Is the shift to taxation at the point of destination inexorable?

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1. Introduction

We address here an issue concerning the nature of the ongoing developments in the reform of the international tax system, with reference to the work conducted at the OECD on the digitalisation of business and its impact on the corporate income tax. More specifically, we explore the argument that those developments reflect an inexorable shift within the international tax system to the widespread acceptance of taxation at the point of destination.

Since the publication of the 2015 BEPS Final Report on the digitalisation of business,[1] several countries have unilaterally introduced, or have developed plans to introduce, digital services taxes (DSTs), also known as equalisation levies.[2] This means the destination approach is already widely seen in practice as an approach to the taxation of companies. However, such unilateral measures are often seen as an aberration from, or as disruptive to, the established order in the international tax system, with the clear implication that such measures should be removed or materially scaled back.[3] This is because those measures fall outside tax treaties and so are often perceived as, in spirit at least, circumventing or undermining the way the signatory states to treaties have agreed between themselves to allocate taxing rights.[4] It is also true that there is little commonality in the scope and operation of individual DSTs, exacerbating the difficulties of compliance where multiple DSTs apply to a taxpayer and increasing the likelihood of double taxation. DSTs also typically involve taxation based on gross revenues which is regarded as especially distortionary to the

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[1] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 BEPS Final Report

[2] DSTs or DST-like measures have been enacted, proposed, or discussed in many countries including Australia, Austria, Belgium, Brazil, Canada, Cambodia, Czech Republic, Egypt, France, Hungary, India, Israel, Italy, Japan, Kenya, Latvia, New Zealand, Norway, Poland, Russia, Sierra Leone, Slovakia, Slovenia, South Africa, Spain, Tunisia, Turkey, and the UK. The OECD statement of 8 October 2021 noted that no newly enacted Digital Services taxes or other relevant similar measures will be imposed on any company from 8 October 2021 and until the earlier of 31 December 2023 or the coming into force of a new multilateral agreement on the 2 pillar package – see OECD/G20 Base Erosion and Profit Shifting Project, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, 8 October 2021 at p.3.

[3] The discussion in the OECD 2018 Interim Report (OECD, Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, (OECD Publishing, 2018)) is critical of such measures – see for example at pp. 159, 178-179. The US has sought to actively oppose and challenge the DSTs adopted by ten of its trading partners through its Section 301 Digital Services Taxes Investigations – see, for example, Office of the United States Trade Representative, USTR Announces Next Steps of Section 301 Digital Services Taxes Investigations, March 26, 2021, available at https://ustr.gov/about-us/policy-offices/press-office/press-releases/2021/march/ustr-announces-next-steps-section-301-digital-services-taxes-investigations

[4] Such a view is in technical terms not well founded given that double tax treaties normally identify the scope of their application, meaning that, in principle, treaty partners are free to enact unilateral measures that are not constrained by an applicable tax treaty. See OECD, Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, (OECD Publishing, 2018), at pp. 181-183.

location and scale of economic activity.[5] The existence of these reasons is why these unilateral measures have largely been portrayed as a retrograde step, undermining the stability of, and causing chaos in, the international tax system.[6]

Notwithstanding the position of these unilateral measures, it is becoming increasingly clear that a more broadly accepted shift is underway to incorporate elements of destination in the international tax system outside of a purely unilateral framework, meaning that the destination approach would be applied in respect of profits, not revenues. Our principal goal here is to explore whether it may reasonably be claimed that the ongoing international tax reform efforts on the digitalization of business that are being led by the OECD and Inclusive Framework reflect a consensus-based and inexorable shift to the acceptance of taxation at the point of destination.

It is useful to note three points by way of preliminary.

First, for the purposes of the discussion, the term "destination" should be understood to mean the location (i.e., state) in which the good or service is sold or consumed. For ease of reference, we also use the term "market" or "market state" to refer to that location.[7] Given that different proposals in support of taxation in the market state may involve different definitions of the relevant market for these purposes, these terms ("destination", "market", "market state") need to be understood loosely as referring generally to the location of the ultimate consumption of a good or service. The variation in approach can be seen in the case of digital advertising, given that some proposals for taxation in the market state require the identification of the location where the viewers or users of that advertising are located, and some do not (in which case the market state is normally identified as the state where

[5] The difficulties are discussed in Garrett Watson, Resisting the Allure of Gross Receipts Taxes: An Assessment of Their Costs and Consequences, Tax Foundation, 6 February 2019, available at https://taxfoundation.org/gross-receipts-tax/.

[6] See for example OECD/G20 Base Erosion and Profit Shifting Project, Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy, As approved by the OECD/G20 Inclusive Framework on BEPS on 29-30 January 2020, at pp. 7-8. The OECD has also suggested that the failure to arrive at a consensus-based solution on the digitalisation of business could lead to uncoordinated and unilateral measures, including DSTs, which, in a "worst-case scenario", could lead to a reduction of global gross domestic product by more than 1% - see OECD, *Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS* (OECD 2020).

[7] The term is therefore used in a broadly similar manner to the established VAT/ GST "destination principle": The OECD VAT/GST Guidelines define the destination principle as designed to ensure "tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction". OECD (2017) International VAT/GST Guidelines, Paris: OECD Publishing at para 1.8.

the *purchaser* of the advertising service is located, rather than, if different, the state where the viewers or users are located).[8]

Second, in discussing the shift to taxation at the point of destination/ in the market state, it is important to emphasise that the discussion of taxation here concerns the corporate income tax. Other taxes, such as the VAT and goods and services taxes, have long been applied based on a destination approach, but those taxes are not the subject of this discussion.

Third, we do not assume that the shift in taxation to which we refer relates to *all* taxation levied as corporate income tax. It is important to note that the arguments and proposals that have been made in recent years in the course of the work on the digitalisation of business are overwhelmingly concerned with a *partial,* not total, re-allocation of taxing rights in favour of the market state,[9] though there are some exceptions which propose a complete change to the existing tax system.[10] We therefore take it as sufficient for the purposes of the proposition being tested here if the shift with which we are concerned relates to *some* (i.e. a *partial*) reallocation of taxing rights to the point of destination.[11]

It is also helpful to note the significance of the shift that is discussed in this chapter. As is well-known, the income allocation rules have operated over the last hundred or so years based on a supply-side or production paradigm. This means that, under the existing system,

[8] There is a more detailed discussion of these definitional issues, and the different approaches to taxation in the market state, in R.S. Collier, M.P. Devereux and J. Vella, Comparing Proposals to Tax Some Profit in the Market Country, World Tax Journal 2021 (Volume 13), No. 3.

[9] A partial re-allocation of primary taxing rights is what is proposed in the US marketing intangibles proposal and the UK user participation proposal, both of which are discussed below. A partial re-allocation would also be delivered by the UN proposal for an Article 12B of the U.N. model double tax treaty, (Co-Coordinators Report, Tax consequences of the digitalized economy – issues of relevance for developing countries, Committee of Experts on International Cooperation in Tax Matters, Twentieth session, 20-23 and 26-29 October 2020, E/C.18/2020/CRP .41) and a host of other proposals made by MNEs such as by Procter & Gamble and Johnson & Johnson (see generally OECD/G20 Inclusive Framework on BEPS, Addressing the Tax Challenges of the Digitalisation of the Economy, Comments Received on Public Consultation Document, 11 March 2019, available at https://www.oecd.org/tax/beps/public-comments-received-on-the-possible-solutions-to-the-tax-challenges-of-digitalisation.htm).

[10] For example, one proposal made, which was considered for adoption in the US, is the destination-based cash flow tax (DBCFT) which is intended to replace completely the existing income allocation rules. See Michael Devereux et al, Taxing Profit in a Global Economy, Oxford University Press 2021, Chapter 7.

[11] The DBCFT, mentioned in the previous footnote, relies exclusively on a destination basis. However, the proposals made by states represented at the OECD introduce a destination or market element in combination with the retention of the existing production or supply-side approach and so propose a partial reallocation of primary taxing rights to the market. See the G-24 proposal, G-24 Working Group on tax policy and international tax cooperation Proposal for Addressing Tax Challenges Arising from Digitalisation, January 17, 2019, available at https://www.g24.org/wp-content/uploads/2019/03/G-24_proposal_for_Taxation_of_Digital_Economy_Jan17_Special_Session_2.pdf; and see also the U.N. Article 12B proposal, Co-Coordinators Report, Tax consequences of the digitalized economy – issues of relevance for developing countries, Committee of Experts on International Cooperation in Tax Matters, Twentieth session, 20-23 and 26-29 October 2020, E/C.18/2020/CRP .41.

income/ profits are allocated within a multinational group by reference to the relative value of the contributions to the overall production of profits made by each separate entity in the group. Under this approach, and in broad terms at least, no account is taken of the contribution to income/ profits from market or demand factors, such as the ability of consumers to purchase goods and services and thereby crystalize profits.[12] The significance of any systemic shift to taxation in the market state is therefore that it would mark a shift away from the paradigm that has been the dominant basis for the income allocation rules over the last hundred years or so.[13]

Our discussion proceeds by reference to the following steps: First, we consider the reasons that have been so far adduced in the debate in favour of a re-allocation of at least some primary taxing rights to the market state. There are many such reasons (we count no less than twelve) that have been advanced in favour of taxation in the market state. We survey all the reasons that we have been able to identify, but our analysis focuses on those that we consider are the more fundamental (and in any event arguably underpin all the others). Second, we turn to consider the position of states, and specifically their receptivity or support for a re-allocation of taxing rights to the market state. We explain why it is useful to consider the position of states. We then identify and consider three broad groups of states participating in the ongoing work at the OECD, with each group adopting a different position relating to the re-allocation of taxing rights to the market. In each case, we explore the degree to which the position of the group is consistent with the notion tested here, namely whether the systemic re-allocation of taxing rights to the market is inexorable. We then explore whether the arguments and momentum in favour of a greater allocation of taxing rights to the market could be undermined or reversed by a successful implementation of the Pillar 2 package of measures. This is based on the hypothesis that the Pillar 1 measures are decoupled from the Pillar 2 measures and that the Pillar 1 measures either fail or are materially deferred. The last section of this paper sets out our conclusions.

2. Arguments made in Support of a Reallocation of Taxing Rights to the Market

2.1 Introduction

[12] Whilst the existing ALP-based system is based on a production or supply-side approach, there are some instances in which account is taken of market-related factors. For example, the transfer pricing comparability analysis would in appropriate circumstances normally take account of market-specific characteristics such as the buying-power in a market, market behaviours, low labour costs, favourable weather conditions, etc. See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris at 6.31.

[13] Under the current approach of the international tax system to income allocation, profits are split, broadly, between source and residence locations. However, these are simply elements of the supply or production-based approach, and it should be noted that, in any case, the "source" location has no necessary connection with the market location. Rather, source and market locations are quite different concepts.

