Corporation Business, Trusts and Estates, Foreign Income and Foreign Taxpayers, 66 Harv. L. Rev. 1161, 1197-98 (1953).

[50] Pub. L. No. 99-514, 100 Stat. 2085.

[51] When considering the 1986 legislation, the Senate Finance Committee explained: "[T]he committee is concerned that the repeal of the title passage rule for sales of inventory property would create difficulties for U.S. businesses to compete in international commerce. Moreover, the committee recognizes that with the substantial trade deficits of the United States, it does not want to impose any obstacles on U.S. businesses that may exacerbate the problems of U.S. competitiveness abroad." S. Rep. 99-313, at 329-30 (1986), reprinted in 1986-3 C.B. (vol. 1) at 329-30.

gaging in significant business activities in the United States without paying U.S. tax. These foreign corporations and individuals were avoiding U.S. tax by using the title-passage rule to generate non-U.S. source income.[52] The enactment of § 865(e)(2) establishes a precedent for departing from the title passage rule in order to prevent base erosion in circumstances where administration is possible.

3. *Disaggregation of Sale-of-Inventory Transactions*

The gain-on-sale-of-inventory rule applies to a huge volume of transactions while the use of the intangibles rule does not arise as often because intangibles are not as frequently sold or licensed. This points to a larger issue: For source rule purposes, the Code (and as far as we can tell the tax laws of other countries as well) does not disaggregate "bundled" transactions involving valuable intangibles in order to separate the intangible element of value in the transaction from the tangible or service element of value in the transaction. The sale of pharmaceutical products is treated the same as the sale of oil, even though the predominant value of the pharmaceutical product is its patent protection. Similarly, the sale of branded consumer products is treated the same as the sale of generic products, notwithstanding that the incremental price for the branded product reflects the value of its brand.

It has always been curious that our source rules have been so focused on form and not substance in this respect. It need not be. Prior to 2018, § 863(b), for example, had since 1921 instructed Treasury to bifurcate income from manufacturing and sale transactions and separately source the manufacturing income from the sales income from a single transaction.[53] Section 863(b) recognized that manufacture and sale are both income-producing activities and that value should be allocated to each of them.[54] The Code could have provided a similar rule for sale transactions where, for example, the purchaser acquires

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[52] See id. at 331.

[53] Revenue Act of 1921, note 29, § 217(e), 42 Stat. at 245. The Tax Cuts and Jobs Act limited the bifurcation rule. Tax Cuts and Jobs Act, note 12, § 14303, 131 Stat. at 2225.

[54] See H. Rep. 67-350, at 12 (1921):

> [U]nder the present language of the law foreign producers or manufacturers who sell from an established office in the United States are subject to taxation on the entire profit derived from the goods sold within this country, although the greater part of this profit may be attributable to manufacture or production abroad.

See also S. Rep. No. 67-275, at 16 (1921), reprinted in 1939-1 C.B. 181, 192 ("The present law is both obscure and economically unsound, inasmuch as the Attorney General has held that where goods are manufactured or produced in the United States and sold abroad, no part of the profit is derived from a source within the United States."); Richard R. Dailey, The Concept of the Source of Income, 15 Tax L. Rev. 415, 451 (1960).

rights to resell the purchased products under a patent from the seller or acquires the right to use the brand name to promote the product. The product and the underlying intangible are both "income-producing" elements and could be treated separately. Under our current rules these purchase transactions with embedded licenses are not disaggregated as long as the rights transferred to the buyer apply only with respect to the resale of the product sold and not more broadly.[55] That seems inconsistent with the principles underlying the royalty source rule given that the "privilege of using" the protected intangible is part of what the buyer is acquiring.[56] This same approach is used in the current transfer pricing regulations. The transfer of an embedded intangible is not disaggregated "if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices."[57] However, the transfer pricing regulations do take a step towards disaggregation by requiring taxpayers to separate the value of the intangible when the transaction transfers the right to exploit the intangible asset in other contexts. The example the regulations provide is that if the controlled transfer of a machine is accompanied by the transfer of the right to exploit the manufacturing process incorporated into the machine, those values must be disaggregated for transfer pricing purposes.[58]

The Code could require the disaggregation of the intangible content of a product from its functional content. That would be a radical change, but it is not inconsistent with the disaggregation under § 863(b). If a reasonably practical transfer pricing or valuation mechanism could be applied to accomplish this disaggregation, it could serve as a useful mechanism for allocating income based more on substance than on form.

This brief review of the U.S. source rules leads to an understanding that, within the principles of an income tax, source rules could: (1) treat as sourced to a jurisdiction the value of intangibles protected by the laws of that jurisdiction or relating to customers located in that jurisdiction; (2) permit the income from sales of products to be split between their imbedded intangible element and their physical trans-

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[55] Rev. Rev. 75-254, 1975-1 C.B. 243 (ruling that income on the sale to a distributor of a trademarked product should not be disaggregated when the right to use the trademark related to the resale of such product).

[56] This principle of the source rule has been further supported by recent developments in patent law. In 2017, the Supreme Court held that patent rights are exhausted when the patentee sells one of its products; therefore, the privilege to use a patented product, including through resale of such product, is inherently transferred along with the product. Impression Products, Inc. v. Lexmark International, Inc., 581 U.S. 1523 (2017).

[57] Reg. § 1.482-3(f).

[58] Id.

formation and functional elements; and (3) treat as sourced to a jurisdiction sales to customers by sellers with at least some type of taxable presence in that jurisdiction. Each of these latter two elements are examined in more detail.

B. Transfer Pricing Rules

The transfer pricing rules in the United States and under the OECD are typically described as applying the arm's length standard.[59] An intercompany transaction is described as meeting the arm's length standard if the transaction realizes the same results as would have been realized by two unrelated parties entering into comparable transactions under comparable circumstances.[60] The application of this arm's length standard is plagued with difficulties and weaknesses. For example, the challenge of accurately pricing intangibles,[61] the fact that the arm's length standard does not account for efficiencies that are achieved when transactions occur on an intercompany rather than third-party basis (as described by Coase),[62] as well the overall complexity of applying the arm's length standard,[63] have each weakened the application of the standard.

Given these difficulties and weaknesses, as the transfer pricing rules have evolved over the past thirty years, the description of transfer pricing as applying an arm's length standard is not completely accurate. Many transfer pricing analyses do not rely on specific third-party transactions but are based on publicly available data of the revenues, costs, and profitability of companies that perform similar activities and functions to those performed by one party to a controlled transaction. These analyses are based on the premise that comparably situated taxpayers will yield comparable financial outcomes over time. A typical analysis involves finding multiple such public companies, determining for each the ratio of relevant operating costs or revenues to

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[59] Reg. § 1.482-1(b)(1) ("In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."); Cym H. Lowell & Mark R. Martin, Transfer Pricing Strategies ¶ 1.05 (2016); OECD, note 5, at 15 ("Transfer pricing rules . . . are used to determine on the basis of the arm's length principle the conditions, including the price, for transactions within an MNE group.").

[60] Reg. § 1.482-1(b)(1).

[61] See Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split, 9 Fla. Tax Rev. 497, 500 (2009).

[62] See R.H. Coase, The Nature of the Firm, 4 Economica 386 (1937); see also Avi-Yonah et al., note 61, at 501 ("Most fundamentally, the SA system ignores the fact that multinational groups of companies arise precisely in order to avoid the inefficiencies that arise when unrelated companies must transact with one another at arm's length.").

[63] See Avi-Yonah et al., note 61, at 502.

operating profits, after making adjustments for differences in profile, and developing some sort of interquartile range of results. The controlled transaction is then priced to yield a profit that is the equivalent to whatever point in the interquartile range is deemed appropriate under the circumstances.[64]

This methodology is most frequently applied in the United States using the comparable profits method under § 1.482-5 of the regulations. In the OECD transfer pricing guidelines it is applied using the transactional net margin method ("TNMM").[65] It is what could be described as an "outsourcing" methodology—yielding a value for specific functions and activities based on what a third-party engaging in the same business but contracting with uncontrolled parties might expect to earn.[66] There are some differences between these comparison parties and parties engaged in controlled transactions, and transfer pricing methodology allows for adjustments to account for such differences.[67] While the comparison parties typically are engaged in such functions or activities as their core business, they can be described as "routine" manufacturers or service providers, and the "routine" profit they make can be described as a routine return. Any intangibles such comparison parties possess are typically minimal besides the going-concern type value of their work force and customer relations. Because they are contracting with uncontrolled parties, the level of risk the comparison parties bear is related to keeping fully occupied with particular engagements, not to the success of the third-party businesses to which they provide services. This same risk allocation can be created for parties engaging in controlled transactions.

Despite some weaknesses, there is nothing wrong with the application of this outsourcing methodology. It provides a useful benchmark for the value of specific types of functions and activities. It permits jurisdictions in which marketing, distribution, contract manufacturing, and even contract research activities take place to expect a reasonable and relatively stable level of income based on activities and functions

[64] Reg. § 1.482-5; see generally Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, ¶ 79.9 (3d ed. 2003) (outlining components of the comparable profits method). For examples of practitioners' approaches to transfer pricing in specific scenarios, see John C. Ramirez, Establishing Defensible Trademark Royalty Rates for Transfer Pricing Analysis, Valuation Strategies, May/June 2015, at 4, http://www.willamette.com/pubs/presentations3/ramirez_royalty%20rates_2015.pdf; Aaron M. Rotkowski & Scott R. Miller, Mastering Intellectual Property Transfer Price Analysis, Valuation Strategies, May/June 2012, at 4, http://www.willamette.com/pubs/presentations/rotkowski_valuation_strategies.pdf.

[65] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 117 (2017), http://dx.doi.org/10.1787/tpg-2017-en.

[66] Reg. § 1.482-5(b)(1); OECD, Transfer Pricing Methods 6 (2010).

[67] Reg. § 1.482-5(c)(2)(iv).

independent of whether the overall business of a multinational group is prospering or struggling.

