Assessing the Flaws in the 1920s Compromise in the Times of the Burgeoning Digital Economy and the Great Lockdown

1. INTRODUCTION

The extraordinary consequences of the COVID-19 crisis mean that the world arrives at the crossroads of international tax reform with a greater sense of urgency.[1] The "Great Lockdown" has been described as the worst recession since the Great Depression and certainly is much worse than the Global Financial Crisis.[2] Most countries around the world will have largely emptied their coffers, and borrowed heavily, to fund strategies to support their businesses and workers. Back in April 2020, the International Monetary Fund (IMF) forecast[3] that the cumulative loss to global GDP over 2020 and 2021 from the pandemic crisis could be around US 9 trillion dollars, greater than the economies of Japan and Germany combined, but the latest information suggests that this is optimistic.[4] Governments will need revenue from every source and multinationals are likely to be part of a logical tax base, particularly when cross-border trade recovers, as no doubt it will.

1.1. The dominance of highly digitalised businesses over their more-traditional counterparts

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[1] International Monetary Fund (IMF) *World Economic Outlook Update A Crisis Like No Other, An Uncertain Recovery* (IMF 2020) at page 1. Global growth is projected at -4.9% in 2020, 1.9 percentage points below the Apr. 2020 World Economic Outlook (WEO) forecast. The COVID-19 pandemic has had a more negative impact on activity in the first half of 2020 than anticipated, and the recovery is projected to be more gradual than previously forecast.

[2] G. Gopinath, *The Great Lockdown: Worst Economic Downturn Since the Great Depression* (IMF 2020).

[3] Gopinath, supra n 2.

[4] IMF, supra n 1, see for the synchronised and deep downturn has led to consumption and services output dramatically falling in conjunction with decreased mobility and a severe hit to the labour market.

In many respects, the COVID-19 crisis confirms the dominance of many highly digitalised businesses in certain key areas highlighted by the effect of the pandemic. This is because many countries, to slow the rapid contraction of the virus, have imposed rules requiring self-isolation or small group isolation. Most people in such situations have become even more reliant on social media, remote and online shopping, streamed entertainment, online education and many other forms of technology-enabled connection. As one commentator has suggested, in the days of COVID-19 and “mandated shutdowns and restricted activity”, so essential is the digital method of business to staying in business, that “it’s go digital, or go dark”.[5]

1.2. Corporate tax under threat anyway from highly digitalised business models

The OECD’s analysis of corporate tax statistics shows that in 2016, corporate tax revenues (for resident and non-resident entities) accounted for 13.3% of total tax revenues on average across the 88 jurisdictions for which data is available. This figure increased from 12% in 2000 despite the overall trend of falling corporate tax rates in that period. Corporate taxation is even more important in developing countries, comprising on average 15.3% of all tax revenues in Africa and 15.4% in Latin America & the Caribbean, compared to 9% in the OECD.[6] In the traditional business models, in addition to corporate tax payments, non-resident companies employ local employees who pay employment taxes and social security contributions, while the companies themselves are responsible for property taxes (to both central and local governments), consumption taxes and environmental taxes. Corporate taxation remains important to government revenues. Corporate tax is also important from an integrity perspective. Residents have confidence in a tax system when they see multinationals paying their fair share of tax.

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[5] BDO USA, *COVID-19 is Accelerating the Rise of the Digital Economy* (BDO 2020) ; where they say: “If there were any lingering doubts about the necessity of digital transformation to business longevity, the coronavirus has silenced them. In a contactless world, the vast majority of interactions with customers and employees must take place virtually. With rare exception, operating digitally is the only way to stay in business through mandated shutdowns and restricted activity.”

The many benefits of digitalisation include business-related attributes such as increasing efficiency, productivity and positive economic changes. These features generally lead to a higher standard of living for people. The consequences of these changes are being felt in a range of different areas, having a huge social impact in its broadest sense (including such things as live streaming of terror attacks, alleged interference with the electoral process and selective exposure to self-justifying news sources), privacy law, and data protection. In the area of taxation, the changes are just as dramatic. New ways of doing business, and better ways to do existing business practices, are currently challenging, and will in the future dramatically challenge, the existing tax system. The combination of businesses using direct and indirect network effects, together with the efficiencies of that marketplace and the low cost of operation, and a global marketplace made available through the Internet, means that there is a superior way to sell goods and services for many businesses. It is an obvious point, but much of this business does not require a physical presence in a jurisdiction. Many transactions involving consumer to consumer, business to consumer, and business to business no longer need someone "on the ground" to organise the deal.

1.3. How to tax the cross-border digital economy?

The combination of taxation shortfalls, increased government spending, and the irrefutable growth in the digital economy adds impetus to resolving the most vexing question in contemporary international tax policy: how to appropriately and fairly tax the digital economy?