Arguments in support of an allocation of profits to the market state in the context of the corporate income tax are not new. Formulary apportionment approaches use a variety of factors by which profits are weighted and allocated and this may include taking account of sales or turnover, in which case profits would be allocated at least in part by reference to the state in which such sales are made.[14] Such approaches have been used by states since the 19th century,[15] though in an international context they have been overshadowed by the emergence of the arm's length principle and its "separate accounting" approach since the early 1930s and so are not extensively used.[16]

Outside of a strictly formulary context, arguments in favour of an allocation of corporate profits to the market state have been made in the course of work at the OECD since the late 1990s[17] and similarly, academics have been outlining arguments about the superiority of a destination approach in relation to the taxation of corporate profits for at least two decades.[18]

What has changed in more recent years is the volume and range of different arguments in support of a reallocation of taxing rights to market states, to the point where some form of destination approach is a feature of all the proposals recently under consideration at the OECD in the high-profile work on the digitization of business.

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[14] A very common approach for formulary apportionment is the use of a three factor formula that would allocate profits based on the location of sales, assets and employees. See for example European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM (2011) 121/4, 16 March 2011;

[15] A discussion of the history of formulary apportionment is available in R Krever and P Mellor, The Allocation of Multinational Business Income: Reassessing the Formulary Apportionment Option, Series on International Taxation, Vol. 76, Kluwer 2020, Chapter 1.

[16] Mitchell B. Carroll, *Taxation of Foreign and National Enterprises, Vol. 4: Methods of Allocating Taxable Income* (League of Nations, Geneva 1933). Broadly, the approach advocated by Carroll was to treat each branch and subsidiary as if it were an independent enterprise, operating based on its separate accounts under arm's length conditions. It is also of note that Scott Wilkie has explored the degree to which formulary approaches have been included in the development of the current income allocation rules – see J. Scott Wilkie, J Scott Wilkie, The Way We Were? The Way We Must Be? The 'Arm's Length Principle' Sees Itself (for What It Is) in the 'Digital' Mirror, Intertax, vol 47, issue 12, 1087-1102

[17] OECD (2005), Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce? Final Report, OECD, Paris at paras 41-42 and 48-49. This final report deals with issues that had been discussed in the Business Profits Technical Advisory Group since the inception of the Group in 1999.

[18] See for example Stephen R Bond and Michael P Devereux, Cash Flow Taxes in an Open Economy, Centre for Economic Policy Research Discussion Paper 3401, May 2002. The chief advantage of a destination basis, it is argued, is its resistance to avoidance activity. This is on the basis that factors of production that are of particular importance in the existing supply side model (such as intangibles and capital) are highly mobile whereas consumers in market states are relatively immobile. The early work on e-commerce led to similar arguments by academics. See Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, 52 Tax L. Rev. 507, 510 (1997) (arguing in favour of a destination-based system to tax e-commerce profits); and Charles E. McLure Jr., Alternatives to the Concept of Permanent Establishment, in Report of Proceedings of the First World Tax Conference: Taxes Without Borders, 2000 World Tax Conference Report (Toronto: Canadian Tax Foundation, 2000) 6:1-15 (proposing taxation at the location of consumption for income tax purposes as the best response to e-commerce).

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2.2 Arguments in support of a reallocation of taxing rights

In recent years many different arguments have been advanced in support of the need to change the existing income allocation system in favour of some re-allocation of taxing rights to the market. We count no less than twelve different arguments, though some of these may overlap. In our view, this reflects both the strength of support for modifying the current international tax system and the variety of concerns relating to the existing entity-based ALP approach using the "separate accounting" approach.

In no particular order, the various arguments for change are founded on:

1. Concerns about responding to international tax avoidance activity which is exacerbated in the digital sector.[19]
2. The break-down of the international tax system and especially the technical and practical failure of the ALP and PE threshold rules,[20] including especially the unsuitability of these tax rules in the context of tech/ digital/ e-commerce activities and the constant technological innovation seen in that sector. [21]
3. The need to equalise the position of domestic and overseas businesses[22]
4. The current approach to the allocation of taxing rights as being inherently unfair. [23]
5. The disproportionately negative impact of the digitalization process on developing states as compared to developed states.[24]
6. The argument that the proper location of the reward from the contribution from "users" and data is in the market state (the argument is typically tied to a value creation approach).[25]

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[19] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 BEPS Final Report at pp. 78-82, 94. See also the discussion in the 2018 Interim Report at para 394.

[20] See 2018 Interim Report at paras 391-393.

[21] See Ministry of Finance (India), Report of the High-Powered Committee on E-Commerce and Taxation, 11-12 (2001), discussed in Arthur J Cockfield, The Rise of the OECD as Informal "World Tax Organization" Through National Responses to E-Commerce Tax Challenges, 8 Yale J. L. & Tech (2006) at pp. 153-4. See also OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing pp. 5, 42-43.

[22] For example, see the discussion of the possible introduction of an Equalisation Levy in OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 BEPS Final Report pp. 115-117 and at para 180. The issue has also been a concern to the EU which has estimated that companies with digital business models pay on average half the effective tax rate of companies with traditional business models – see EU Commission Expert Group on Taxation of the Digital Economy (2014).

[23] See generally Government of India, Ministry of Finance, Department of Revenue, Central Board of Direct Taxes, Public Consultation on the proposal for amendment of Rules for Profit attribution to Permanent Establishment-reg, 18 April 2019.

[24] See, for example, Chang Hee Lee, "Impact of E-Commerce on Allocation of Tax Revenue between Developed and Developing Countries", (2004) volume 4 number 1 Journal of Korean Law 19 at 21 which argues that extending the existing rules into the digital era, as suggested by developed countries (led by the OECD), would increase the revenue share of developed countries at the loss of developing countries.

[25] See HM Treasury, Corporate tax and the digital economy: position paper, November 2017 and also Collin and Colin Task Force on Taxation of the Digital Economy; Report to the Minister for the Economy and Finance, the Minister for Industrial Recovery, the Minister Delegate for the Budget and the Minister Delegate for Small

7. The argument that the proper location of the reward from the contribution from marketing intangibles is in the market state.[26]
8. The need to move from the existing system to a more systemically robust, efficient, and stable system which is resistant to avoidance activities (these are arguments that are routinely raised by academics).[27]
9. The need to respond to the fact that developed, traditionally capital exporting, states find they have now become disadvantaged (by losing tax revenues) because of being in the position of source states in relation to highly digitalised business.[28]
10. The argument that the Benefit Principle and the use by a remote seller of infrastructure in the market state, and the general participation in the economy, requires an allocation to the market state.[29]
11. Concerns that the mobility of electronic commerce/ digital business and its geographic sensitivity to tax differentials could exacerbate harmful tax competition.[30]
12. The need for change in the allocation of taxing rights to keep the peace or retain the consensus supporting the international tax regime and avoid chaos in the system. A version of this line of argument is based on the pressing need to remove unilateral DSTs and therefore restore stability to the system and avoid chaos.[31]

It may be debated whether this list of arguments captures *all* the various individual arguments that have been put forward in support of re-allocating profits to the market, though the volume and range of the arguments seems incontrovertible. There are, in the view of the authors, two central themes that seem to underpin broadly all these multiple arguments. These are the themes of fairness and mobility.

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and Medium-Sized Enterprises, Innovation and the Digital Economy, January 2013, Executive Summary at pp. 33-60.

[26] See the discussion of the US marketing intangibles proposal, discussed in Public Consultation Document, Addressing the Challenges of the Digitalisation of the Economy, OECD, 13 February 2019 at paras 29-49.

[27] For example, see Michael P. Devereux and John Vella, Are we heading to a corporate tax system fit for the 21st century? Fiscal Studies, 2014, November PP 1-26. See further footnote 18 above.

[28] See the comments of Pascal Saint Amans cited in Matt Thomson, International Income Allocation Rules Outdated, OECD Tax Chief Says, Law360, Feb. 4, 2020.

[29] The "benefit principle" of taxation holds that taxes paid should reflect the benefits received (in the form of goods and services) from the state. See Graeme S. Cooper, The Benefit Theory of Taxation, Australian Tax Forum 11 (1994): 493. The argument in reliance on the benefit principle is illustrated by OECD (2005), Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce? Final Report, OECD, Paris at para 51. The wording is more recently echoed by the OECD in, for example, OECD (2020), Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy – January 2020, OECD/G20 Inclusive Framework on BEPS, OECD, Paris at paras 15 and 17.

[30] OECD (2001) Tax Administration Aspects of Electronic Commerce: Responding to the Challenges and Opportunities - A Report from the Forum on Strategic Management to the Committee on Fiscal Affairs, OECD, Paris: February 2001 at para 43. It is reported that a large number of web sites facilitating aggressive tax planning were identified and that many of these appeared to be associated with a few promoting organisations, often based in tax havens (see at para 44).

[31] 2018 Interim Report paras 343,346,367-368.

The fairness arguments come in various forms, such as the argument that the approach to the allocation of taxing rights on the inception of the international tax system some 100 years ago is not fair, or alternatively that the system has more recently become unfair because of the advanced digitalisation of business given that business that is conducted purely domestically is taxed differently to that conducted by remote sellers.

In referring to the theme of "mobility" it is intended to refer to two core problems of the existing system. These concern mobile activities or assets, meaning activities or assets that can easily be shifted between states or, more specifically, that can easily be shifted to low- or no- tax states. Such activities or assets are usually regarded as including risks, intangibles, other licences, and contractual rights, etc. The problems from mobility in relation to the existing income allocation system are:

> *Problem 1* – it is hard to tax "mobile" activities and assets under the ALP. This means both that it is common for MNEs to game the system using mobile activities and also that making the system work at a technical level so that it taxes mobile activities presents a number of technical challenges.[32] The difficulties are accentuated by the fact that mobile activities and assets often attract the highest reward under the current income allocation system based on the ALP, meaning that the rewards to MNEs from gaming the existing income allocation system will usually be significant.
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> *Problem 2* – because of the significant reward given to mobile assets, states have an incentive to attract such assets and engage in tax competition, destabilising the system.[33]

An important component in arguments supporting the inexorable nature of the shift to taxation at the point of destination is the conclusion that the existing international tax system is not capable of giving a satisfactory response to the issues discussed above, particularly as represented in the two major themes that we identify. This point is explored below.

2.3 The "fairness" argument – and problem

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[32] The first point is very well known, the second is familiar to transfer pricing specialists but not otherwise widely appreciated. For an example of the type of problems that emerge in the application of the detailed BEPS transfer pricing changes (and which were designed to make the technical operation of those rules more effective) see to the Transfer Pricing Guidelines see Richard Collier and Ian Dykes, The Virus in the ALP, *Critique of the Transfer Pricing Guidance on Risk and Capital in the light of the covid-19 pandemic,* Bulletin for International Taxation, 2020 (Volume 74), No 12; Andrew Hickman, Arm's length principle mutations: control of risk in the OECD guidelines and variations in practice, MNE Tax, 13 January 2021; and Eyal Gonen, Leonid Karasik, and Michael McDonald, Control Over Risk, DEMPE Functions, And the Remuneration of R&D Service Providers, Tax Notes International, vol 102, June 21, 2021, pp. 1615-1630.

[33] This is what Devereux et al. refer to as the "incentive compatibility" problem. See M.P. Devereux et al, Taxing Profit in a Global Economy, Oxford University Press, pp.55-56.