But, of course, when combined with source and taxable presence rules, this methodology permits multinational groups to structure intercompany contractual arrangements that limit their overall tax burden. Multinational groups are able to achieve this by applying the outsourcing model to allocate routine profits to the jurisdictions where many activities and functions take place and allocating any residual profits (any profits that a company earns over the routine profits amount) to tax-favored jurisdictions.[68] Not surprisingly, multinational groups engage in self-help to separate their routine profits from their residual profits in a manner that minimizes global taxation.[69]

But a methodology that separates routine from residual profits may serve as a useful proxy for the division of income between that attributable to destination-focused intangibles and that attributable to functions and activities for both transfer pricing purposes and for purposes of disaggregating intangible value under source rules. In doing so, valuation concepts are useful. Standard asset-based valuation methodologies value tangible assets based on fair market value with the remaining value attributed to intangibles; goodwill is typically the residual value after other intangibles are valued under various methodologies.[70] The transfer pricing methodologies that ascribe routine returns to functions and activities can be applied in similar ways that take into account the appropriate impact of valuable tangible property as part of any routine return; valuable real estate assets, for example, can be properly considered through actual or imputed rents. Viewing any residual profit that remains as attributable to destination-focused intangibles thus could make sense.

Treating residual profits as a proxy for intangible profits does in some sense mismeasure enterprise intangible value because an element of intangible value is taken into account in determining routine returns. The third-party businesses analyzed in the outsourcing model, if subject to valuation analysis, typically would have some goodwill/going-concern value, mostly attributable to the workforce in place and their general reputation. Allocating profits to controlled entities conducting similar functions and activities based on these third parties results in allocating to the controlled entities comparable levels of goodwill/going-concern value. That seems entirely appropri-

[68] Both the residual profit formulary apportionment proposal and the residual profit allocation proposal, discussed below, use this same concept of routine and residual profits.

[69] See Kleinbard, note 2, at 703-04.

[70] See, e.g., Reg. §§ 1.338-6, 1.1060-1.

ate. Moreover, adjustments should also be made for other specific intangibles that relate to these activities. Supplier-based intangibles, for example, can be attributed to the controlled entity with the supplier relationship. Similarly, production intangibles can be attributed to the entity undertaking the production. The residual profit that is attributed to other intangibles of a multinational group would then reflect the value of its intangibles in excess of what might be called the routine goodwill/going-concern value and any intangible attributable to various of its specific functions and activities.

To avoid confusion, it is important to understand that this concept of routine profits attributable to functions and activities of individual affiliates of a multinational group based on an outsourcing model and residual profits attributable to the success of the group as a whole is distinguishable from the economic concept of "normal" returns versus "excess" returns or "rents," as Grubert and others have described them.[71] Normal returns typically are based on the cost of capital, or a similar metric, and are determined on an enterprise basis.[72] So, for example, a young biotech company facing large clinical testing costs could have a normal return based on the cost of venture capital investments. An established pharmaceutical company facing similar investments would have a normal return based on the costs of debt and equity for that company. Yet the two companies can have similar routine returns to the specific function of conducting clinical testing based on the returns to companies whose business is to conduct such testing for third parties. The cost of capital for outsourced companies could be substantially different than that for either the young biotech company or for the established pharmaceutical company.

These differences arise because the concepts serve completely different purposes. The transfer pricing concept is intended to distinguish the value of specific functions and activities (and related goodwill) from the portion of the value of the enterprise that reflects specified or imbedded intangibles.[73] The economic concept is intended to distinguish the level of expected returns that drive invest-

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[71] See, e.g., Grubert, note 1; Grubert & Altshuler, note 2; Kleinbard, note 2, at 70 (defining "tax rents" as "low-risk inframarginal returns derived by moving income from high-tax foreign countries to low-tax ones").

[72] See Edward D. Kleinbard, Capital Taxation in an Age of Inequality, 90 S. Cal. L. Rev. 593, 602-03 (2017); see also Grubert & Altshuler, note 2, at 679 (using cost of capital as a method to determine normal returns).

[73] T.D. 8552, 1994-2 C.B. 93 (explaining the legislative history behind the U.S. transfer pricing regime and the goal that consideration transferred in a controlled transaction be in line with the relative income produced by the transferred asset); see Kleinbard, note 2, at 733-37 (describing the U.S. transfer pricing system and its weaknesses).

ment decisions from the actual returns that result from those investments.[74]

In any system allocating income among taxing jurisdictions in the context of an income tax, it would seem that separation of the routine and residual profits is more relevant and more useful. Allocating a routine return to specific functions and activities based on the outsourcing model reasonably rewards those functions and activities while minimizing the incentives to locate them in tax-favored jurisdictions. As an example, if on an outsourcing basis a particular research function would earn a return equal to a 10% operating margin, moving that activity from a 30% tax rate jurisdiction to a 10% tax rate jurisdiction would reduce the total after-tax cost of earning $100 of revenues from $93 to $91. Given all the nontax factors that influence decisions on undertaking and locating research activities, that 2% cost differential is not likely to be determinative. And for consumer as well as most business transactions, the allocation of residual profit will be unlikely to affect the location of their sale.

C. *Taxable Presence Rules*

The transfer pricing rules described above can be applied to separate intangible profits for allocation to destination jurisdictions consistent with source-of-income rules. But, by definition, transfer pricing rules only apply to related-party transactions, and intangible profits can only be effectively taxed in destination jurisdictions if similar rules apply to third-party transactions as well. Yet, as history illustrates, sourcing income to a jurisdiction has a practical consequence only if taxpayers are treated as being subject to tax on a net income basis in that jurisdiction. Gross income withholding taxes as final taxes are generally too imprecise to be effective or appropriate.[75]

The Code and most tax treaties require some form of substantial physical presence in a jurisdiction for a legal entity or individual to be subject to tax in that jurisdiction.[76] Dependent agent activities are

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[74] See Kleinbard, note 72, at 675-77.

[75] See Michael J. Graetz, Taxing International Portfolio Income, in Follow the Money, note 27, at 307 ("No one believes that source country-imposed, gross basis withholding taxes are a good way to measure ability to pay. They ignore deductions necessary to measure net income and, even if the residence country allows tax credits for the foreign withholding taxes, the tax imposed may be inconsistent with the residence country's judgments about appropriate taxation."); Lokken, note 32, at 332-33 (discussing the inability to incorporate deductions when taxes must be collected via withholding).

[76] J. Ross MacDonald, "Songs of Innocence and Experience": Changes to the Scope and Interpretation of the Permanent Establishment Article in U.S. Income Tax Treaties, 1950-2010, 63 Tax Law. 285, 285, 288 (2010); Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, 52 Tax L. Rev. 507, 510 (1997).

taken into account but only in limited circumstances (for example, where such agents act for named principals and share the ability to and in fact do sign revenue-generating contracts on their behalf).[77] The history of the permanent establishment rules in the U.S. and OECD model treaties go back to the League of Nations meetings of Technical Experts in the mid-1920's.[78] According to Mitchell Carroll, the focus leading to the 1928 Model was on European countries desiring to avoid potential U.K. taxation of their taxpayers trading goods through U.K. agents.[79] This desire led to rules that distinguished sellers operating through their own fixed place of business ("something permanent and composed of 'bricks and mortar' or other physical property") or through dependent agents, from sellers dealing through a "bona-fide agent of independent status."[80] A bona-fide agent of independent status was intended to require "absolute independence, from both legal and economic viewpoints."[81] According to Carroll, over the years thereafter various less developed countries advocated for broader taxation of nonresidents at source, reflected in a Mexico Draft League of Nations Model Treaty provision at a Western Hemisphere Regional Conference in 1943.[82] But following World War II, the developed countries reasserted themselves, leading to a London draft in 1946 that is similar to the OECD Tax Committee Model first published in 1963.[83] That draft contained a list of activities that give rise to a permanent establishment similar to early League of Nations provisions but expanded the activities that would not give rise to a PE, including purchasing, marketing, research, and warehousing activities.[84]

In today's world where research and marketing are so central to the value of products and services, it seems surprising that such activities would be viewed in 1963 as not constituting a PE for the sale of related products. The 1963 Model Commentary explained that, while it was recognized that marketing and research activities might contribute to the productivity of a business, to assume that they do would be "axiomatic."[85] It stated that these services "are so far antecedent to

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[77] MacDonald, note 76, at 381-409.

[78] Id. at 295-96.

[79] Mitchell B. Carroll, International Tax Law: Benefits for American Investors and Enterprises Abroad, 2 Int'l Law 692, 700-01 (1968).

[80] Id. at 701.

[81] Id.

[82] Id. at 708.

[83] Id. at 712.

[84] Id. at 714.

[85] OECD, Commentary on the Article 5 Concerning Permanent Establishment, Art. 5(12), in 1963 and 1977 OECD Model Income Tax Treaties and Commentaries (Kees van Raad ed., 2d ed. 1990).

the actual realization of profits by its parent body that no profits can properly be allocated to it."[86] The 1977 OECD Model Treaty removed the specific reference to marketing and research in its list of activities that would not give rise to a PE. Instead, the model treaty excluded from the definition of permanent establishment fixed places of business established solely for the purposes of carrying on any activity of a "preparatory or auxiliary character."[87] The commentary to the model treaty includes marketing and research as examples of activities that could be of a preparatory or auxiliary character but leaves open the possibility that marketing and research could result in a PE if they form a significant part of the overall activity of the business enterprise.[88] The 1977 OECD Model Treaty's approach has remained in the OECD model treaties through today.

The OECD reviewed several aspects of the current model treaty permanent establishment provisions as part of its BEPS action plan. In Action 7 of its BEPS report, the OECD did not adopt any fundamental changes but focused on three modifications: (1) expanding the concept of PE to apply to commissionnaire arrangements involving agents that are closely related to the foreign enterprises and agents that substantially negotiate but do not formally conclude contracts on behalf of principals; (2) limiting the specific exceptions to the PE definition, including the exceptions for warehousing and purchasing arrangements, to circumstances where those specific activities are in fact "preparatory or auxiliary" to the business; and (3) developing an "anti-fragmentation rule" under which the overall activities of closely related entities of an enterprise are considered together in determining whether a permanent establishment exists.[89]

Obviously these proposals are not dramatic given that the emergence of the digital economy has facilitated business models that allow an expanded range of sales of goods and services to customers without any seller presence in the customer's country.[90] Some commentators have argued that the concept of physical presence should be replaced

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[86] OECD, Model Double Taxation Convention on Income and on Capital, art. 5(3)(e) (1963).

[87] OECD, Model Double Taxation Convention on Income and Capital, art. 5(4)(e) (1977).

[88] 1977 OECD, Commentary, Model Double Taxation Convention of Income and Capital, art. 5, para. 22 (2017).

[89] OECD, Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7: 2015 Final Report 9-10 (2015), http://www.oecd-ilibrary.org/docserver/download/2315341e.pdf?expires=1521665349&id=id&accname=guest&checksum=E1699155A7BE24D2C8FE617459FC0E3C (declining to apply different PE rules to business activities conducted through the digital economy).

[90] Avi-Yonah, note 76, at 516; Pierre Collin & Nicolas Colin, Task Force on Taxation of the Digital Economy 63-64 (Jan. 2013), https://www.hldataprotection.com/files/2013/06/Taxation_Digitial_Economy.pdf.

with a concept of "economic presence."[91] Many of these proposals are specific to digital commerce.[92] In BEPS the contrary view taken by the OECD, among others, was that digital commerce is just one form of remote transaction and does not require separate rules.[93] That is a fair point; whether a U.S. customer orders a Canadian product from the internet on a computer or from a catalog over the telephone should not matter.[94]

But at this point a basic question must be faced: What income should be attributed to that remote sale? If it is merely the income resulting from the process of making the sale itself, it could be seen as de minimis and arguably not worth any fundamental change in the rules. But if the income from the sale includes at least some of the income attributable to the intangible value of the property sold, as some commentators would advocate, consideration of economic presence rules becomes important.[95]

But if any economic presence-type rules that tax remote income from sales cause substantial income to be taxed in the jurisdiction of the customer, the rules must extend beyond remote transactions directly with ultimate purchasers. Sales through third-party distribution channels must also be considered.[96] If a foreign clothes designer, for example, sells to a U.S. customer through a department store or other retailer's website, should its tax consequences in the United States be

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[91] See, e.g., Arthur J. Cockfield, Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test, 38 Can. Bus. L.J. 400 (2003); Walter Hellerstein, State Taxation of Electronic Commerce, 52 Tax L. Rev. 425, 440-41 (1997); Charles E. McLure Jr., Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws, 52 Tax L. Rev. 269, 295 (1997).

[92] See, e.g., Hellerstein, note 91, at 440-41; McLure, note 91, at 295.

[93] See OECD, note 5; Gary D. Sprague & Rachel Hersey, Permanent Establishments and Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests, 38 Ga. L. Rev. 299 (2003).

[94] But see Avi-Yonah, note 76, at 510-16 (identifying changes in interactivity, speed, and electronic payment as key ways in which internet commerce differs from previous forms of "electronic commerce" and highlighting additional challenges these changes bring).

[95] Commentators have noted the base erosion problems created by not properly attributing the value of the intangibles to the sale of products. See, e.g., Michael J. Graetz, Technological Innovation, International Competition, and the Challenges of International Income Taxation, in Follow the Money, note 27, at 193-94 (describing income-shifting techniques that "allow MNEs to deflect IP income to low- or zero-tax countries even in circumstances where the value of the IP as created in the United States and the resulting products are sold in the United States."); Kleinbard, note 2, at 733-34 (describing methods by which MNEs are able to locate profits from intangibles to jurisdictions other than the jurisdiction of final sale); see generally Xuan-Thao Nguyen & Jeffrey A. Maine, The History of Intellectual Property Taxation: Promoting Innovation and Other Intellectual Property Goals, 64 S.M.U. L. Rev. 795, 827-30 (2011) (highlighting the need to consider both the tax consequences of the intellectual property and the tangible form in which it is embodied).

[96] See Grubert, note 1, at 56-57 (noting the potential in a destination-based system for taxpayers with sales in high-tax jurisdictions to use unrelated distributors in low-tax jurisdictions as a conduit to avoid tax in the high-tax jurisdiction).

different than if the purchase is from its own website where the attributable income exceeds a website service fee? Should the answer turn on the formality of whether the retailer takes title to the clothes? Even sales through physical third-party retail outlets can raise similar issues: If designer clothes sold to consumers over the internet by a third party are taxed to the designer in the customer's jurisdiction, why should the designs not be taxed if the clothes are sold through a third-party's physical location? The point here is that if the tax law is to treat an "economic presence" as a basis for taxing a nonlocal business and ascribes to that presence more than the de minimis income resulting from the process of making the sale, the economic presence concept should not be limited to remote sales directly to ultimate customers. Selling goods through third-party distributors or retailers is too easy a way to avoid tax.

At this point the practical limitations of imposing an income tax—as opposed to a consumption tax or tariff—on cross-border transactions have to be acknowledged. In the above case, whether or not the foreign clothes designer pays a consumption tax on a sale to a domestic retail distributor does not affect the ultimate tax base if the retailer only gets a deduction where the designer pays the tax. Thus for business-to-business transactions, tax enforcement against a business with potentially no connection to that jurisdiction is not a fundamental issue. Under an income tax, however, the domestic retailer properly should have a deduction whether or not the foreign designer is subject to tax. The tax can only be collected by asserting jurisdiction against the clothes designer even where no physical connection to that jurisdiction exists. That in turn means the only practical way to enforce the tax is by imposing a withholding tax on the purchaser (with the potential for a refund on a net income basis to the designer).[97] In the end, given all that is at stake, such a blunt mechanism may be acceptable. But at a minimum it is a large leap in enforcement that, if ap-

[97] Reuven Avi-Yonah has proposed a similar withholding tax regime for electronic commerce. His proposed regime would function as follows: First, a gross withholding tax would be imposed on sales or services in the market jurisdiction at a rate equal to the corporate tax in the market jurisdiction. Second, the taxpayer would obtain a refund or reduction in the gross tax by filing a return showing deductions. Third, the market jurisdiction would disallow deductions to related and unrelated parties in jurisdictions with lower rates than the market jurisdiction and the same rules for deductibility, unless the parties file a return and pay tax to the market jurisdiction. Avi-Yonah, note 76, at 537-39.

The House-proposed tax plan included a similar provision—a 20% excise tax on foreign imports from subsidiaries. Tax Cuts and Jobs Act, H.R. 1, 115th Cong., § 4303 (2017). It faced criticism because it would cause foreign corporations with no connection with the United States other than selling, licensing, or providing services to a U.S. subsidiary to become net basis U.S. taxpayers. It was not included in the final version of the bill.

plied by most countries, would substantially increase the compliance friction of an income tax.

Less radical alternatives between today's PE concept and a pure "economic presence" concept thus should be considered. For example, the concept could require continuous physical presence, but eliminate the exceptions for "preparatory and auxiliary" activities altogether. Moreover, the activities of entities within a multinational group could be aggregated for purposes of determining presence in any jurisdiction. The OECD took limited steps in this latter direction in its Action 7 "anti-fragmentation rule."[98]

The United Kingdom has taken a broader step in its recently enacted diverted profits tax legislation. Under that legislation, a 25% diverted profits tax, rather than a normal 19% corporate income tax,[99] is levied on large MNEs "with business activities in the United Kingdom who enter into contrived arrangements to divert profits from the United Kingdom by avoiding a U.K. taxable presence and/or by other contrived arrangements between connected entities."[100] The first prong of the diverted profits tax is meant to prevent MNEs from circumventing U.K. tax by avoiding establishing a PE in the United Kingdom. Under this legislation, if any affiliate of a remote seller has a physical presence in the United Kingdom and carries on activities related to the remote seller's U.K. transactions, the remote seller is treated as having a taxable presence in the United Kingdom. Thus, for example, where a remote seller of equipment has a U.K. affiliate that performs equipment installation or other customer assistance, the seller would be treated as having a PE in the United Kingdom. The U.K. diverted profits tax has come under substantial criticism for many reasons, including the lack of clear guidelines as to what "contrived arrangements" are and compatibility with tax treaties and

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[98] The OECD's anti-fragmentation rule considers the overall activities of closely related entities of an enterprise together in determining whether a permanent establishment exists. OECD, note 5, at 39-42.

[99] The U.K. corporate tax rate will decrease to 17% for tax years starting April 1, 2020, thus increasing the negative impact of the diverted profits tax. HM Revenue & Customs, Guidance: Rates and Allowances: Corporation Tax (Apr. 1, 2017), https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax.

[100] HM Revenue & Customs, Diverted Profits Tax, at 1 (2015), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf. The 25% diverted profits tax is also levied against large MNEs that engage in "contrived arrangements between connected entities." Id. This second prong of the legislation is targeted towards companies employing transfer pricing schemes that shift profits from the United Kingdom to lower-tax jurisdictions.

BEPS.[101] The measure has also been criticized because, while it makes efforts to tax on a net income basis, all business expenses will be not be recoverable by the taxpayer.[102] Therefore, it suffers from the same problems (albeit to a lesser degree) that taxing cross-border transactions via a withholding tax does. Despite these criticisms, it appears that the U.K. approach may be spreading. Australia adopted a similar diverted profits tax in 2016.[103]

But the U.K. type of approach to expanding taxable presence rules has significant advantages over an economic presence rule. First, as a practical matter, by retaining a tie to physical presence, it gives a jurisdictional reach for tax enforcement. Penalties, for example, can be assessed on the local business even if imposed with respect to the income of nonlocal affiliates. Thus, it can avoid or at least minimize the need for a withholding tax or other blunt enforcement mechanisms. Second, also from a practical perspective, it will exempt most infrequent sellers of goods and services in a jurisdiction because they are less likely to require any continuous presence there. Third, it is intuitively most consistent with the underlying notion that source-based taxation is tied in some way to the benefits a taxpayer receives from a jurisdiction. The existence of some physical presence makes a more understandable connection between the taxpayer and the jurisdiction. And there would seem to be nothing particularly offensive from a traditional income tax policy perspective about ignoring the separateness of legal entities within a multinational group in determining whether group members have that necessary presence.

In addition, anti-abuse rules could be considered to deal with taxpayers implementing artificial arrangements to avoid any presence in a jurisdiction. In particular, rules deeming a presence based on the activities of "captive" third-party service providers, as opposed to truly independent service providers, could be considered. This assessment could be analogous in some respects to the difference between dependent and independent agents, a difference that has been explored and interpreted by the OECD, IRS, and U.S. courts.[104] This

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[101] See, e.g., Keith Brockman, Illusory Transparency: A Symptom of BEPS Complexity, 26 Int'l Tax Rev. 4, 4 (2015); Daniel Shaviro, The Crossroads Versus the Seesaw: Getting a Fix on Recent International Tax Policy Developments, 69 Tax L. Rev. 1, 32 (2015).

[102] See, e.g., Bret Wells, The Foreign Tax Credit War, 2016 B.Y.U. L. Rev. 1895, 1940-41.

[103] Shinasa Wasimi, Jai Nario & Kathryn Bertram, Diverted Profits Tax: U.K., Australian, and New Zealand Approaches, 87 Tax Notes Int'l 349 (July 24, 2017).