Fairness arguments are pervasive in the literature on the digitalisation debate. Many (if not most) articles and papers dealing with the subject argue for change to achieve a fairer result than is delivered by the existing international tax system. For example, it has been commonly argued that it is not fair market countries cannot tax remote sellers, or that it is not fair that “user” countries cannot tax companies that are able to monetise the contribution to corporate profits that is made by such users, etc. Specific proposals favouring a reallocation of taxing rights to the market are invariably justified by reference to “fairness” arguments.[34] Notions of what is a fair result can also be seen to influence wider aspects of the tax system.[35] As is clearly demonstrated in the digitalisation discussion, there seems to be a strong general attraction to some sort of fairness norm.[36]

However, notwithstanding the frequent recourse to fairness, that notion is difficult to apply in relation to the corporate taxation system.[37] This is because, in the context of corporate taxation, there is no general definition or understanding of what the notion means or requires.[38] Notions of fairness could be based on one or more of: absolute allocations of taxable revenues between states; tax rates applied; value creation factors; recognition of market factors; the degree to which a formulary approach is applied; or the degree to which certain formulary factors are used; etc. There are also the fundamental uncertainties of whether and in what degree it requires fairness between companies, or fairness between

[34] See for example the description of the policy objective behind the UK’s Digital Services Tax on the HMRC website; “This measure will ensure the large multinational businesses in-scope make a fair contribution to supporting vital public services.” (see at https://www.gov.uk/government/publications/introduction-of-the-digital-services-tax/digital-services-tax); or the OECD press release describing the 8 October 2021 agreement of the OECD Pillar 1 and Pillar 2 proposals: which agreement ensures “that these firms pay a fair share of tax wherever they operate and generate profits” (available at https://www.oecd.org/tax/beps/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm).

[35] Examples where the notion of fairness may have an influence include the bargaining process involved in disputes between tax authorities and taxpayers or in the tax authority to tax authority mutual agreement procedure under double tax treaties. Fairness notions may also be relevant in influencing the scale of evasion from what is perceived as an “unfair” tax system or rule, etc.

[36] The attraction of the fairness notion to politicians is also much in evidence. For example, the very brief comments of the President of the European Commission, Ursula von der Leyen, welcoming the Inclusive Framework agreement on the Pillar 1 and 2 proposals, included the following statements: “It is a major step forward in making our global tax system fairer…It is above all a question of basic fairness…All companies have to pay their fair share…we have to ensure that everyone pays their taxes in an equitable way…”. European Commission, Statement by President von der Leyen following the OECD/ G20 Inclusive Framework meeting on the Global Agreement on International Taxation Reform, 8 October 2021.

[37] Work attempting to address the issue of perceived fairness in relation to the operation of the ALP illustrate the difficulties - See Stefan Greil, Christian Schwarz , Stefan Stein, Perceived Fairness in the Taxation of a Digital Business Model, Düsseldorf Working Papers in Applied Management and Economics, December 2018, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3303530; and by the same authors, Fairness and the Arm’s Length Principle in a Digital Economy, Düsseldorf Working Papers in Applied Management and Economics, June 2018, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3209205

[38] For example, Greil et al note the EU communication 'A Fair and Efficient Tax System in the European Union for the Digital Single Market' uses the term eighteen times without describing or explaining what can be understood as “fair”. See Stefan Greil, Christian Schwarz , Stefan Stein, Perceived Fairness in the Taxation of a Digital Business Model, Düsseldorf Working Papers in Applied Management and Economics, December 2018, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3303530 at p. 2.

countries, or both. There is also a further complicating factor relating to the use of any fairness notion. The incidence or cost of corporate taxes fall on individuals (including consumers, in the form of higher prices; shareholders, in the form of lower returns; suppliers, in the form of lower prices received; and employees, in the form of lower wages). Yet notions of fairness are made even more elusive because the incidence of corporate tax in any case may be difficult to identify (meaning it is unclear whether and to what extent the cost of a corporation tax falls on any one of these groups). It is also true that notions of fairness that might seem potentially useful (such as fairness between businesses on the one hand and fairness between states on the other) may lead to conflicting results.[39]

The problems discussed above mean that any attempt to answer concerns about the fairness of the current international tax system are unlikely to be resolved by recourse to arguments based on the *inherent nature* of that system. Rather, the absence of objective, or even broadly agreed, criteria to determine what is a "fair" allocation of taxing rights between states, means that the matter becomes a subjective assessment.[40] The early OECD thinking on the digitalisation of business drew exactly this conclusion. [41]

So, notwithstanding the very common recourse to notions of fairness in arguments supporting the desirability of shifting some profits to market states (and the likelihood that such arguments do also influence the positions adopted by states), the notion of fairness is not a particularly useful guide or benchmark for allocating profits between states.[42]

2.4 <u>The "mobility" issue</u>

[39] All these problems are discussed in some detail in Devereux et al, Taxing Profit in a Global Economy, Oxford University Press, pp. 34-40, 117-118, 171-172.

[40] This is not universally true. In some cases, it may still be useful to apply notions of fairness by reference to the inherent nature of a tax system. For example, the different treatment that is accorded to some larger, but not all, MNEs under the current OECD Pillar 1 proposals might be described as a fairness issue. To draw more widely on the fairness test in assessing the existing system or in designing a new approach it would be necessary to determine the underlying principle or principles which determine what is fair result. The BEPS project arguably tried to create some such principle around the notion of value creation, but the endeavour has not been successful. The attempt has proved highly problematic and yielded little consensus. See for example M.P. Devereux and J. Vella, Value Creation as the Fundamental Principle of the International Corporate Tax System, Eur. Tax Policy Forum Policy Paper, p. 3 (31 July 2018); R.S.Collier, The Value Creation Mythology, Chapter 6 in W. Haslehner & M. Lamensch (Eds), *Taxation and Value creation*, EATLP International Tax Series, vol. 19, Amsterdam: IBFD, 2021.

[41] That early discussion on digital noted the fairness argument is inherently problematic because of the wide acceptance that there are no universally agreed principles for allocating taxing rights. See OECD (2005), Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce? Final Report, OECD, Paris at paras 38, 110. That conclusion is also reflected in Richard M Bird and J Scott Wilkie, Source- vs. Residence-based Taxation in the European Union: The Wrong Question? in Sijbren Cnossen, ed., Taxing Capital Income in the European Union, Oxford University Press, 2000, pp. 78-109.

[42] Devereux et al, who consider the fairness issue at some length, conclude "Ultimately, these notions of fairness are almost impossible to operationalise in designing a business-level tax on profit". See Devereux et al, Taxing Profit in a Global Economy, Oxford University Press, 2020, at p.40.

The consequences of the mobility issues identified above (i.e. the incentives to MNEs to game the income allocation system and to states to engage in tax competition) are central to concerns about the existing system and especially about the current income allocation rules based on the ALP. Such concerns are reflected in several of the specific reasons referred to above, such as the concerns about MNE avoidance or about the failure of the existing rules, or about the impact of remote sellers on the revenues of developing states, etc. Arguably, several of the other concerns which might be interpreted as fairness issues may be better articulated by reference to concerns about mobility. For example, concerns about the different tax treatment afforded to domestic rather than digitalised or remote sellers (such as the comparison of a local bookshop to the business of Amazon) may be presented as a fairness issue. However, this issue might better be understood as a mobility issue, namely that an international business can, because of the nature of the international tax system, take advantage of the mobility issue in a way that is not open to a purely domestic business. As this example illustrates, unlike fairness, mobility concerns can be articulated by reference to the *inherent nature* or *inherent efficiency* of the international tax system since mobility problems flow directly from the nature and operation of that system. This is a significant point because it makes it easier to assess and appraise the various concerns. This is because the relevant test then becomes about what is effective or efficient in the operation of the income allocation system, and whether it works in the context of that system. Put another way, the use of a destination approach means that taxes are levied by reference to the existence of relatively immobile things (namely, customers), whereas the existing income allocation rules based on the ALP have to contend with all the problems from the attempt to tax by reference to mobile factors such as people, assets like intangibles, and capital. The use of a destination base, therefore, provides a higher degree of reliability to taxation revenues because the tax base is much less likely to move (or be moved) to another jurisdiction. Such an efficiency-related perspective, based on fundamental economic pressures, is a more reliable barometer than unanchored claims about what is “fair” - and so more likely to influence states.[43]

It has been objected by some that that the mobility problems besetting the ALP could be addressed by buttressing the existing international tax system, obviating the need for reform of the type that is proposed under the OECD’s Pillar 1 approach.[44] However, the immediate problem for any such argument is that the buttressing of the existing international tax system is broadly what the BEPS project sought to do – and there is a widespread perception, including on the part of many – and probably most - states (see

[43] See Wolfgang Schön, Value Creation – Its rise and fall in international tax policy, Chapter 7 in W. Haslehner & M. Lamensch (Eds), *Taxation and Value creation*, EATLP International Tax Series, vol. 19, Amsterdam: IBFD, 2021, at p.165.

[44] See for example Lorraine Eden, The Arm’s-Length Standard Is Not the Problem, 48 Tax Management International Journal 10, 10/11/2019 at pp. 1-9 and Oliver Treidler, The Arm’s-Length Principle Works Just Fine (Most of the Time), Tax Notes International, December 23, 2019. This is also the view of some states (see further the discussion in section 3).

further below), that the BEPS project was at most a partial success.[45] On that view, a number of problems with the ALP system that facilitate mobility remain unresolved. This includes: the separate entity approach itself,[46] the ability to transfer risks and assets, such as intangibles, intra group;[47] and the complete failure to regulate movements of capital given that capital transfers are generally regarded as not being within the scope of ALP rules.[48]

A further problem is the fact that often digital/ business models are not even subject to whatever disciplines the transfer pricing or PE profit attribution rules may seek to impose because digital business models may operate on a "remote seller" basis, meaning they have no taxable presence in the market they sell into. This in turn means that such profit allocation rules have no application in these circumstances.[49]

It is also relevant to note the widespread perception that all these problems associated with mobility are growing, or have grown, and become pervasive. This is due to the extensive and rapid digitalisation of the whole economy (and the inability to ring fence the digital economy in any meaningful way), creating a much broader set of problems for the international tax system.

In addition to these concerns relating to mobility there are also concerns about the practical operation of the existing income allocation rules. For example, several problems are commonly regarded as besetting the operation of the transfer pricing rules. These include: the application of practical valuation issues; the availability of data, including especially the lack of available comparables in many instances; the practical and technical complexity of

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[45] See for example the acknowledgement of remaining risks of profit shifting after the BEPS project in OECD Public Consultation Document, Addressing the Tax Challenges of the Digitalisation of the Economy, 13 February 2019, at p. 6.

[46] The problems arising from the ALP and its reliance on the separate entity approach are well summarised by Jens Wittendorf; "The arm's length principle goes hand in hand with tax planning, which may undermine national tax bases. The arm's length principle is like a Trojan horse, and contains the seeds of the problem it is intended to resolve." See Jens Wittendorf, *Transfer Pricing and the Arm's Length Principle in International Tax Law*, Kluwer Law International, 2010, The Netherlands, p. 786.