[104] See, e.g. OECD, Commentaries on the Articles of the Model Tax Convention 46-59 (2010), http://www.oecd.org/berlin/publikationen/43324465.pdf (outlining considerations to determine independent agent status); Taisei Fire and Marine Ins. Co. v. Commissioner, 104 T.C. 535 (1995) (assessing the independence of a U.S. company accepting reinsurance on behalf of Japanese insurance companies); Rev. Rul. 90-80, 1990-2 C.B. 170 (assessing the independence of an agent working in the United States for a foreign principal).

body of interpretation could help prevent the anti-abuse rules from facing the criticism levied against the U.K. diverted profits tax that guidelines are unclear.[105]

In the end, as many commentators have argued,[106] it could be that, particularly with the rise of digital commerce, the avoidance possibilities of limiting any taxable presence standard to situations where an affiliated group of taxpayers (together with unrelated "captive" service providers) have a presence in the jurisdiction are too substantial to be ignored, and some sort of broader economic presence test accompanied by withholding tax enforcement mechanisms must be considered. But that should only be done with full recognition of the administration and enforcement costs and difficulties that inevitably follow.[107]

III. Alternative Approaches to Destination-Based Taxation

It should now be apparent that some combination of modified source rules, outsourcing model transfer pricing rules, and expanded taxable presence rules can lead to a destination-based tax that is consistent with the principles of an income tax. With these principles as a guide, the three most discussed destination-based proposals can be analyzed: a residual profit formulary apportionment proposal, a residual profit allocation proposal, and a two-sided transfer pricing proposal.

A. *Residual Profit Formulary Apportionment Proposal*

The first proposal to consider is a variation on formulary apportionment originally suggested by Avi-Yonah, Kim Clausing, and Michael Durst in 2009.[108] The proposal allocates global profits first to entities undertaking functions and activities based on actual costs incurred plus a 7.5% mark-up. It then apportions any residual returns to various jurisdictions based on the ratio of local sales to global sales.[109]

The cost plus 7.5% mark-up is intended to be a formulaic mechanism for approximating routine returns.[110] As described above, most transfer pricing methodologies under the outsourcing model are based

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[105] See note 101 and accompanying text.

[106] See, e.g., Cockfield, note 91; Hellerstein, note 91; McLure, note 91.

[107] It should also be acknowledged that an expanded concept of PE as described above could be applied to prevent base erosion effects of related-party transactions rather than altering transfer pricing for related-party transactions and applying an expanded concept of PE only as a "back-stop" to prevent base erosion schemes for third-party transactions. While this approach might be able to accomplish the goal of limiting base erosion, it would be administratively cumbersome and, therefore, not a beneficial approach.

[108] Avi-Yonah et al., note 61.

[109] Id. at 508-09, 540.

[110] Id. at 508-10.

on ratios of operating profits to operating costs or operating profits to revenues.[111] Each can mathematically be converted to a cost-plus formulation, making the authors' methodology consistent with that frequently used in transfer pricing today. The use of a 7.5% fixed mark-up (essentially equivalent to a 7% operating margin) is intended to minimize disputes while providing a modest allocation of profit based on locally incurred costs.[112] Actual transfer pricing studies often encompass a wide range of margins.[113] When applied to any specific type of function or activity, the range is often broad enough that disputes arise, so there is something to be said for an arbitrary, but fixed, mark-up.[114] Several difficulties must be dealt with, however. Many functions and activities have quite different capital structures; contract manufacturing, for example, can require substantial capital compared to many distributors or service providers. Any formulaic measure that does not adjust for levels of capital investment would seem inappropriate.[115] Second, many functions and activities conducted by a global group of companies involve substantial costs that are incurred through third parties. In the pharmaceutical industry, for example, clinical testing costs are often outsourced; for consumer products most advertising costs are paid to third parties. In today's transfer pricing studies these costs are only taken into account where the comparable companies that are used as benchmarks incur comparable levels of those costs or where the costs are not separately stated in published financial statements but are imbedded in larger cost categories.[116] It is not clear under the formulaic approach proposed here how those costs should be treated. Finally, as discussed above, there are some intangibles that are more properly attributed to the location of production, including manufacturing process intangibles and supplier-based

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[111] See discussion at Section II.B.

[112] Avi-Yonah et al., note 61.

[113] See generally U.N. Dep't Econ. & Soc. Aff., United Nations Practical Manual on Transfer Pricing for Developing Countries 191-268 (2013); Joel B. Rosenberg, Barbara N. McLennan, Ahmed H. Mohamed & Alan D. McInnes, Transfer Pricing Comparability: Concepts, Methods and Applications, 5 Corp. Bus. Tax'n Monthly 4 (2003) (detailed overview of methods for determining margins).

[114] See Avi-Yonah et al., note 61, at 504-06 (discussing the prevalence and impact of disputes over transfer pricing); Andrus & Oosterhuis, note 6, at 92 (discussing potential issues of enforceability associated with BEPS transfer pricing proposals).

[115] See Reg. § 1.482-5(b)(4) (noting that the use of rate of return on capital employed under the comparable profits method becomes more reliable in circumstances where assets play a greater role in generating profits); Rosenberg et al., note 113, at 10-11 (discussing the appropriateness of different transfer pricing methods for capital intensive versus non-capital intensive functions).

[116] See Reg. § 1.482-6(c)(2)(ii)(C)(1) (noting the need to make adjustments under the comparable profit split method in instances such as when the tested party or the comparison party contracts with controlled suppliers).

intangibles. An arbitrary mark-up cannot accurately take these elements of value into account.

Under the proposal any remaining global profits are apportioned based on relative third-party sales in each jurisdiction.[117] That apportionment raises a number of questions. First, the location of a sale has to be determined. The treatment of sales through third-party distributors and sales of raw material, intermediate goods, and capital goods raise issues that have been discussed elsewhere; these types of sales typically require drawing somewhat arbitrary lines between sales for distribution and sales for further manufacture.[118]

Once the location of a sale is determined, what happens to sales treated under these rules as having been made into jurisdictions where the seller has no presence? While the authors do not address this question specifically, elsewhere they have suggested that the profit attributable to remote sales be "thrown around" and added to a jurisdiction's apportionment share (as determined by other factors included in the apportionment formula) or be "thrown out" entirely from the sales apportionment.[119] In either case, the result is obviously an arbitrary rule that is not consistent with any of the income tax sourcing notions described above.

More importantly, the proposal apportions residual profits from an overall global business.[120] Thus, the profits allocated to any jurisdiction will only coincidentally relate to the value of legally protected intangibles or customer-based intangibles or any function or activity in that jurisdiction. A global average level of profits, for example, will be allocated to jurisdictions where patent protections are weak just as they are allocated to jurisdictions with robust protections. Admittedly, this occurs because the income allocation is mechanical, which has the advantage of potentially reducing the magnitude of disputes. And the profit to be allocated is presumably net of actual research and development ("R&D") and G&A costs so that, in effect, those costs are charged out (based on sales for multinational groups that

[117] Avi-Yonah et al., note 61, at 508-09.

[118] See Grubert, note 1, at 50-51, 53 (discussing issues caused by transactions with unrelated distributors in assessing jurisdiction of sale as well as difficulties in assessing jurisdiction of sale for different categories of goods). For examples in the current U.S. source rules of arbitrary lines that must be drawn to determine location of sale, see IRC § 861(a)(6) (sourcing of inventory sales), and the discussion of sourcing income derived from the sale of inventory and the title passage rule in Subsection II.A.2, and the discussion of sourcing of sales of manufactured inventory items in Subsection II.A.3.

[119] Durst, note 9, at V.D.4.c.2.

[120] The proposal treats each business activity as a single taxpayer and calculates income subtracting global expenses from global income, using a global accounting system and not differentiating between income or expenses in different jurisdictions. Avi-Yonah et al., note 61, at 508.

have residual profits in excess of those costs). But, arguably, this apportionment is not consistent with any sourcing principles under an income tax. Thus, it is worth considering (if at all) only in a context where most substantial jurisdictions are in agreement to replace their current business income tax with a tax based on an agreed formula.

B. *Residual Profit Allocation Proposal*

An alternative proposal has been considered by an informal group organized by Michael Devereux.[121] It applies the same transfer pricing methodologies used today by multinational groups to allocate routine returns on a cost-plus basis to activities and functions. But rather than allocating any residual profits based on contractual arrangements within a group, the residual profit allocation proposal allocates these residual profits to the jurisdiction of the ultimate sale to a third-party customer.[122] Essentially the proposal mandates specific ground rules for applying today's transfer pricing methodologies. A group member that manufactures products for sale to an intermediate distribution affiliate would charge a transfer price based on its costs plus a contract manufacturer's return, as determined from the returns of comparable manufacturers. The intermediate distribution affiliate would similarly charge its local market affiliate a transfer price that reflects a mark-up on its costs (other than its cost of goods) based on what similar third-party distributors earn. The local market affiliate would take that transfer price as its cost of goods and earn a profit based on its actual third-party revenues from the sale of the products. Thus, the local market affiliate earns any residual returns from the products sold in its market. The system is essentially the same as that used by many multinationals today, except the entity earning any residual profit is mandated to be the local market affiliate, rather than a tax-favored affiliate designated by the multinational group through contractual arrangements.[123]

One crucial issue that this proposal faces is what to do with group expenses that are neither included in cost of goods nor allocable directly to the sale of any particular products. R&D expense, G&A expense, and (in some circumstances) global marketing expenses all must be taken into account in some jurisdiction. Here the Devereux proposal applies a cost-sharing type notion and apportions these expenses, plus a mark-up reflecting a routine return on the functions and activities involved, based on relative third-party revenues from a sin-

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121 See Michael Devereux, Residual Profit Allocation Proposal (July 14, 2016), http://www.taxpolicycenter.org/sites/default/files/residual-profit-allocation-proposal_2.pdf.
122 Id. at 3; see also Andrus & Oosterhuis, note 6, at 102.
123 Andrus & Oosterhuis, note 6, at 102.

gle broadly defined business. As a result R&D and G&A are effectively treated as service functions that are contracted out to the market jurisdictions.[124]

As considered by the Devereux group, the proposal would apply to remote sales, thus requiring that such sales establish a taxable presence in a jurisdiction. To prevent avoidance, rules would be required to look through third-party distribution and similar arrangements, effectively treating such distributors as if they were commission agents, rather than purchasers and sellers of goods.[125] It is conceivable the proposal could be applied only to jurisdictions where the multinational group has some minimum level of presence. But residual profits attributable to remote sales would then be subject to little or no tax based on which affiliate within the multinational group was chosen to make product sales to third parties.[126]

The Devereux proposal shares many of the same problems described above with regard to the residual profit formulary apportionment proposal. Both work best if combined with rules establishing a taxable presence based on local product sales without regard to any seller physical presence in the jurisdiction. Both require facing issues in identifying the location of sales for raw materials, intermediate goods, and capital goods. Both also face difficulties when applied to services-type activities that generate residual profits. Finally, the treatment of losses, of profit levels that fall short of routine returns, and of sales into new markets must be dealt with. A particular concern results from taxable period mismatches between R&D expenditures and resulting intangible profits, which creates problems of over-allocating expenses to some jurisdictions and over-allocating income to other jurisdictions. For example, in year one a pharmaceutical company could have sizable revenues from a product in *Country A*, which country would then fund Year 1 R&D expense that could ultimately lead to sales in other countries. The treatment of each of these issues adds complexity and elements of arbitrariness to each proposal. That is a significant drawback that can only be mitigated if business income taxes generally require the capitalization and amortization of R&D expense.[127]

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[124] Devereux, note 121, at 5, 13.

[125] Id. at 14.

[126] See notes 76-107 and accompanying text for a more in-depth discussion of the challenges presented by the need to establish a taxable presence.

[127] The United States took a tentative step in that direction in the Tax Cuts and Jobs Act by requiring R&D expenses incurred after December 31, 2021 to be capitalized and amortized over five or fifteen years. See Tax Cuts and Jobs Act, note 12, § 13206(a), 131 Stat. at 2111.

The Devereux proposal is more consistent with today's framework of source rules and transfer pricing methodologies.[128] The allocation of actual residual profit from local transactions to the local market jurisdiction reasonably matches the source notion that the allocation of profits from legally protected intangibles and customer-based intangibles to that jurisdiction is appropriate.[129] Moreover, the pricing of functions and activities based on current outsourcing methodologies will in many cases result in an allocation of income to various jurisdictions similar to what is done today by multinational groups using "entrepreneurial" tax planning models.[130] Thus, it is more likely to be acceptable in the context of unilateral, rather than multilateral, adoption. Multinational groups that do face double taxation of residual profits can attempt self-help by changing their contractual arrangements to be consistent with the mandated allocation of residual profits.[131]

It would thus seem that the Devereux destination base proposal could in many ways be seen as consistent with an appropriate tax on income with respect to source and transfer pricing rules. The need for economic presence rules to prevent significant avoidance is a substantial departure, but one that may be necessary independent of implementing a Devereux-type destination base given the growth of the digital economy.[132] It is, then, the practical problems with the proposal, relating in particular to the treatment of R&D expenses and losses more generally, that should be further explored. It is difficult to defend a tax as an income tax if it does not match income and expense.[133] As described above, under the Devereux proposal R&D expense often will not match with related intangible income in a particular jurisdiction. In a world where expensing of R&D costs is nearly universal this mismatch could be a serious problem.[134] Further work needs to be done on the magnitude of this mismatch and the distortions that it would create.

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128 See note 121 and accompanying text.

129 See notes 121-25 and accompanying text.

130 See Andrus & Oosterhuis, note 6, at 102.

131 See id. at 103 ("[O]ver time, multinationals concerned about [results of the residual profit allocation proposal] could adapt their transfer pricing methodologies to minimize any double tax.").

132 See notes 92-96 and accompanying text (discussing the impact of the digital economy on taxable presence rules and the potential need for reform).

133 See Bittker, note 35, at 925.

134 See Graetz, note 95 (discussing issues related to R&D and international taxation, including the problem of mismatching R&D expenditure and income among jurisdictions in an open economy).

C. *Two-Sided Transfer Pricing Proposal*

The final alternative to be considered is a variant of a proposal developed by Bret Wells and Cym Lowell that is specifically focused on inbound taxation in the United States. Under their proposal: (1) Inbound transfer prices would be determined based on a "one-sided transfer pricing" methodology, ensuring a routine return to the U.S. distribution/marketing affiliate (this methodology is described as "one-sided" transfer pricing because the price (and, therefore, the U.S. profit) can be determined with reference only to the costs of the U.S. affiliate, without regard to costs and profits of non-U.S. affiliates);[135] (2) a 10% "base-protecting surtax" would be levied on the U.S. related-party payor, reflecting a high-end approximation of residual profit; and (3) the U.S. payor would have the right to claim a refund of some or all of the surtax through a "base clearance certificate process."[136] That process would involve a determination of whether, under a "two-sided" transfer pricing methodology that takes into account the global profits of the multinational group of companies, the surtax was excessive.[137]

The authors describe the certificate process as being similar to an advanced pricing agreement (APA).[138] But they provide little guidance as to how a "two-sided" transfer pricing methodology would be applied. Based on today's transfer pricing methodologies, the most logical approach would be a "profit split" method, similar to that reflected in § 1.482-6 of the regulations. That method typically is applied where each of the two parties to a controlled transaction owns intangibles that contribute significantly to the value of the product or service in question.[139] Thus, a two-sided transfer pricing approach could be implemented by mandating that any customer-based intangibles related to the relevant market be treated as owned by the local marketing/distribution affiliate, while any product design/development/manufacturing intangibles would be treated as owned by the affiliate or affiliates owning them under today's transfer pricing rules. In effect the proposal would ignore contractual risk-shifting through limited risk distribution arrangements.[140] Inbound companies per-

[135] Wells & Lowell, note 23, at 750-60.

[136] Wells & Lowell, note 2, at 604-06.

[137] Id. at 605-06.

[138] Id. at 605-06 n.145.

[139] OECD, Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10: 2015 Final Report 100-02 (2015), http://www.oecd-ilibrary.org/docserver/download/2315351e.pdf?expires=1521836511&id=id&accname=guest&checksum=D4A877A66BC777AAAAED16815D6E50F6 (noting that the profit split and CUP methods are most often useful in the context of transfers of intangibles).

[140] In contrast, the BEPS proposal, while downplaying the importance of contractual or legal ownership, relies heavily on contractual relationships between parties, most notably

forming and funding R&D outside the market jurisdiction and importing products to that jurisdiction would have transfer prices determined by a profit split based on the relative values to their business of their technology intangibles versus their customer-based intangibles. While these values are always uncertain and often subject to dispute, there are transfer pricing and valuation methodologies that can be used to determine them.[141] Moreover, in situations where the R&D intangibles are already owned by a U.S. affiliate (for example, as in many cost-sharing agreements), a two-sided transfer pricing analysis as applied in U.S. market sales would be unnecessary. Rather, a one-sided analysis could be applied to ascribe a routine return to the nonmarket country functions and activities, with the residual falling to the market jurisdiction.

Wells and Lowell's two-sided transfer pricing proposal thus seems worth considering if it is accepted that, from a source-rule perspective, attributing customer-based intangibles to the local market jurisdiction is appropriate.[142] It could result in bringing to transfer pricing analysis a wider perspective that takes into account all customer-based intangibles, including local customer base and networks, as well as local goodwill and going-concern value, and applying valuation as well as transfer pricing techniques to determine the relative values of those intangibles versus other intangibles.

Other aspects of their proposal, however, are questionable. In particular, it is difficult to see how the proposal would effectively mitigate base erosion if limited to a related-party transfer pricing. Pharmaceutical companies selling to third-party distributors and consumer goods companies selling to retailers could easily avoid the proposal by selling to the respective third parties from foreign affiliates not doing business in the United States. Thus, as with the residual profit formulary apportionment and residual profit allocation proposals, consideration would need to be given to establishing taxable presence rules based on economic (rather than physical) presence. But if the goal is to respect the source of customer-based intangibles and permit R&D intangibles to remain sourced to their legal owner or creator, perhaps a taxable presence test that falls short of purely economic presence would be

assumption of risk and contribution of funding for development of intangibles, in determining allocation of intangible income. This reliance leaves open the possibility of value shifting by MNEs through contractual risk shifting. See Andrus & Oosterhuis, note 6, at 92. A two-sided transfer pricing methodology, as described above, could ignore such shifting.

[141] Yariv Brauner, Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes, 28 Va. Tax Rev. 79, 95-120 (2008) (providing an overview of issues and methods in valuing intangibles under transfer pricing principles).

[142] See notes 37-39 and accompanying text (arguing that it is consistent with source-rule principles to allocate customer-based intangibles to the local market jurisdiction).

sufficient. For it may be true that in most situations where customer-based intangibles are a significant element of local value for the multinational group, that group needs some physical presence in that jurisdiction. If that is accurate, perhaps the problems of remote sales and sales through third-party distributors are limited; a rule that expands the current PE concept to include any continuous group-wide presence might be sufficient. Such a rule could eliminate most of the current exceptions involving continuous physical presence, such as the exceptions in the OECD Model Treaty for physical presence related to activities of a "preparatory or auxiliary character"[143] and attribute the presence of any member of a controlled multinational group in a jurisdiction to an affiliate selling goods into that jurisdiction, similar to provisions of the U.K. diverted profits tax.[144] Such an expansion would certainly be within the realm of reasonable taxable presence rules under a tax on income.

A final troubling aspect of the Wells and Lowell proposal is its base-protecting surtax. The tax would increase cash flow to any implementing jurisdiction. But in many countries, including often the United States, getting refunds can be painfully difficult. Moreover, it would seem that such a surtax would be unnecessary in related-party transactions where the related-party payor of the tax is a U.S. entity. Determining whether a two-sided transfer price is appropriate, and, if so, what the right price is, could be resolved on audit with whatever adjustments are appropriate through that process. Perhaps it can be argued that the certification process to determine that price in the surtax refund context would receive higher level or more efficient review by the IRS. But there is no reason why that need be. Moreover, if applying the proposal to third-party transactions is limited to situations where the selling multinational group has some presence in the local jurisdiction, there would seem to be no enforcement reason to apply the surtax to third-party transactions to assure compliance. Tax assessments (including penalties) can be levied on the affiliate that has the physical presence in the jurisdiction to achieve that result.

Unlike the Devereux proposal, the two-sided transfer pricing approach avoids the need to allocate R&D expense from nonmarket jurisdictions to the market country; the affiliate incurring the expenses will be compensated through transfer pricing. That leaves G&A expenses as the primary cost not accounted for. That expense could be charged out where an affiliate directly benefits from the cost, as is

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[143] See notes 87-89 and accompanying text.