[47] The BEPS project toughened the substance requirements relating to the ownership of intangibles and for entities purporting to bear risk but there remain significant concerns that the new rules are not wholly effective. The UK perspective for example is that the new rules introduced by the BEPS project cannot be relied upon to stop the type of profit shifting activity that BEPS tried to counter. See HM Treasury, Corporate tax and the digital economy: position paper, November 2017, at para 3.5.

[48] For a discussion of the problems arising from capital, see R.S. Collier and J.L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, 2017, Chapter 5.

[49] Some digital models may include a sales agent in the market state to support marketing and promotion activities, yet with sales still being made remotely direct to a customer – meaning that again transfer pricing rules would normally be inapplicable. Even where the distribution or sales function is routed through a local agent, there have been long-standing tax authority concerns about the quantum of profits recognised in the relevant state (as, for example, in the case of limited risk distributors). The apparent ineffectiveness of the income allocation rules to deal with these issues has led to some states introducing specific anti-avoidance rules (such as a diverted profit tax) to deal with this problem.

the rules; etc.[50] It is also true that the OECD's attempt to create a uniform approach to the interpretation of the PE profit attribution rules has not proved a success, meaning that significant dispute and uncertainty is also common in relation to those rules.[51]

It may therefore be concluded that in recent years many justifications have been advanced in favour of a greater allocation of taxable profits to the market state. The two dominant arguments have concerned varieties of a claimed "fairness" test (which is commonly advanced, though ultimately problematic) and a mobility/ efficiency perspective (which is ultimately the more persuasive test). These arguments have also been supported by a set of wider concerns about the practical operation of the ALP system.

Having established there is no shortage of arguments in support of a greater re-allocation of taxing rights to market states, the next section considers the receptivity of states to these arguments in favour of such a re-allocation.

3. The position of States in support of a Reallocation of Taxing Rights to the Market

3.1 *Introduction*

Arguments in favour of re-allocating taxing rights over corporate profits to the market have been made for some years, particularly by several academics. Significant concerns about the existing income allocation rules have also been expressed for many years (again, particularly by academics). The issues discussed here are therefore far from new. However, what seems to have changed radically over the last four or five years is the receptivity of states to alternative responses to these issues. It is true that some states have expressed long-standing concerns about the existing international tax system and the need to change it. However, it is only more recently that such views have become more widely held by states. Examining the position of states is highly relevant to this discussion because, to state the obvious, the reform agenda is set and pursued by states. It is states therefore that determine what reform actions are undertaken. Exploring the position of states is considered especially relevant in testing the nature of any shift to supporting a re-allocation of taxing rights to the market because of the dramatic shift in thinking seen over the last four to five years. This shift can readily be illustrated by looking back to the position at the end of the BEPS project. At that time, the support on the part of states for the type of actions comprised in the two-pillar package that is now being pursued by the Inclusive Framework was very limited.[52]

[50] See generally R.S. Collier and J.L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, 2017. The issues and problems relating to the practical application of the ALP are discussed in Chapters 3 and 4.

[51] See R. Collier and J. Vella, Five Core Problems in the Attribution of Profits to Permanent Establishments, World Tax Journal, Volume 11, Issue 2, May 2019 159 at 163-168.

[52] However, this point also suggests a note of caution in examining the position of states. The views of states can change, sometimes quickly, as can be seen in dramatic shift in thinking on the tax aspects of digitalisation

3.2 *Identifying the three groupings of states*

Inevitably, states have different views on the issues discussed so far, including the desirability of reform to the international tax system. There can be significant variations or nuances in the positions of individual states. States may also change their views. This makes talking about the position of states difficult. Nonetheless, based on our perception of country positions, coupled with the evidence of proposals made or endorsed by certain states, we observe three broad camps or groups of states as follows:[53]

> *Group 1:* this group is keen on a shift to reallocate significant taxing rights to market/ destination states. Many of the states in this group have major concerns about the operation of the ALP.
>
> *Group 2:* this group desires a more limited move to destination. Many of the states in this group have reservations about the ALP, but do not wish to do more than make some modifications to its operation. Most states in this group have concerns that the BEPS project has not fully succeeded in its goal of putting an end to BEPS practices.
>
> *Group 3:* the majority of this group is largely opposed to any change in the international tax system and wishes to retain the ALP in its current form.

We consider these three different groupings of states and in each case assess the position of the group and its relevance to the point under discussion, namely whether the shift to taxation in the market or destination state is "inexorable".

Group 1

This group is dominated by what may loosely be referred to as developing country states.[54]

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over the last four to five years. This means it is also important to bear in mind the quality of the underlying arguments, and the relevant strengths and weaknesses of approaches to the reform of the international tax system, not just what states seem to want to do at any moment.

[53] The 2018 Interim Report also distilled the views of Inclusive Framework states into three broad groups, the first and second of which have some broad correspondence to, respectively, the second and first groups discussed here. In the view of the authors, the third group identified in the Interim Report is now split across the second and third groups of states discussed here. See OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD Publishing, 2018), paras. 389-395.

[54] In referring to "developing countries" we recognise the breadth of what is included in that category given it includes the BRIC (Brazil, Russia, India and China) states where there are greater resources in the tax administration as well as much smaller economies which tend not to be big consumer or industrial economies, but typically derive their tax revenues from natural resources, such as minerals, oil and gas, and agriculture.

There are many states in this group (in purely numerical terms it is the largest group), and they are generally very dissatisfied with, and so seek to change, the existing international tax system. This group wants to move away from the reliance in the existing income allocation rules on the existing production or supply-side paradigm to include some explicit recognition of market or demand-side factors. Not surprisingly, therefore, this group sees a significant role for the introduction of destination approaches. For example, it would ideally wish to see any re-allocation of profits to market states going beyond any limitation based on residual profits and to include also routine profits.[55]

The position of group 1 states may helpfully be understood by reference to the long-standing concerns on the part of developing states about the perceived under-allocation of profits to them under the existing system. To a significant extent, those concerns have been addressed as arguments about the balance of taxing rights between residence and source states, the argument being that source states are under-rewarded by the approach adopted based on the OECD Model Convention. These concerns have been evident from virtually the inception of the current international tax system, for example being reflected in the different approach to the allocation of taxing rights that is reflected in the 1943 Mexico draft model double tax treaty.[56] The special importance to developing states of boosting source taxing rights is emphasised in the most recent version of the UN Model double tax convention.[57]

Source state taxing rights are obviously not the same as market state taxing rights.[58] However, states concerned about limited source taxing rights are primarily concerned with what they see as the resulting under-allocation of revenues. In practice, these states see allocations to the market state as potentially useful in redressing – at least to some degree - this under-allocation from the existing system. Therefore, there is in practice a significant

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These countries typically have limited resources and expertise with which to administer a tax system. The authors therefore recognize that the nature and attributes of developing countries may vary markedly from one country to the next. *See* M. Keen, *Taxation and Development – Again*, International Monetary Fund (IMF) Working Paper (WP) No. 12/220, pp. 4-9 (Sept. 2012).

[55] This position is evidenced in the G24 paper submitted to the OECD in Jan 2019 (see further below) and has been a point of discussion throughout the Pillar 1 process.

[56] The Mexico draft model double tax treaty allocated extensive primary taxing rights to the source state but this approach was later materially reversed in the 1946 London version of that model double tax treaty. The London and Mexico model tax treaties are discussed in R.S. Collier and J.L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Oxford University Press, 2017, at pp. 44-47.

[57] See 2017 UN Model Double Taxation Convention, Introduction, at paragraph 3. The point is also reflected in much of the ongoing work of the UN Committee of Experts on International Cooperation in Tax Matters, for example in relation to the development of Articles 12A and 12B (Article 12B is discussed further below).

[58] Arguments about the balance of taxing rights between source and resident states take place within the paradigm of a production or supply-side approach to the allocation of taxing rights. Market state taxing rights necessarily require that paradigm to be altered in favour of a partial, at least, recognition of a demand-side approach.

overlap between states historically pressing for an increase in source taxing rights and those pressing for a material re-allocation of taxing rights to the market state.

Further, while states in this group have generally supported the increase of source-state taxing rights, many of the states in this group also have a long-standing position in support of market-based profit allocations, a good example being India, which has lobbied for many years for account to be taken of market factors.[59]

Generally, the states in group 1 consider it likely that they will increase their allocation of taxable profits under the Pillar 1 proposal. This is because Pillar 1 delivers a re-allocation to the market state, meaning there will be a gain by reference to the size of the relevant market in developing states. Any such gain will be in addition to any return that is already derived under the existing ALP system. However, the elimination of double tax mechanism, under which an amount equal to the profits re-allocated to market states under the Pillar 1 re-allocation is in effect taken away from the ALP system,[60] is expected to have a relatively small impact on developing states. This is because that mechanism operates by reference to locations where pools of residual profit are booked in MNE group entities. The assumption made by group 1 states is that such residual profits tend not to be booked in MNE group entities located in developing country states. This means developing countries are likely to benefit from the Pillar 1 re-allocation of profits to the market state but not be greatly affected by the corresponding adjustment mechanism to eliminate double taxation. The logic is supported by results from the OECD's economic impact assessment.[61]

Notwithstanding the potential gains for developing states discussed above, support for the Pillar 1 proposal on the part of group 1 states is by no means unconditional. There are two major concerns. These relate to scope and complexity. The scope concern is that the proposal does not go far enough and is framed in overly limited terms. This is reflected in pressure from group 1 states for a reduction in the very high qualification threshold (the

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[59] In relation to India, see for example Government of India, Ministry of Finance, Proposal for Amendment Of Rules For Profit Attribution To Permanent Establishment, April 2019, Section 4, which outlines the economic basis for allocating taxing rights to the market in respect of income from business. The recognition of market-side taxing rights is of course also reflected in the sales factor in formulary apportionment, a method for profit allocation that is supported by many states in group 1 (the three factors usually referenced in the formulary apportionment profit allocation mechanism are sales, assets and employees). It is notable that states in group 1 have generally argued in favour of market-based profit allocations based on fairness and simplicity (or absence of complexity) arguments, rather than based on the systemic merits of a destination approach, such as the point that a destination approach is less prone to mobility problems in comparison to the ALP.

[60] More accurately, where the elimination of double taxation approach relies on an exemption mechanism the profits are in effect taken out of the ALP system. However, where a credit mechanism is used, secondary taxing rights would be retained within the ALP system. At the time of writing, it seems likely that it will be open to states to choose which of these approaches they wish to apply in operating an elimination of double tax mechanism. See OECD/G20 Base Erosion and Profit Shifting Project, Inclusive Framework on BEPS, Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint, October 2020, Chapter 7.

[61] See OECD (2020), *Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, pp14-19 and 27-75. The study is based on an earlier version of the scoping of Pillar 1.

requirement for MNE revenues equal to at least €20bn) as well as for an expansion of the base (the proposed 10% PBT threshold beyond which there is a 25% allocation of residual profits).[62] Arguments have also been advanced to expand the re-allocation under Pillar 1 from being based on merely a partial portion of residual profits to being based on all profits.