[144] See notes 99-100 and accompanying text.

typical under today's transfer pricing rules.[145] But it is often unclear when an affiliate subject to a two-sided transfer pricing analysis benefits from such an expense. As a result it might be preferable to change internationally acceptable rules to permit some form of cost-sharing of G&A expense among affiliates within a multinational group.

As described above, the two-sided transfer pricing proposal is much more of an incremental step toward destination-based income taxation than either the residual profit formulary apportionment or residual profit allocation proposals. Because it does not charge out R&D expenses, it creates fewer issues relating to mismatches, losses, and allocations to new market jurisdictions. While some timing differences can exist between investments in marketing expenses and returns on those expenses, the life cycle of such expenses is short and, thus, not likely to cause substantial mismatches of expense and income. Thus, while the proposal's division of income based on two-sided transfer pricing will likely increase the number and size of transfer pricing disputes, it is worth serious consideration.

IV. The Path Forward?

Our current source, transfer pricing, and taxable presence rules have been applied by multinationals to earn large amounts of income in tax-favored jurisdictions. The BEPS effort will not likely reduce the magnitude of this planning. Moreover, the recently enacted U.S. base erosion minimum tax misses most conventional inbound base erosion planning and hits many transactions that do not give rise to base erosion.

All of these factors make our current base erosion rules unstable. The three proposals discussed above to reduce inbound base erosion planning raise serious issues and concerns. Further analyses need to be undertaken. But there is nothing in the concepts or history of our source rules that makes the allocation of substantial intangible value to the country that protects legally protected intangibles and the country where customers are based for customer-based intangibles inherently unprincipled in the context of an income tax. Moreover, the rules that characterize all income from a sale transaction as having a single source, even when the product sold has substantial intangible content, elevate form over substance and can be re-examined. Finally, the taxable presence rules that require substantial physical presence by the selling legal entity in order to assert jurisdiction to tax net in-

[145] Wells & Lowell, note 2, at 583 (describing the 1977 OECD Model Treaty's provision that general administrative expenses are deductible in the jurisdiction of the associated profits whether such expenses were deductible within or outside the country).

come are subject to active debate. Changes in these sets of rules, when combined with transfer pricing rules that separate ordinary returns reflecting functions and activities from residual returns reflecting valuable intangibles, may provide a workable path toward a more stable destination base for a tax that remains an income tax.

A LOOK AHEAD

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A Multinational Prescription for Global Tax Policy

by Jefferson VanderWolk

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In this article, VanderWolk discusses the influence of the OECD inclusive framework on tax policy and its importance for multinational business in all sectors.

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Q1: What is the OECD doing now? I thought the BEPS project was over.

A1: The G-20/OECD base erosion and profit-shifting project has evolved into the Inclusive Framework on BEPS, a truly global tax policy body made up of more than 120 member countries, including the United States and all the other major national economies of the world.[1] This evolution was contemplated during the initial two years of the BEPS project. The BEPS inclusive framework's mission is described by the OECD as follows:

> Countries and jurisdictions are now working together on implementing the BEPS package consistently on a global basis, and to develop further standards to address remaining BEPS issues. To these ends, the decision-making body for the OECD's tax work — the OECD Committee on Fiscal Affairs (CFA) — has been opened up to interested countries and jurisdictions to put in place an Inclusive Framework on BEPS. The Inclusive Framework on BEPS held its first meeting on June 30 and July 1 of 2016 in Kyoto, Japan, and the second on January 26 and 27 of 2017 in Paris.[2]

Members of the framework work on an equal footing to tackle tax avoidance, to improve the coherence of international tax rules, and to ensure a more transparent tax environment. Specifically, the framework:

- develops standards regarding remaining BEPS issues;
- will review the implementation of agreed minimum standards through an effective monitoring system;
- monitors BEPS issues, including tax challenges raised by the digital economy;[3] and
- facilitates the implementation processes of the members by providing further guidance and by supporting development of toolkits to support low-capacity developing countries.[4]

Q2: I've heard about BEPS implementation through peer reviews and the like, but what are the 'remaining BEPS issues' for which the BEPS inclusive framework is developing standards?

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[1]The BEPS inclusive framework had 124 members as of November 2018; *see* OECD, "Members of the Inclusive Framework on BEPS" (Nov. 2018).

[2]Further meetings of the BEPS inclusive framework were held in June 2017, January 2018, and June 2018. The next meeting will be in January 2019.

[3]The digital economy work has evolved into much more than mere monitoring.

[4]OECD, "Background Brief: Inclusive Framework on BEPS," at 8 (2017). It is not clear whether the framework will exist for a limited time or indefinitely, but it will exist at least until the end of 2020.

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A2: Two major areas of unfinished business, in the view of many countries, are transfer pricing (which was covered by actions 8-10 of the BEPS action plan) and the tax challenges presented by the digitalization of the global economy (as outlined in action 1 of the BEPS action plan).

On transfer pricing, some countries believe the work under actions 8-10 made the OECD's transfer pricing guidelines more complex and difficult to apply in practice for tax administrations and taxpayers alike. Consequently, these countries suspect that well-advised multinationals will continue to shift profits to low-tax locations while arguing that their transfer pricing complies with the arm's-length standard as dictated by the OECD guidelines. Moreover, some countries believe the transfer pricing rules fail to allocate income appropriately to the demand side of the supply-and-demand chain of value creation. Specifically, the use of development, enhancement, maintenance, protection, and exploitation (DEMPE) analysis to allocate income related to intangibles is viewed by some delegates as a flawed approach.[5]

On the tax challenges posed by the increasing digitalization of the global economy, the BEPS inclusive framework restarted work on this issue in late 2016, after the OECD had deferred it in 2014 on the basis that the entire economy was becoming digital and so it would be impossible to ring-fence one sector defined as "the digital economy." Subsequent political developments in Europe and elsewhere have increased the pressure for a consensus-based solution and have thrust the OECD's work in this area into the spotlight.

Q3: Hasn't the OECD's work on digitalized business taxation been preempted by the digital services tax (DST) proposals of the United Kingdom, the European Commission, and others?

A3: No. On the contrary, those unilateral proposals have given added importance to the OECD's work. Not only have major players such as the United States and the Nordic countries urged the EU finance ministers to wait for the OECD process to play out, many of the DST proponents themselves, such as the United Kingdom, have designed their proposals to give the OECD time to reach agreement on a long-term solution by 2020.[6] Similarly, countries such as Australia and New Zealand appear to be inclined to wait and see what emerges from the OECD process before making any decision about their own tax policy.[7]

Q4: If the focus is on taxing the tech giants — Google, Amazon, Facebook, Apple, Netflix, and the like — why should multinationals in other sectors care about the OECD's work on this issue?

A4: Others should care because the focus is broadening. The rapid digitalization of the economy has caused the OECD process to evolve to have a much wider scope. With the support of the OECD's Centre for Tax Policy and Administration, the BEPS inclusive framework is looking at options for a long-term solution to perceived tax challenges presented by the digitalization of business models in all industries, not only internet-based businesses. Therefore, all multinational corporations should be aware that the outcome of the current discussions at the OECD may have a significant impact on their businesses and should seriously consider what steps they might take to influence that outcome.

Q5: How is the policy work being done, as a practical matter? And how far has it progressed?

A5: The BEPS inclusive framework's work in this area has been delegated to a subsidiary body called the Task Force on the Digital Economy. This is a misnomer, given that the task force stated in its initial report that there is no digital economy that can be ring-fenced from the rest of the global

[5]This is even though DEMPE analysis and all the other guidance developed under actions 8-10 were agreed on by all the countries involved in the process in 2015. The multinational business community has a very different perspective on the effects of the current transfer pricing rules. Moreover, U.S. multinationals now live in a world where the global intangible low-taxed income rules mean that a significant level of tax must be paid on all foreign-derived income other than routine returns on tangible property.

[6]The latest proposal for an EU DST, at the time of writing, would defer implementation of the new tax to 2021, and then only if the OECD process fails to produce an agreement on a long-term solution. *See* European Council, "Franco-German Joint Declaration on the Taxation of Digital Companies and Minimum Taxation" (Dec. 4, 2018).

[7]New Zealand Tax Working Group, "Future of Tax: Interim Report" (Sept. 2018); and Australian Treasury, "The Digital Economy and Australia's Corporate Tax System," Treasury Discussion Paper (Oct. 2018).

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economy.[8] Rather, the operating assumption now is that all types of businesses, of all sizes and in all sectors, are adopting digital tools and processes — in various ways — in their different business models. A more accurate name for the group would therefore be the Task Force on Multinational Corporate Income Taxation.

The tax policy challenges initially identified as the focus of the task force's work were twofold. First, the internet has enabled remote sellers of goods and services to compete effectively in markets where they have no physical presence and thus no taxable presence for income tax purposes (as opposed to VAT/consumption tax purposes). Second, the ever-increasing value of intangible assets such as computer algorithms and name brands arguably made it easier — at least before the BEPS project — for multinationals to allocate profits to low-tax locations where those intangibles were located for income tax purposes. One challenge that was identified regarding intangibles was whether profits should be allocated to the value that may arise from user contributions (such as user reviews on Amazon, videos uploaded to YouTube by members of the public, or personal data gathered from users of Facebook or Google).

Following 18 months of research and discussion, the task force issued an interim report in March, with the approval of the BEPS inclusive framework.[9] The interim report concluded that the task force should undertake further study of possible changes to the existing international standards regarding taxable nexus and the allocation of profits among countries. The report acknowledged that countries were divided about the right approach to finding a long-term solution. (The question of short-term solutions, such as the European Commission's DST proposal, was essentially set aside by the task force.) One group of countries, led by the United Kingdom, argued for a "user contribution" approach addressing only large internet-based businesses that derive significant value from user contributions.

Another group, led by the United States, preferred an approach that would apply to all industries and would modify (or clarify) current international standards of transfer pricing to ensure that a greater share of the value of marketing intangibles was taxed in the relevant market or destination jurisdictions. Countries advocating such an approach have stated that while it would allocate greater profit to the market jurisdiction, it should not be interpreted as a wholesale move to market- or destination-based taxation.

A third group, including Ireland, Sweden, and others, advocated doing nothing until enough time has passed to be able to assess the effectiveness of the various BEPS project measures, including changes to the transfer pricing rules and the threshold for taxable presence under the model tax convention. Although the third group's position is consistent with what was agreed in the final report on BEPS action 1, it seems to have been superseded by later events.

Q6: Are those three alternative approaches still the only options under discussion?

A6: No. More recently, a new approach has been put forward by Germany and France. They suggest that every country adopt (1) controlled foreign corporation rules that impose tax at the parent-company level, at a non-trivial rate, on global profits exceeding routine returns on tangible assets (like the U.S. global intangible low-taxed income rules), and (2) anti-base-erosion rules that would deny deductions or, alternatively, deny treaty benefits, such as a withholding tax exemption, for payments to low-taxed nonresident affiliates (somewhat like the U.S. base erosion and antiabuse tax rules). The German Finance Ministry has called this proposal the global anti-base erosion (GLOBE) approach.[10]

Although the GLOBE approach does not directly address the ability of remote sellers to compete in a market without having a taxable presence there, it does address the desire to do something about profit shifting via transfer pricing. Moreover, it would do so without the

[8] OECD, "Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015 Final Report," at 11-13 (2015).

[9] OECD, "Tax Challenges Arising From Digitalisation — Interim Report 2018: Inclusive Framework on BEPS" (2018).

[10] *See, e.g.*, Stephanie Soong Johnston, "Germany, France Explore GLOBE Proposal to Tax Digital Economy," *Tax Notes Int'l*, Nov. 19, 2018, p. 782.

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need to make radical changes to the transfer pricing guidelines or the model tax convention. And it would be politically attractive to policymakers by ensuring that (1) multinationals are taxed somewhere on all their profits at a meaningful rate, and (2) market countries can tax at least part of the profits of remote sellers from sales to local customers. It's worth noting that the United States is unlikely to oppose the GLOBE approach, as it is conceptually similar to the GILTI and BEAT regimes enacted in the United States last year. Further, the U.S. model treaty has a special-regimes provision that is conceptually like the contemplated treaty element of the GLOBE approach.[11]

It's possible that the BEPS inclusive framework will pursue work on both the GLOBE approach and either the user participation approach or the marketing intangibles approach to income allocation and taxable presence. Given that the United States opposes the user participation approach, it appears more likely that the framework will opt to explore the viability of the marketing intangibles approach.

Q7: What will the task force and the BEPS inclusive framework do next?

A7: Following the task force's meeting in early December, it will report to the BEPS inclusive framework at the next meeting of the plenary body in late January 2019. If the framework can agree on pursuing one or more of the alternative approaches under discussion, the task force will proceed to work on the details of the chosen approach, with a view to submitting a second interim report to the G-20 finance ministers in mid-2019.

Depending on what is agreed on in January, the work on details during the first half of 2019 is likely to be delegated to one or more of the OECD's working parties, such as Working Party 6 (multinational enterprises), which deals with transfer pricing; Working Party 1 (tax conventions and related questions), which deals with treaties; or Working Party 11 (aggressive tax planning), which deals with CFC rules and base-eroding payments (among other things).

The OECD is committed to delivering, on behalf of the BEPS inclusive framework, a final report to the G-20 in 2020, with details of the agreement (assuming there is an agreement) on a long-term solution.

Q8: Isn't the OECD (and the task force and the BEPS inclusive framework) just a talking shop? What makes people think that its conclusions — if an agreement is reached — will have any effect in the real world?

A8: All 124 BEPS inclusive framework countries are participating in the OECD-led process to find an agreed, multilateral, long-term solution to what is widely perceived to be an international tax policy issue that many countries would address unilaterally in the absence of a multilateral agreement. This work is fully supported at the highest political level: the G-20 leadership.[12] Moreover, all the framework countries have managed to reach agreement on the BEPS minimum standards and measures to monitor the implementation of those standards, and to "name and shame" through a peer review process any countries that fail to live up to their agreement. For treaty-based standards, the multilateral instrument is now available as a tool to update large numbers of bilateral tax treaties in a short period of time. For transfer pricing standards, the OECD's transfer pricing guidelines are already incorporated into the domestic laws of some countries and are relied on as persuasive authority by the courts in many more countries. Global tax policymaking at the OECD, at least regarding corporate income tax on multinational groups, appears to have become a reality.

Thus, it is possible — perhaps likely — that a new, globally harmonized approach to multinational corporate income taxation will be determined over the course of the next year or two, and then implemented over time by countries individually. As with the BEPS

[11] *See* article 28(1) of the U.S. Model Income Tax Convention (2016).

[12] "We will continue our work for a globally fair, sustainable, and modern international tax system based particularly on tax treaties and transfer pricing rules, and welcome international cooperation to advance pro-growth tax policies. Worldwide implementation of the OECD/G20 Base Erosion and Profit Shifting package remains essential. We will continue to work together to seek a consensus-based solution to address the impacts of the digitalization of the economy on the international tax system with an update in 2019 and a final report by 2020." G-20, "G-20 Leaders' Declaration: Building Consensus for Fair and Sustainable Development," para. 26 (Dec. 1, 2018).

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minimum standards, such as country-by-country reporting, a peer review system would probably be established to monitor compliance with the agreement.

Q9: What should multinational businesses be doing at this point?

A9: Companies with international operations should be monitoring developments closely so they can factor them into their long-term plans. They should also be thinking about which of the alternative approaches would be best (and worst) and preparing to act when the process reaches the point at which it is a strategic imperative for the company to try to influence the outcome of the OECD process, either individually or through industry associations or other groups. At that stage — which arguably has already arrived — multinationals should advocate their preferred approach directly to the policymakers who are participating in, and influencing, the process. They include senior OECD officials based in Paris as well as country representatives from, for example, Treasury officials, European finance ministries, and members of the tax policy units of other G-20 countries such as Japan, China, India, Australia, and Canada. And given that tax policy is heavily influenced by political considerations, advocacy efforts directed at political players are advisable as well.

Q10: Doesn't the OECD normally ask the public to comment on discussion drafts before finalizing any recommendations on an issue? Why shouldn't companies wait for that to happen?

A10: Although it's possible that at some point the task force will formally consult with the public, including the business community, it cannot be assumed that comments submitted in response to such consultation alone would be influential. By the time a discussion draft has been written and published, much of the debate among policymakers on the issues will already have occurred. To be effective, the business community must promote their views in this matter proactively, with detailed, practical suggestions, as U.S. business representatives do in the halls of Congress and Treasury. Written communications are of course one method of advocacy, but face-to-face meetings are advisable (at least by video conferencing, if not in person).

The stakes are too high for multinationals to allow the OECD/BEPS inclusive framework to proceed in the traditional way, without significant ongoing input from those who will be affected by the outcome of the process. Policymakers must understand evolving business models and processes so that they can balance concerns about inappropriate allocations of income and taxing rights against the risk that undue tax burdens could stifle economically beneficial innovation using digital tools and processes. In a new world of global tax policymaking, there should be a new kind of global tax policy engagement and advocacy as well. ■

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VIEWPOINT

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Digital Business and Corporate Income Taxation: What's Value Creation Got to Do With It?

by Jefferson VanderWolk

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In this article, the author discusses value creation and international corporate income tax policy.

International corporate income tax policy discussions are increasingly focused on the concept of value creation.[1] The OECD, the European Commission, and the U.N. have all used the term as a touchstone in recent policy documents.[2] Tax administration is also being affected.[3]

The OECD's March 2018 interim report on digitalization tax challenges starts:

> The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and *ensure that profits are taxed where economic activities take place and value is created*.[4] [Emphasis added.]

As indicated in Chapter 1 of the interim report, this language was drawn from the October 2015 final BEPS project reports:

> Launched in 2013, the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project consisted of 15 separate action areas targeting the gaps and mismatches in the international tax system that facilitated the shifting of profits by multinational enterprises (MNEs) away from *where the underlying economic activity and value creation took place.* Action 1 of the BEPS Project undertook to consider the tax challenges raised by digitalisation for both direct and indirect taxation.[5] [Emphasis added.]

It is worth noting that the OECD's formulation contains two concepts — economic activity being one and value creation being the other. The two would seem to be linked, at least insofar as economic activity results in the creation of value. Yet the focus of current discussions and analyses,

[1] *See, e.g.*, Allison Christians, "Taxing According to Value Creation," *Tax Notes Int'l*, June 18, 2018, p. 1379; and materials cited below.

[2] OECD, "Tax Challenges Arising From Digitalisation — Interim Report 2018: Inclusive Framework on BEPS" (2018) (hereinafter "interim report"); and United Nations, "Report on the Fifteenth Session of the Committee of Experts on International Cooperation in Tax Matters" (Oct. 17-20, 2017), paras. 28-29.

[3] Ryan Finley, "'Value Creation' Cases Present Challenges for IRS APMA Program," *Tax Notes Int'l*, June 11, 2018, p. 1335 (quoting John Hughes of the IRS, speaking at the OECD-USCIB International Tax Conference in Washington on June 5, 2018).

[4] Interim report, Foreword.

[5] Interim report, Chapter 1, para. 12.

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including the interim report, has been mainly on value creation, with little mention of economic activity. This preference is reflected in the title of the OECD's final report on BEPS actions 8-10: "Aligning Transfer Pricing Outcomes With Value Creation."

At the same time, however, the OECD's explanatory statement on the BEPS project final reports goes the other way: "Changes to the Transfer Pricing Guidelines will ensure that the transfer pricing of MNEs better aligns the taxation of profits with economic activity." This suggests that perhaps the OECD did not see any difference in the meaning of the two phrases. Nevertheless, "value creation" has been in the forefront of subsequent work.

The interim report's second chapter lays the groundwork for the rest of the report and makes its focus on value creation clear in the introductory paragraph:

> This chapter presents an in-depth analysis of value creation across different digitalised business models, with the aim of informing the current debate about international taxation. Section 2 describes the main characteristics of digital markets. Such characteristics shape the three different processes of value creation identified in Section 3 (value chain, value network and value shop) and analysed in detail in Section 4 through business case studies. Section 5 identifies three key factors that are prevalent in more highly digitalised businesses and it accounts for the related differing views of the members of the Inclusive Framework on BEPS.[6]

The problem with talking only about value creation, rather than economic activity, is that value creation is much more difficult to define as a practical matter. According to one commentator, "Part of the OECD's problem is the hopelessly vague standard it developed during the BEPS project: that profits must be taxed where value is created."[7] At a recent conference, a leading international tax academic "observed that deriving a correct definition of 'value creation' or its source in tax jurisprudence, is difficult."[8]

The interim report adopts an economist's view:

> Discussions of value creation tend to start with the value chain. Developed by Michael Porter in the mid-1980s, the value chain is a standard tool in academia and business applied to analyse a firm's competitive advantage. Value chain analysis divides a firm into discrete activities in order to understand how to create superior value, where superior value has two sources: by offering differentiated products which can justify a premium price or by reducing costs.[9]

In the context of income tax law, this approach is problematic for at least two reasons. First, it is premised on the concept of a unitary firm, regardless of whether that firm does its business as a single business entity or through a group of commonly controlled entities. Tax law does not have such a concept. Rather, the taxation of business income occurs in relation to individual business entities or groups of business entities whose tax attributes are consolidated through common ownership or control, regardless of whether they are all engaged in carrying on a unified business as a "firm."