The complexity concern (relating chiefly to how the new rules are framed and administered in practice) is especially relevant for states, of which there are many, with limited tax administration capacity. At the time of writing, it remains to be seen how far a centralised administration process for Pillar 1 will obviate these difficulties. However, this point also leads to a further concern on the part of several developing states, namely whether any centralised administration arrangements will undermine the position relating to the sovereignty of participant states. This is an especially sensitive area in relation to how transfer pricing disputes are settled and means that several developing states are resistant to any dispute measures that weaken their ability to deal with transfer pricing disputes in the manner they choose.[63]

As noted, group 1 states harbour significant concerns about the existing international tax system. These concerns are especially focussed on the prevailing nexus or PE standards and the ALP-based income allocation rules.[64] The concerns tend to be that these two sets of rules are easily gamed by MNEs to the disadvantage of these states and that the transfer pricing rules are also too complex to be administrable for low-capacity states.

Two major proposals have been made by states in group 1 in the course of the work on the digitalization of business. These are a G24 proposal in January 2019 and a more recent UN proposal for a new article in bilateral tax treaties. These proposals reflect several of the points made above about the position of group 1 states.[65]

[62] See for example the comments on the need for a more expansive allocation of profits to the market state in African Tax Administration Forum, Technical Note, The Inclusive Framework's Two-Pillar Solution to Address the Tax Challenges from the Digitalisation of the Economy, CBT/TN/08/21 (published on the 11 November 2021) at p.3.

[63] See for example the comments on the strong opposition of African states to any mandatory arbitration process and on the successful negotiation by ATAF to the effect that the mandatory arbitration process will not be imposed on African and other developing states - African Tax Administration Forum, Technical Note, The Inclusive Framework's Two-Pillar Solution to Address the Tax Challenges from the Digitalisation of the Economy, CBT/TN/08/21 (published on the 11 November 2021) at p.5.

[64] See, for example: G-24 Working Group on tax policy and international tax cooperation Proposal for Addressing Tax Challenges Arising from Digitalisation, January 17, 2019, at p.1; African Tax Administration Forum ("ATAF"), Suggested Approach to Drafting Digital Sales Taxation, 30 September 2020 at p.3.

[65] It may also be noted that the African Tax Administration Forum ("ATAF"), which has 38 African member states, has developed a guide, Suggested Approach to Drafting Digital Sales Taxation. The Suggested Approach, which has been developed by the ATAF Secretariat and ATAF's Cross-border Taxation Technical Committee, is intended to help African countries that are considering implementing digital service taxes. Some African countries such as Kenya and Nigeria have already advanced Digital Service Tax laws and other African countries are considering this option. The motivations for the use of a DST reinforce the concerns on the part of African states about the efficacy of the existing rules: *"Much of the recent public concern about the under- taxation of*

Broadly, the proposal made by the G24 countries[66] adopts a nexus concept of significant economic presence (SEP) combined with a new profit allocation approach based on either fractional apportionment or through a new withholding tax.[67] The proposal made is that the SEP nexus test could be based on the generation of sustained revenues from a state.[68] The fractional apportionment approach would operate by reference to a defined tax base, using weighted factors to allocate the profit. The proposal is that the tax base would be represented by the global profit rate applied to the revenues derived from a state. Account would then be taken of certain factors in the apportionment of that base, namely: sales, assets, and employees. In addition, the proposal contemplates that for those businesses for which users meaningfully contribute to the value creation process, users would also be considered in apportioning income. users (reflecting the demand side), and (representing the supply or production side). The proposal also advocates an alternative approach based on a proxy withholding to reflect the contribution in value of user actions.[69]

The proposal is based on a very clear break from the approach of the existing ALP-based system:

> "sustained participation of the businesses in the economic life of a country can give rise to profits which are not taxed given the present international tax rules. This creates a mismatch between the source of generation of profits and the jurisdiction where they are taxed….The solution is to rework the international tax framework regarding nexus and profit allocation rules, and take into account value created within the supply chain, representing the contribution of supply side, along with the contribution of demand side factors for determining corporate profits attributable in a tax jurisdiction. There is a need to acknowledge the fact that value of goods and services are also contributed by

multinationals has focussed on high- profile digital companies that do not have a physical presence in countries so are not subject to income tax. By taxing these companies, a DST could improve public confidence in the fairness of the tax system, which is an important factor for the enhancement of voluntary compliance." ATAF, Suggested Approach to Drafting Digital Sales Taxation, 30 September 2020 at p.1. As noted above, ATAF has also released a Technical Note discussing the Inclusive Framework's Two-Pillar approach and which contains several comments and views on the desirability of that approach.

[66] The G-24 was founded in 1971 and is now comprised of the following 28 developing countries (China attends as a special invitee): Algeria, Côte d'Ivoire, Democratic Republic of the Congo, Egypt, Ethiopia, Gabon, Ghana, Kenya, Morocco, Nigeria, South Africa, Argentina, Brazil, Colombia, Ecuador, Guatemala, Haiti, Mexico, Peru, Trinidad and Tobago, Venezuela, India, Iran, Lebanon, Pakistan, Philippines, Sri Lanka, and Syria.

[67] G-24 Working Group on tax policy and international tax cooperation Proposal for Addressing Tax Challenges Arising from Digitalisation, January 17, 2019, available at https://www.g24.org/wp-content/uploads/2019/03/G-24_proposal_for_Taxation_of_Digital_Economy_Jan17_Special_Session_2.pdf

[68] In addition to the revenues factor, it is noted that the existence in the state concerned of one or more of the following may also be considered relevant for constituting the nexus of the SEP: (1) a user base and associated data input; (2) measures of the volume of digital content – such as user created content, product reviews, search histories; (3) other factors such as local currency billing, a local language website, sustained marketing, etc.

[69] G-24 Working Group on tax policy and international tax cooperation Proposal for Addressing Tax Challenges Arising from Digitalisation, January 17, 2019, at pp. 6-8.

the purchasing power of the markets in which goods and services are consumed. Hence, the country that hosts these markets has a right to tax them."[70]

Thus, *both* production (supply) factors and sales (demand) factors are essential for the generation of profits, and neither, it is claimed in the proposal, can be ignored for the purpose of determining the profits that should be taxable in a jurisdiction.[71]

The proposal reflects several of the points made earlier. It rejects the core reliance on the existing supply- or production-side paradigm relating to the allocation of taxing rights, seeking to boost the allocation of profits to market countries, and thus moving away from the prevailing reliance on the ALP (two of the factors proposed for the formulary profit allocation – sales and users – reflect this demand- or market-side approach). The proposal is also intended to be as simple as possible.

The UN "Article 12B" proposal is for a new article to be inserted into tax treaties.[72] The new provision would apply to cross-border payments from automated digital services ("ADS"). There are three main elements to this proposal. First, Article 12B would permit source state withholding tax on payments from ADS (except where those payments already qualify as royalties or fees for technical services within Article 12 or 12A of the Model). The rate of any withholding tax would be negotiated bilaterally with treaty partners, though the draft recommends what it regards as a modest rate in the order of 3-4% of the gross amount.[73] This approach represents a departure from traditional international tax principles applicable to income from the performance of services, which allocate taxing rights to the jurisdiction where the services are performed, rather than the jurisdiction where the recipient of such services is resident. Second, an alternative net basis of taxation may apply in the source state at the request of the owner of the relevant ADS income. This works on the basis that the profitability ratio (relevant annual profits divided by annual revenue) of that owner's ADS segment (or group accounts if there is no segment data) is applied to the gross revenue arising in the source state and 30% of the resulting net profits is then treated as the profits that are taxable in that state. This is conceptually similar to the discussions occurring in the OECD with respect to the Pillar 1 profit allocation.Third, there is an exclusion from the new allocation of taxing rights under Article 12B where the relevant ADS income is attributable to a PE in the source state.

[70] G-24 Working Group on tax policy and international tax cooperation Proposal for Addressing Tax Challenges Arising from Digitalisation, January 17, 2019, at p.2.
[71] G-24 Working Group on tax policy and international tax cooperation Proposal for Addressing Tax Challenges Arising from Digitalisation, January 17, 2019, at p.5.
[72] United Nations Committee of Experts on International Cooperation in Tax Matters Twenty-second Session, Tax consequences of the digitalized economy – issues of relevance for developing countries, Co-Ordinator's Report 19-28 April 2021. E/C.18/2021/CRP .1
[73] UN proposal commentary at para 15. The commentary (in para 16) considers various factors that should be taken into account in setting the rate.

The Article 12B withholding proposal is particularly relevant in reflecting the concerns of group 1 states about complexity. In comparison to the Inclusive Framework approach, the proposal is intended to offer an alternative and much simpler option for a response to the digitalization of the economy. The approach is designed to fit into the existing treaty framework.[74] The simplicity is delivered at the cost of a narrower approach (i.e., the targeted payments in respect of ADS). The proposal is also constrained by the need to attach the taxing mechanism to the making of payments. This means that the proposed source state is always the state of the (direct) purchaser from which the payment is made. This may not be the state where an indirect purchaser or a user or consumer of the ADS resides.

It may be concluded that there are a several commonalities to the position of states in group 1, namely that group 1 states: recognise the market as a legitimate contributor of value and generator of profits and a factor that should therefore be recognised in revised income allocation rules; have material concerns over base depletion due to the inadequacy of current nexus standards as reflected particularly in existing PE definitions, and due to exploitation of the transfer pricing rules; and generally, support Pillar 1 but nonetheless have concerns it does not go far enough and is too complex.

The overall conclusion is that there is significant pressure from these group 1 states in support of a paradigm change which includes a destination element. The long-standing nature of the concerns of these states about the existing international tax system coupled with the nature and positioning of their arguments over the last couple of years suggests no future diminution in this pressure.

Group 2

States in this group are predominantly OECD member states (but not all OECD member states are in group 2). These states do not generally accept the need for a wholesale change in the approach to income allocation, meaning that they have largely resisted the market/ demand paradigm as being relevant to the income allocation rules. Instead, states in this group broadly want to maintain the existing production- or supply-side paradigm.

Nonetheless, Group 2 states generally wish to make some changes to the current production side approach. This is normally expressed in terms of the need to modify the current approach to take account of certain additional factors, such as the contribution from users, data, and marketing intangibles, etc. In large measure, states in this group see the need to change the existing rules as arising from the features of the digital sector, though

[74] Article 12B is not self-executing but is designed to serve as a model for countries to consider in determining their approach to the taxation of automated digital services, and in the context of future treaty negotiations.

this is not a position that is held uniformly (the US clearly does not accept this view). The position of these states has very often been expressed in terms of the value creation approach, the argument being that the requirement to align profit allocation with the value creation approach requires a re-alignment of the current rules to take account of specific value-creating functions such as the contribution from users.

Group 2 states may arguably be divided into two further sub-groups. Both groups would broadly subscribe to the position set out above. However, there is a notable difference in the views of the two sub-groups in relation to the relationship between any modifications to the system and the current income allocation framework.