Second, the taxation of a business's income is not based in any way on the value of the business. A business can have value but no income and no income tax liability. The expectation of future income may result in substantial value for a business that has not yet made a single sale. Business income taxation depends on the realization of net profits from operations of the taxpayer through its agents — that is, its employees, directors, and authorized contractors.

It is odd, therefore, that the OECD and many international tax policy specialists have opted to focus on value creation, rather than on economic activity, in the effort to address the tax challenges

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[6] Interim report, Chapter 2, para. 31.

[7] Mindy Herzfeld, "A Post-Truth Tax World," *Tax Notes Int'l*, June 18, 2018, p. 1369.

[8] Frans Vanistandael, "An Octogenarian on Value Creation," *Tax Notes Int'l*, June 18, 2018, p. 1385 (referring to a comment by prof. Wolfgang Schön at the 80th anniversary of the International Fiscal Association panel discussion on "Tax in a New Universe: The Role of Value Creation," Rotterdam, May 18, 2018).

[9] Interim report, Chapter 2, para. 66.

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of digitalized businesses. As the interim report shows, an economist's analysis of value creation does not lead to any clear conclusions regarding what ought to be done in the corporate income tax area to address perceived problems resulting from digitalization. Perhaps an approach based on economic activity, rather than value creation as defined in the world of economics, would be more fruitful.

Nexus and Profit Allocation

The interim report concludes that:

> [M]embers of the Inclusive Framework agree that they share a common interest in maintaining a single set of relevant and coherent international tax rules, to promote, inter alia, economic efficiency and global welfare. As such, they have agreed to undertake a coherent and concurrent review of the two key aspects of the existing tax framework, namely the profit allocation and nexus rules that would consider the impacts of digitalisation on the economy.[10]

Following a brief summary of the nexus and profit allocation standards embodied in the OECD's model tax convention articles 5 and 7 (regarding the definition of permanent establishment and the attribution of profits to a PE) and the OECD transfer pricing guidelines, the interim report states:

> [T]he taxation of a non-resident enterprise depends on rules that are strongly rooted in physical presence requirements to determine nexus and allocate profits. The principal focus of the existing tax framework has been to align the distribution of taxing rights with the location of the economic activities undertaken by the enterprise, including the people and property that it employs in that activity. This conceptual approach was recently reinforced by the BEPS Project, which sought to realign the location where profits are taxed with the location where economic activities take place and value is created. However, the effectiveness of these rules may be challenged by the ongoing digitalisation of the economy to the extent that value creation is becoming less dependent on the physical presence of people or property.[11]

For the reasons noted earlier, the words "value creation" in the last sentence of the above passage ought to be replaced by "profit realization" or words to that effect. Nevertheless, the passage appropriately recognizes the importance of the "location of the economic activities undertaken by the enterprise" and "the location where economic activities take place."

In essence, the tax problem posed by digitalized businesses is that they are able to penetrate the market in a jurisdiction and earn profits from regular and continuing sales to customers located in that jurisdiction without needing to have a traditional taxable presence — that is, an office or dependent agent with authority to conclude sales in the jurisdiction. The internet has created this problem. Before the internet, a remote seller could make some sales in a jurisdiction where it had no office or dependent agent by means of print advertising or other forms of marketing, or by concluding sales over the telephone or on paper through the mail, but this did not result in remote sellers making so many local sales that local suppliers of similar goods or services were undermined by tax-advantaged competition. Also, the local tax authorities did not perceive any significant threat to their income tax base from the activities of remote sellers.

Now, however, thanks to the internet, remote sellers are competing successfully with local sellers everywhere, reducing the local business income tax base. The questions that need to be addressed are: how can the definition of PE in article 5 of the OECD model tax convention be amended to permit the relevant jurisdiction to impose income tax on remote sellers; and how can the rules for the attribution of profits to a PE under article 7 of the model tax convention be amended to achieve appropriate results?

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[10] Interim report, Chapter 5, para. 373.

[11] Interim report, Chapter 5, para. 379.

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Tweaking the Tax Rules

To address these questions, it is not necessary to analyze a business's value creation. Rather, we need to consider the ways in which the existing tax rules are falling short of achieving the desired results and the options for tweaking the rules to achieve those results without causing new problems.

The nexus issue is relatively easy to deal with. The PE definition in article 5 already contemplates a deemed taxable presence based on the activities of a dependent agent that habitually concludes sales or habitually plays the principal role leading to the conclusion of sales by the remote seller.

It should not be too difficult to amend the PE definition to deem a remote seller to have a taxable presence in a jurisdiction if it has actively marketed its goods or services to customers located in the jurisdiction, whether through digital means such as a local-language website and online advertising or through one or more service providers located in the jurisdiction; or if its sales to these customers exceed a stated revenue or number-of-sales threshold during the tax year, or both.[12] The fact that the remote seller does not have any physical presence in the jurisdiction should not by itself prevent the jurisdiction from asserting the right to tax if the stated conditions are met. The U.S. Supreme Court's recent decision in the *Wayfair* case supports this proposition.[13]

The more difficult issue is profit attribution to a deemed taxable presence. Attribution of profits to a PE has never been consistently done internationally, and the OECD's attempt to spell out an agreed approach in its 2010 Report on the Attribution of Profits to Permanent Establishments has not in practice resulted in consistency. Nevertheless, all Inclusive Framework countries have been able to agree on this principle:

> Under Article 7 of the [OECD model tax convention], the profits to be attributed to a PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that cause it to be a PE. [T]his principle applies regardless of whether a tax administration adopts the authorized OECD approach as explicated in the 2010 Report on the Attribution of Profits to Permanent Establishments.[14]

In other words, a PE should be taxed on the profits attributable to the activities conducted by the PE, taking into account the assets used by the PE and the risks assumed as a result of the PE's activities. The basic approach prescribed by article 7 of the model tax convention deems the PE to be a separate and independent enterprise transacting with its head office, or other parts of the enterprise of which it forms a part, at arm's length. This implicates the OECD transfer pricing guidelines, which relate to arm's-length pricing under article 9 of the model tax convention. The core of the guidelines is the requirement to analyze each transacting party's functions, assets, and risks as a matter of practical reality, in determining what an arm's-length result (or the range of possible arm's-length results) would be.

On reflection, it should be possible to take a common-sense approach, consistent with the agreed principle and based on the relevant activities of the taxpayer, to the attribution of profits to a remote seller's deemed PE where the taxpayer has no physical presence or dependent agent in the taxing jurisdiction. The PE would be based on two requirements: an active marketing requirement and a revenue/sales threshold requirement. The revenue from sales to customers located in the jurisdiction should be the starting point for the computation of attributable profits. Costs to be deducted from the revenue should include all costs of marketing to those customers,

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[12] At the time of writing, the Indian government had launched a public consultation, related to its new "significant economic presence" test of business connection in India giving rise to a taxable presence in India, on what the thresholds should be for both total receipts of a nonresident from sales to customers located in India and the number of users located in India solicited or otherwise engaged by the nonresident through digital means.

[13] *South Dakota v. Wayfair Inc.*, No. 17-494 (2018). Although the case was concerned with sales taxes, it is nevertheless relevant to taxing rights more generally, as the issue was whether a nonresident seller had availed itself of the privilege of carrying on business in South Dakota by virtue of having more than $100,000 in revenue from sales to customers located in the state or more than 200 transactions with such customers during the year. *See* Squire Patton Boggs discussion.

[14] OECD, "Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7" (2018), para. 6.

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regardless of where those costs were incurred, as well as all costs related to the purchase or production of the goods or services sold to those customers (including, for example, research and development costs).

This would require a country-by-country allocation of certain costs that are not directly related to any one country, such as the compensation costs of a global or regional marketing team, or the cost of a global or regional marketing campaign. Directly related costs, such as the cost of creating and maintaining a website in a language spoken only in one country (for example, Hungarian), or the service fees paid to one or more marketing services providers in a country, would be wholly allocated to the PE deemed to be in that country.

If after-sale services are provided to customers without charge, the cost of such services should also be deducted, regardless of where the cost is incurred (for example, a global customer service center in India), using an appropriate method of allocation to individual countries.[15]

[15] This discussion is concerned only with fact patterns in which the remote seller conducts no production-related activities in the jurisdiction. Clearly, if a remote seller was conducting production-related activities in a jurisdiction in which its active marketing and sales operations created a "virtual" PE as discussed in this article, a portion of its profits would have to be attributed to the production-related activities as well. A transactional profit-split method might be appropriate in such a case unless the particular facts supported the use of another method.

Attributing profits to a deemed PE in this way would be consistent with the principle that taxation of business income should be aligned with the economic activities giving rise to that income. Existing transfer pricing methodologies would not be disturbed. The value of both production intangibles and marketing intangibles would be reflected in the pricing of the relevant transactions (or hypothesized transactions between the PE and other parts of the enterprise of which it is a part). The substance-based transfer pricing guidance that emerged from actions 8-10 of the BEPS project could continue to be implemented as intended by all the countries that participated in formulating it.

Nor would this approach require acceptance of a simplistic destination-based taxation of business income, which gives a jurisdiction the right to tax a resident's business income solely because customers located in that jurisdiction bought goods or services from the nonresident. Income taxes, unlike consumption taxes, should be based on the activities and attributes of the taxpayer, not on the mere fact that customers have chosen, for whatever reason, to buy particular goods or services from a particular supplier.

In conclusion, the current focus on value creation in discussions of the tax challenges posed by digitalized business models appears to be misplaced. Value creation is an economic concept that does not fit well with corporate income taxation in the global arena. The focus ought to be on the activities of taxpayers regarding the various markets in which they make their sales. ■

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