A first sub-group of states adopts the view that any modification of the system cannot undermine the current transfer pricing system. This means that whilst a reallocation of some residual profits of the MNE group is warranted, this should preferably meet several tests. These include that the re-allocation should be as accurate as possible, meaning reallocating residual profits that are connected to relevant products or business units that generate income in market states. On this view, any re-allocation mechanism should not inadvertently capture unrelated profits. One consequence of this view is that there should be a stricter use of a segmentation approach (whether by business lines or by regional activity or possibly both) in the relevant calculations under Pillar 1. It also means that those group entities that are to be regarded as suffering the tax charged on any profits re-allocated to market states (these entities are the “paying entities” in the terms of the Pillar 1 proposal) should meet a “market connection” test. That test would require that, via transaction flows, profits derived in the market states can be traced back to the legal entity (or entities) that is to be regarded as the relevant paying entity. Further, it is argued that paying entities should be identified using transfer pricing concepts (rather than just a quantitative threshold based on their profits), such as being an owner of intangibles (IP), and that the measure of residual profits should be based on the transfer pricing (not accounting) measure of residual profits. At a practical level, these points significantly complicate the interactions between the existing system and any new allocation of profits to market states.

A second sub-group, which is smaller than the first sub-group described above, is less rooted in the existing transfer pricing system. This group prioritizes administrative simplicity and is therefore less concerned about the points referred to above. For example, in identifying relevant paying entities, this group considers that administrability issues are best served by a test based simply on quantitative thresholds based on an accounting measure of profits.

While this article does not seek to discuss the position of individual states in detail, it is relevant to note that the US is included in what we refer to as this second group of states even though, for various reasons, it may be argued that the US merits its own separate category or "group" for the purposes of this discussion. These reasons include the unique position of the US as the state in which many digital businesses and many of the businesses within the scope of Pillar 1 are headquartered; the various shifts in the US position over the last two to three years on matters relating to the digitalization debate; the political uncertainty surrounding the delivery of Pillar 1 in the US; the relatively strong influence of its business sector; and the widely varying perspectives that are reflected in the views of its business sector.

The motivations of states in group 2 seem driven by several factors. These states clearly wish to expand their taxing rights. For European states in particular, the apparent widespread public perception that highly profitable digital business has for some time not been paying its "fair share" of tax in the countries in which they operate has been a major political problem. These states also see an opportunity given the revenue foregone under the operation of the essentially physically based nexus and profit allocation rules: most (but not the US) seem to have a strong sense they are losing out under the current rules.[75]

However, the marked support of group 2 states for the retention of the current income allocation framework is presumably based on the view that they have been beneficiaries of this framework. This is on the basis that they are states whose resident corporates tend to own intangibles, capital, assets, etc. as well as having value-generating strategic and senior management. This means that these states benefit from the current residence system and the ALP-based income allocation rules. The two sub-groups discussed above may approach the process of re-allocating some limited taxing rights to the market state slightly differently, but ultimately, they see themselves as benefiting from the current system and do not want to see it materially dismantled.[76] This explains why states in group 2 do not want to lose taxing rights they already have over business through the current system and hence why they seek incremental/ limited taxing rights by restricting the re-allocation of taxing rights to situations where they cannot already tax and where they have little to lose from the adoption of a symmetrical approach (because these states, other than the US, have relatively limited digital business).

It is also relevant to note that group 2 states seem to have accepted that they cannot realistically hold back the tide of Group 1 states pushing for additional market-based taxation: If there is no movement in that direction, then, as the experience since the BEPS project clearly evidences, such additional market state taxation can be imposed anyway by

[75] It is notable that such arguments by these states in favour of expanding their taxing measures tend to be based on fairness or anti-avoidance grounds. Arguments based on efficiency grounds, such as the point that a destination-based approach is less prone to mobility issues and so works as an effective form of taxation seem less common.

[76] These comments reflect the observations of the authors on the apparent motivations of states in group 2. We are not aware of any detailed analysis of whether these states would actually be better off under an alternative income allocation system, such as a system based exclusively on the destination approach.

unilateral measures such as DSTs, etc with no recourse to generalised standards or accepted levels of taxation that might otherwise be available under a network of bilateral treaties.[77] The same point might be expressed in more positive terms as the recognition by group 2 states of their (moral) obligations to support developing country economic development, particularly in the light of the covid pandemic. Such a view is suggested by the G20 Finance Minister Statements of July and October 2021, which give a significant emphasis to the needs of developing countries and the importance for developed economies of supporting these countries.[78] This may provide a further political impetus for the acceptance by group 2 states of changes to the existing income allocation rules which will benefit developing states.

A further factor in the positioning of group 2 states is the assumption that the entities treated as suffering the tax on the re-allocated profits to market states (the "paying entities" under Pillar 1) will to a significant degree be in the low-tax group 3 states (the position of these states is discussed further below). On this basis, group 2 states may assume they will either not lose out from the new approach or will have the amount of any loss mitigated. The OECD's economic impact assessment of Pillar 1 confirms the validity of this assumption.[79]

Two major proposals to change the existing income allocation rules have been made by states in group 2 in the course of the work on the digitalization of business.[80] These are a UK "user participation" proposal first made in November 2017[81] and a US "marketing intangibles" proposal made in 2018.[82] These two proposals reflect several of the points made above about the position of group 2 states.

Under the UK proposal the profit attributable to the value created by the participation/ contribution of "active users" to certain highly digitalised businesses activities would be taxed in the jurisdiction where those users are located. The proposal is therefore limited in

[77] For an overview of potential unilateral measures, see OECD, Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, (OECD Publishing, 2018), Chapter 4.
[78] See Third Finance Ministers and Central Bank Governors meeting, Communique, 9-10 July 2021, available at https://www.g20.org/wp-content/uploads/2021/07/Communique-Third-G20-FMCBG-meeting-9-10-July-2021.pdf; and Fourth G20 Finance Ministers and Central Bank Governors meeting, Communique, 13 October 2021, available at https://www.g20.org/wp-content/uploads/2021/10/G20-FMCBG-Communiqué-Fourth-G20-FMCBG-meeting-13-October-2021.pdf
[79] See OECD (2020), *Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, pp14-19 and 27-75. The study is based on an earlier version of the scoping of Pillar 1.
[80] It is also true that the Pillar 2 package is largely based on proposals made by Germany and France, though the different anti-avoidance character of Pillar 2 means it is not considered in this article.
[81] HM Treasury, HMRC, Corporate tax and the digital economy: position paper, November 2017. This paper was updated in March 2018 – see HM Treasury, Corporate tax and the digital economy: position paper update, March 2018
[82] The US proposal is summarised and discussed in OECD, Public Consultation Document, Addressing the Challenges of the Digitalisation of the Economy, 13 February 2019, at pp.11-16.

scope to certain highly digitalised businesses. Under the proposal the state in which active users are located would be entitled to tax a share of the non-routine profits of the group attributable to those users. All other group income would remain taxed under existing profit allocation rules. The proposal is founded on the argument that the existing nexus and profit allocation rules fail to recognise the contribution made by the participation of active users to the value of certain highly digitalised businesses, such as such as social networks, search engines and intermediation platforms. The proposal seeks to correct this problem by allocating taxing rights to user jurisdictions in appropriate situations.

The general approach under the US proposal is to treat market jurisdictions as being entitled to impose tax on returns from local country marketing intangibles[83] such as brands, trademarks, user base, and goodwill. The approach would override the place of legal ownership of such intangibles, or the location in which the critical "DEMPE" functions are carried on, if different.[84] The proposal would therefore expand the taxing rights of market countries to the extent the marketing intangibles were not already booked into the market state. The scope of the proposal is wider than UK proposal in that it applies to all businesses for which local marketing intangibles are a material driver of profits (including digital companies and traditional bricks and mortar businesses). The proposal is based on the view that marketing intangibles like trademarks and brands can be intrinsically linked to the market state in a way in which other intangibles such as trade, product and design intangibles and technology cannot. More specifically, the proposal assumes that the time and effort spent on developing a customer base in a state (through advertising, tailoring the product, soliciting data and user contributions, etc.) creates valuable intangibles that have a factual connection to the users/ customers in the state concerned. For example, in the case of an automobile business, technology intangibles (such as in connection with fuel efficiency) are fully portable but brand recognition is not, because it must be developed and sustained locally.

[83] Though there is a definition of marketing intangibles in the Transfer Pricing Guidelines, it was recognised from the outset that this would need to be modified and broadened to accommodate certain types of digitalized business with the result it would need to also include user data and user created content, as well as dealing with borderline issues such as market specific characteristics and group synergies (which are treated as comparability factors rather than intangibles under the Transfer Pricing Guidelines). Transfer Pricing Guidelines Glossary, 6.16, 6.18 and 6.30-6.31.

[84] DEMPE functions are functions related to the development, enhancement, maintenance, protection, or exploitation of an intangible. See 2017 OECD Transfer Pricing Guidelines at 6.50-6.54.

The UK and US proposals raise many issues[85] but in the present context it is a number of their commonalities that are of particular relevance.[86] Both proposals seek to modify the existing international tax system on the shared view that the system does not properly accommodate modern business models.[87] Both provide for systemic change going beyond (i.e., that is inconsistent with) the ALP and the current nexus standards. The proposals allow taxation in the state of the user or the market state respectively regardless of which legal entity in the MNE group owns the relevant taxing rights under the existing system. Thus, both provide for a disregard of existing separate entities for certain purposes. In the case of the UK proposal, the user state tax charge arises irrespective of which overseas entity derives returns under existing rules; and in the case of the US proposal the owner of the marketing intangibles is changed from an overseas owner to a local owner. Both proposals also emphasise their relevance in countering problems in the existing income allocation system from mobility.

Even though the two proposals seek to increase the allocation of taxing rights to the user or market state, both proposals firmly reject the need for an approach based on the destination principle and each maintains that it reflects a modification to the supply side paradigm. The UK proposal states its objective is not to allocate transfer taxing rights to a market jurisdiction where no value is being created but only to deal with new sources of value creation in certain more digitalised businesses by targeted changes to the existing income tax framework. It includes some strong arguments against the destination approach.[88] The position of the US proposal is similar, namely that it is based on the supply side principle of allocating taxing rights based on activities and assets of the MNE related to a specific state, i.e. being the state where the enterprise creates value.

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[85] For example, in relation to the UK proposal it has been objected that the participation of users within highly digitalised businesses is no different from other business input sourced from third parties. Grinberg uses the examples of fax machines and the medical industry to illustrate the non-special feature of user participation. Grinberg also mentions a farmer's market as an example of a multisided platform, which he calls a market maker. Itai Grinberg, 'User Participation in Value Creation' [2018] British Tax Review 407. In relation to the US proposal, there are fundamental concerns about whether marketing intangibles can reliably be isolated and valued.

[86] There are some commonalities that are of less relevance in the present context. For example, both proposals recognise the many implementation challenges they raise in approaching the relevant scope, nexus, profit allocation issues, etc, as well as how the proposals would be applied across the wide range of business models

[87] It is notable that both proposals draw heavily on the notion of value creation in justifying the modification to the existing system that is proposed. The UK argument is that the user created value constitutes an integral part of the value creation process of certain highly digitalised businesses, but the location of active users is not taking into account under the existing profit allocation rules which focus exclusively on the physical activities of the business itself. The US argument is that there is an intrinsic legal and functional link between marketing intangibles and the market jurisdiction – marketing value is regarded as generally created in the market and so should be taxed there to align with the value creation notion.

[88] HM Treasury, Corporate tax and the digital economy: position paper update, March 2018 at 1.13-1.15.

Notwithstanding the approach of the US and the UK proposals in seeking to preserve the (as it seems to the authors, highly questionable)[89] argument that any changes to the income allocation rules are consistent with the production- or supply-side paradigm, the position of these states on this matter (and other group 2 states that have shared this view) has softened over the last couple of years. This is for probably three reasons. First, it has become clearer that finding a suitably-targeted mechanism which both constrains any general re-allocation of profits to market states and which can also be characterised as merely an extension of the production-side approach is both extremely difficult technically and is unlikely to be accepted by the wider body of states.[90] Second, the position of the US in flatly rejecting an approach which targets specific sectors – particularly the digital sector – makes it more difficult to characterise any re-allocation of profits as an extension of the production side paradigm. Third, over this period the general pressure for a re-allocation of profits has increased and the viability of the "value creation" notion as either an explanation or norm of the current income allocation system has been materially eroded.[91]

However, this softening of the argument based on the production- or supply-side paradigm has not affected the general objective of group 2 states to limit any general expansion of taxing rights based on an outright market or destination approach. At the time of writing this may be seen in several ways in relation to the ongoing work on the Pillar 1 proposal. For example, group 2 states generally prefer an approach based on an allocation of a portion of residual profits (i.e., a partial allocation from a limited pool of profits) of an MNE group. Some group 2 states have also resisted basing a nexus test on mere revenues alone, preferring the argument that there should be additional "plus factors" (such as distribution activities or activities directly supporting sales into the market, e.g. facilitating billing and payment in the local currency, etc.) in the test, even though such factors are problematic.[92]

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[89] We find this argument in support of a "flexed" supply paradigm to be unconvincing. It seems hard to resist the conclusion that this argument is simply a mechanism to support a limited recognition of demand side rights. In any event, the effect of what is being argued is the equivalent in substance of moving to a partial allocation to the market.

[90] The point is illustrated by the technical design and political problems that were encountered by the US and UK proposals themselves. The OECD Secretariat proposal that has become Pillar 1 was initiated once it had become clear that neither of these proposals would be acceptable to the wider body of Inclusive Framework states.

[91] The OECD broadly stopped using the term from Spring 2019 – see Wolfgang Schön, Value Creation – Its rise and fall in international tax policy, Chapter 7 in W. Haslehner & M. Lamensch (Eds), *Taxation and Value creation*, EATLP International Tax Series, vol. 19, Amsterdam: IBFD, 2021 at p.157-158. The value creation notion has also been subject to a barrage of criticism – see for example, Rebecca M. Kysar, Value Creation: A Dimming Lodestar for International Taxation? 74 Bull. Intl Taxn 4/5, 216 (2020); M.P. Devereux and J. Vella, Value Creation as the Fundamental Principle of the International Corporate Tax System, Eur. Tax Policy Forum Policy Paper, p. 3 (31 July 2018);; R.S.Collier, The Value Creation Mythology, Chapter 6 in W. Haslehner & M. Lamensch (Eds), Taxation and Value creation, EATLP International Tax Series, vol. 19, Amsterdam: IBFD, 2021.

[92] See OECD/G20 Base Erosion and Profit Shifting Project, Inclusive Framework on BEPS, Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint, October 2020, Chapter 3. These plus factors are problematic because of the apparently limited assistance they provide in defining a meaningful nexus test.

A number of group 2 states also support the proposed Marketing and Distribution Safe Harbour mechanism, which has the effect of further limiting the impact of Amount A but which raises a number of complex issues in the design of Pillar 1.

The overall conclusion is that, for the variety of reasons discussed earlier, states in group 2 support a change in favour of increased market-based taxation. These states may resist any acknowledgement that the change is based on a destination approach, and they may seek to limit the scale of the change. However, the wish for at least a limited reallocation of taxing rights to the market state is incontrovertible.

Group 3

Group 3 is the smallest of the three groups and the composition of the group comprises three broad sub-groupings of states.

Most, but not all, of the states in group 3 are what the OECD economic impact assessment describes as "investment hubs". States in this sub-group include some OECD member states and some non-member low tax states. These states have two broad concerns. First, that the Two Pillar package will cause them to lose foreign direct investment (FDI). This is mainly on the basis that these countries have used low tax rates extensively as a major lever to attract FDI and Pillar 2 is intended to nullify this strategy by the imposition of a 15% minimum tax rate. It is recognised that Pillar 1 also has an adverse effect on the attractiveness of these states. This is because the Pillar 1 re-allocation of a portion of an MNE group's residual profits to market states (the re-allocated "Amount A"), will reduce the benefit of booking residual profits in cash box companies, IP companies, asset holding companies, etc. located in these states. Further, several of the investment hub states are relatively costly places in which to do business. Their fear is that, because of the removal of their ability to offer very low rates of tax on corporate profits (often, residual profits), companies will move to lower cost locations or fold activities into other existing locations where the MNE group has business operations.

A second major concern for states in this sub-group is that they will bear what they consider a disproportionate portion of the cost stemming from the re-allocation of profits to market states (Amount A under Pillar 1). These states therefore consider they have more to lose than other states from reform of the system. The OECD's economic impact assessment confirms that much of the "cost" of Pillar 1 will indeed fall on these "investment hub" states, based on the location where MNE group residual profits are typically booked.[93]

[93] See OECD (2020), *Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, pp14-19 and 27-75. The study is based on an earlier version of the scoping of Pillar 1.

Group 3 also includes a sub-group comprising a very small number of highly developed OECD member states with relatively small domestic markets that are concerned they may be net losers from the Two Pillar package, and particularly from Pillar 1. This is on the basis of the expectation that the taxable profits "lost" under the re-allocation to market states under Pillar 1 will be greater than any taxable profits that might be re-allocated to these states as "market" states.[94]

The two sub-groups described above have a common concern they will lose out from the Inclusive Framework Two Pillar package (though in different ways as between the two sub-groups). As a result, both sub-groups wish to oppose any change to the existing income allocation rules and typically argue that the ALP-rules are adequate.

The third (and, like the second sub-group described above, also very small) sub-group of states, also seeks to oppose the proposed changes to the existing rules, but for very different reasons. States in this sub-group oppose the Pillar 1 changes not because they go too far, but because they do not go far enough in re-allocating profits (particularly to developing states) and because of concerns about the complexity of Pillar 1 (again, particularly in so far as that is an issue for developing states). The states in this sub-group are therefore adopting a position which is like that of the states in group 1, but tougher.

Given that the first two sub-groups broadly oppose change to the existing international tax system, it is no surprise that states in these sub-groups have not made any proposals for reform in the manner of those made by states in group 1 and group 2. Neither have states in the third sub-group made any proposals for reform, although they would naturally support the proposals that have been made by states in group 1.[95]

Although group 3 states do not support the Pillar 1 package of measures, this does not necessarily mean that these states adopt a position of outright opposition. The position of the states in group 3 is therefore not necessarily reflected in the way they pledge – or withhold – support for the Inclusive Framework package. Rather, these states may consider they may be more effective if, rather than overtly opposing the proposals, they work to shape the way they are developed. For example, in the case of the first sub-group, the investment hubs, they may wish to be involved in the process of developing the rules under Pillar 1 (rather than being seen simply as adopting a contrarian position) to influence matters such as how a paying entity (or paying entity jurisdiction) is identified. In such a case, the intention would be to limit the impact of the rules on the investment hubs (which might otherwise bear the biggest cost, particularly if the relevant paying entity is identified

[94] States in this sub-group also seem less concerned about the rise in transfer pricing, permanent establishment, etc disputes between states under the existing system, possibly because the number of such disputes is more limited than it is for some of the larger economies.
[95] See the discussion earlier of the G-24, Article 12B and ATAF proposals.

by tests based on, for example, the highest return on assets or operating costs, etc). It is also true that these states may have wider policy concerns that influence their positioning, for example they may want to avoid being listed on black (or grey) lists and be seen to be a responsible member of the global tax community that is open to multilateralism rather than as uncooperative.

Similar concerns and objectives may also be relevant to the other two sub-groups. For all these states a hard-line opposition may be less effective than being involved in the process to influence the specific rules that are agreed. They therefore do reluctantly engage in the process as they recognise that if they do not, then the design of the new taxing model is less likely to be mitigated from their perspective.

4. Could a successful Pillar 2 (and a failed Pillar 1) reverse the momentum to a reallocation of taxing rights to the market?

This section considers whether an expedited and successful Pillar 2 might stall or reverse the momentum for a re-allocation of taxing rights to the market.

Despite the initial intention to treat the Pillar 1 and Pillar 2 measures as two parts of the same package of measures, there is at the time of writing more discussion about the possibility of decoupling Pillar 2 from Pillar 1 and enacting Pillar 2 on an expedited time scale. This might be possible in practice because the Pillar 2 measures are the relatively easier of the two pillars to implement.[96] It is also true that the US supports and has already progressed its own version of Pillar 2 in its domestic law. It is also possible that some states may wish to prioritise Pillar 2 given the pressure on tax revenues following the covid crisis, coupled with the relatively higher returns expected from Pillar 2 compared to Pillar 1.

At the same time, there remain formidable challenges to agreement on the detail of Pillar 1 and its implementation. For example, some challenging questions are raised by the need to identify "paying entities" to deal with the elimination of double tax and the need to deal with the intended "tax certainty" measures relating to the prevention of disputes, as well as new measures to address the resolution of outstanding disputes.[97] There also seems to be some scepticism on whether some countries could even implement Pillar 1 by 2023 given

[96] The measures are voluntary and in comparison to Pillar 1 depend to a lesser extent on achieving changes through the use of a multilateral agreement, being to a greater extent reliant on a domestic law package of measures being enacted in adopting states. See Mary C. Bennett, Contemplating a Multilateral Convention to Implement OECD Pillars 1 and 2, Tax Notes, June 11, 2021.

[97] A number of the difficulties are discussed in: J. Li, *The Legal Challenges of Creating a Global Tax Regime with the OECD Pillar One Blueprint*, 75 Bull. Intl. Taxn. 2 (2021), Journal Articles & Opinion Pieces IBFD; and Mary C. Bennett, Contemplating a Multilateral Convention to Implement OECD Pillars 1 and 2, Tax Notes, June 11, 2021.

domestic law timing issues and constitutional issues.[98] These challenges may have the effect of stalling the Pillar 1 measures or causing them to fail.

Given the points made above, it seems appropriate to address the implications of a successfully implemented Pillar 2 combined with a stalled or failed Pillar 1. Specifically, in such a case, would there likely be a fall-off in the momentum or perceived need for a reallocation of taxing rights to the market as in Pillar 1? The question is essentially asking if a sufficient "fix" for the various concerns that are regarded as besetting the international tax system could be delivered by the Pillar 2 measures alone. Obviously, if this were a likely outcome then the shift to destination would fall well short of being inexorable.

In the view of the authors, it seems very unlikely that a successful Pillar 2 (together with a failed or materially deferred Pillar 1) might stall or reverse the momentum for a re-allocation of taxing rights to the market. There are several reasons for this conclusion.

First, there is some uncertainty about how many states will adopt the Pillar 2 measures given that the adoption of those measures is not mandatory for any state.[99] Given that the historic justification for the OECD work is that states cannot deal with the problems of the international tax system by acting alone, this suggests a critical mass of states is needed to make the package effective. It is also possible some difficulties may remain with the compatibility of the Pillar 2 measures with EU law.[100]

Second, even if the Pillar 2 measures are widely adopted, the package would deliver little or no response to most of the key problems recognised in the digitalization debate to date. For example, the Pillar 2 measures do not respond to the identified nexus problem concerning the point at which economic activity in a state should properly be regarded as giving rise to a tax charge in that state. Neither would they address the issues caused by the functions-based transfer pricing rules that materially constrain the taxing ability of market states, notwithstanding the perceived participation of remote sellers in the economy of such states. Further, the problems of avoidance activities by MNEs and tax competition activities by states would be constrained within more limited parameters by the 15% minimum tax rate

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[98] For example, Japan implements domestic law only on the 1 April of each year, meaning an implementation on 1 April 2023 would lead a first year of implementation starting on 1 January 2024; the status of Australia as a federation of states would require all the states to agree on the measures; and in Sweden it would be necessary to address certain constitutional issues relating to the ceding of rights on domestic tax issues such as transfer pricing adjustments in the tax certainty process.

[99] The Pillar 2 agreement announced in July and October 2021 is for a "common approach" which means that states have agreed only to follow the design of the agreed minimum tax *if* they choose to adopt the minimum tax package. See OECD/G20 Base Erosion and Profit Shifting Project, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, 1 July 2021, at p.3.

[100] See for example Michael Devereux, François Bares, Sarah Clifford, Judith Freedman, İrem Güçeri, Martin McCarthy, Martin Simmler, and John Vella, 'The OECD Global Anti-Base Erosion Proposal', *Oxford University Centre for Business Taxation* Report, (2020); and Maarten de Wilde, Why Pillar Two Top-Up Taxation Requires Tax Treaty Modification, Kluwer International Tax Blog, 12 January 2022.

of Pillar 2 but not stopped altogether.[101] Also, all the operational problems of the ALP system (such as identifying appropriate comparables, inherent complexity, and mobility concerns, etc.) would remain, raising the obvious question why use Pillar 2 to bolster a system (the ALP system) that is currently thought to be so problematic? These issues are simply not addressed by the core income inclusion rule of Pillar 2: the default allocation of taxing rights to *parent* states does nothing to satisfy the concerns raised by *market* states (and neither are those concerns met by the newly introduced "Qualified Domestic Minimum Top-Up Tax" (QDMTT) rule which allows source states to capture additional revenue under Pillar 2).[102]

Third, if for some reason the Pillar 1 measures fail or are materially deferred, it seems very likely that many states would look to pursue alternative destination-based approaches. Most obviously, this would presumably put DSTs back on the table, a point that is emphasised by the limited time for which they are suspended pending a successful Pillar 1 implementation.[103] States may also look to other approaches, possibly based on some of the other proposals for increased market taxation that have been made, such as the proposals on Article 12B,[104] or for some sort of new digital PE, or versions of the earlier UK,

[101] See OECD/G20 Base Erosion and Profit Shifting Project, "Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy", 8 October 2021, page 4 where it is confirmed that Pillar 2 does not aim at eliminating tax competition but merely sets "multilaterally agreed limitations on it." The various points made here emphasise the fact that the Pillar 1 and Pillar 2 measures reflect two radically different (and arguably contradictory) policy directions, with neither being a substitute for the others.

[102] Broadly, the new QDMTT rule, first introduced in the Pillar 2 Rules that were released by the OECD on 23 December 2021, puts the government in the relevant "source" state at the head of the queue to collect the Pillar 2 top-up tax. The rule is explained and analysed in Michael Devereux, John Vella, and Heydon Wardell-Burrus, Pillar 2: Rule Order, Incentives, and Tax Competition, Oxford University Centre for Business Taxation, Policy Brief, 14 January 2022.

[103] The compromise agreement of 21 October 2021 between the US/UK/France/Germany/Italy/Austria/Spain makes the repeal of DSTs contingent upon the enactment of Pillar 1. See U.S. Department of the Treasury, Press Release of 21 October 2021, Joint Statement from the United States, Austria, France, Italy, Spain, and the United Kingdom, Regarding a Compromise on a Transitional Approach to Existing Unilateral Measures During the Interim Period Before Pillar 1 is in Effect, available at https://home.treasury.gov/news/press-releases/jy0419. The pressure for the continuation of DSTs is also illustrated by the comments in African Tax Administration Forum, Technical Note, The Inclusive Framework's Two-Pillar Solution to Address the Tax Challenges from the Digitalisation of the Economy, CBT/TN/08/21 (published on the 11 November 2021) at p. 6.

[104] United Nations Committee of Experts on International Cooperation in Tax Matters, Twenty-second Session, *Tax consequences of the digitalized economy – issues of relevance for developing countries: Co-Ordinator's Report*, E/C.18/2021/CRP.1 (19-28 Apr. 2021). Although Article 12B has been approved, the authors refer to it as a proposal in this article.

US or G24 proposals,[105] or a diverted profits tax ("DPT").[106] Such measures might be enacted as alternatives to a DST or in combination with a DST.

These developments seem a very likely consequence in the event of a failed or materially deferred Pillar 1. This is because, in our view, the views of many states on what is an appropriate nexus have now moved beyond the traditional nexus restriction based, broadly, on physical presence. This, in turn, might be due to some normative notion (such as one couched in terms of value creation) or due simply to the increasing recognition by states that they can readily tax remote sellers. The result seems to be that many states clearly now wish to tax on this basis. We therefore conclude that whilst the market or destination approach is currently represented by the Pillar 1 measures, that approach is not tied solely to Pillar 1 but could be delivered in various ways and would very likely be so delivered in the event of a Pillar 1 failure.

5. Conclusion – is the shift to taxation at the point of destination inexorable?

This article is intended to analyse the question whether recent and current developments relating to international tax policy signal an inexorable shift to the re-allocation of at least some taxing rights at the point of destination (market).

We note the many arguments that have been advanced in recent years in favour of a re-allocation of taxable profits to the market. The two dominant themes underlying these arguments concern varieties of a claimed "fairness" test (which is commonly advanced, though ultimately seems problematic) and a mobility/ efficiency perspective (which we consider ultimately a more persuasive test). These arguments have also been supported by a set of wider concerns about the practical operation of the ALP system. These concerns have over this period progressively come to be accepted by several OECD states (including several of the most influential OECD member states), leading to a widespread (but not universal) view that these concerns cannot be resolved or accommodated under the production/ supply side paradigm which underpins the existing ALP-based system of income allocation. In our view, these developments mark the end of the hegemonic status of the ALP (as signalled by the 2017 US tax reform, and the Inclusive Framework's Two Pillar package).

[105] These proposals were made by country delegates to the OECD in the period 2017-2019. The UK proposal was based on the approach of allocating profits to the market state based on the relevant contribution to profits from "users" in that state, whereas the US proposal was framed by reference to the contribution from a deemed marketing intangible in the market state. The G24 proposal was for the creation of a modified nexus – a significant economic presence – combined with a formulary approach to profit allocation that included an element of return to the market state. See OECD, Public Consultation Document, Addressing the Challenges of the Digitalisation of the Economy, 13 February 2019, at pp. 9-17.
[106] DPT is discussed in OECD (2018), Tax Challenges Arising from Digitalisation - Interim Report 2018: Inclusive Framework on BEPS at pp. 149-157.

We have also sought to assess the position of states by reference to what we see as three broad groupings of states. While the first two groups considered have different philosophies in terms of the basis for profit reallocation to market, ultimately both groups support a reallocation of taxing rights to market jurisdictions to a greater (group 1) or lesser (group 2) extent for the reasons discussed above.[107] They also share a belief in the shortcomings of the current ALP-based income allocation rules, though again in different measure. These two groups represent powerful blocks of states.

The main difference between group 1 and group 2 lies in the degree to which they favour a re-allocation of profits to the market state. Specifically, group 2 is more cautious about the measure of that reallocation in comparison to group 1. This means there is nothing like a multilateral consensus in favour of a full destination-based taxation model, at least for now. A partial shift to market taxation is acceptable to groups 1 and 2.

A majority of the third group of states, group 3, (which comprises the investment hubs) is not supportive of the ongoing reform but seems to accept that the pressure for such a reallocation makes it almost inevitable. This group does not want to reject outright the ongoing direction of reform because they are concerned this would cause them to be isolated outside the wider collection of states shaping the future rules. Therefore, these states may slow or circumscribe the shift to demand side taxing rights, but they do not prevent it.[108]

It is concluded there is therefore material support for (groups 1 and 2), or acceptance of (group 3), at least a partial shift of taxing rights to the market state.

Notwithstanding the above analysis, it may be asked if states might change their mind on the attractiveness of the destination approach (just as there has been a significant shift in perspectives on this matter since the BEPS project). In our view, this seems unlikely. For several states, there seems to have been a fundamental shift in thinking on two matters in particular, which is unlikely to be easily reversed. These two issues are, first, the wider recognition that a destination approach is potentially more robust and reliable than the existing production-based approach (it is less prone to avoidance activity because it does not have the same vulnerability to mobility factors). Second, for many states, wider concerns about the existing system based on the ALP seem to have become baked-in.

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[107] As noted, group 1 is represented by developing states and the existence of this group reflects the increasing power of developing countries in policy matters relating to the development of the international tax system. Group 2 includes many G20 and OECD member states. This grouping of States continues to hold significant economic and political sway at the OECD.

[108] While this grouping of states may not have significant political support, they are still a key element in the international tax architecture and will need to agree to any new market-based allocation system because they are likely to be the paying jurisdictions in this new system.

It might also be asked if the pressure for a shift to at least a partial re-allocation of taxing rights to the market might be removed or reduced in the event of a successful implementation of the Pillar 2 measures, and in the event Pillar 1 was deferred or failed. Again, that outcome seems unlikely to us. Leaving aside the current uncertainty on the take-up and implementation of Pillar 2, the Pillar 2 package of measures delivers little or no response to most of the core problems recognised in the digitalization debate to date. Further, even if for some reason the Pillar 1 measures fail or are materially deferred, it seems very likely that many states would look to pursue alternative destination-based approaches, including the re-instating of DSTs, etc. This also means that we do not consider that the momentum for an (at least partial) destination approach hinges on the successful implementation of Pillar 1. We recognise the various challenges to the implementation of Pillar 1. However, our conclusion here is not contingent on the successful implementation of the Pillar 1 measures.

For all these reasons, we conclude that the shift (meaning in practice the partial shift) to market-based taxing rights is very likely to prove inexorable.