For a time there has been a prevailing view that the international tax rules are not fit for purpose. Originally this was driven by a variety of aggressive tax planning techniques and countries entering into or permitting, tax competition between themselves. The Action Plan on Base Erosion and Profit Shifting (BEPS), and the BEPS package itself consisting of 15 action points were agreed to by all OECD and G20 countries in November 2015. The BEPS package was designed to achieve certain fundamental changes in behaviour from both countries and multinational enterprises such as (amongst other things):

- Discouraging tax competition which had occurred based on a lack of transparency;

- Preventing the artificial location of profit where there is little or no economic activity;
- Eliminating the exploitation of loopholes or differences in countries' tax systems (cross-border arbitration).

A multilateral forum, the OECD/G20 Inclusive Framework, was been established with more than 130 countries representing over 95% of global GDP. There has been much progress made in a remarkably short period.

Notwithstanding all these cooperative and multilateral actions, the tax challenges of the digitalisation of the economy have been identified as one of the key foci of the BEPS Action Plan. The Action 1 Report includes two key conclusions:

- That the whole world economy is digitalising, and it is difficult, if not impossible, to ring-fence the digital economy; and
- That beyond BEPS (and aggressive tax planning), the digitalisation of the economy raises several challenges relating to the question on the allocation between countries of taxing rights.

This question of how to tax the digital economy is, arguably, the most difficult issue in the whole of the Base Erosion and Profit Shifting (BEPS) programme. [7] Even though the "Tax Challenges Arising from Digitalisation" were highlighted as BEPS Action 1, little progress was made in this area relative to the other 15 Actions released in 2015. The reason for this is that changes to taxation concerning the digital economy involved examining solutions which would propose changes that go right to the heart of the existing international tax framework. Because of the necessity for such seismic change, the view of most countries is that there is a clear advantage to implementing a new multilateral consensus-driven international tax framework.[8] With such change, it would be necessary to address key issues relating to the nexus of an entity in a foreign country (the fact that a non-resident enterprise requires a physical presence in a jurisdiction) and the allocation of income (what portion, if any, of the profits are attributable to the

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[7] For a history of the OECD's various reports and discussions see the BEPS Actions webpage focusing on Action 1 available at https://www.oecd.org/tax/beps/beps-actions/action1/.

[8] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (OECD Publishing 2018), at para. 407.

activities carried on in the market or source jurisdiction). As the solution to these problems comes from a radical overhaul of the international tax "architecture"[9] it is no wonder that any possible alternative has involved extensive planning and policy-making over several years. Additionally, it also involves attempting to obtain political consensus and agreement to change the fundamental basis of cross-border taxation.

Whether there is the political will to achieve this consensus has yet to be seen. The United States Treasury Secretary Steven Mnuchin indicated in a letter to four European Finance ministers in mid-June 2020 that discussions had reached an "impasse".[10] The OECD continues to work towards a multilateral solution recognising that such a solution is "long overdue"[11] and they have made it clear, according to Pascal Saint-Amans (the director of the Organization of Economic Cooperation and Development's Centre for Tax Policy and Administration), that discussions are continuing.[12]

1.4. International tax at the crossroads

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[9] OECD, supra n 7, where the heading "Change the allocation of taxing rights through a coherent and concurrent review of the profit allocation and nexus rules (Pillar 1)" it states: "The implications of these proposed solutions reach into fundamental aspects of the current international tax architecture, as they entail modifications potentially going beyond the arm's length principle and no longer constrained by physical presence requirements."

[10] S. Fleming et al., *US Upends Global Digital Tax Plans after Pulling Out of Talks with Europe* (Financial Times 2020), where the letters were sent to the Finance Ministers of the United Kingdom, France, Spain and Italy on 12 June (all of whom are members of governments which are keen to progress proposals to tax digital companies and which have advanced these proposals into planned or existing arrangements to introduce digital services taxation through a specific unilateral digital services tax (DST).

[11] OECD, *Secretary-General Angel Gurría has Reacted to Recent Statements and Exchanges Regarding the Ongoing Negotiations to Address the Tax Challenges of the Digitalisation of the Economy* (OECD 2020).

[12] I. Gottlieb, *U.S. Still Committed to Digital Tax Talks, OECD Tax Chief Says* (Bloomberg Tax 2020), where Saint-Amans confirmed "the U.S. has not walked away from the negotiation, the U.S. has not pulled out". See also OECD, *OECD Tax Talks* (OECD 2020) where it is still expected that the G 20 Finance Ministers will sign off on a developed blueprint for both Pillars One and Two by Oct. 2020.

It can thus be said that the international tax system stands poised at the crossroads of reform. This reform will either be in the format proposed by the OECD and the Inclusive Framework and representing a consensus-driven multilateral response, or we will see the introduction of more interim, or unilateral, domestic taxes. These domestic taxes vary in their design and scope, but the most common form is a group most commonly known as digital services taxes (DSTs). There is concern that a failure to obtain consensus will result in a proliferation of these DSTs around the world.[13]

This paper assesses the effectiveness of the multilateral response to identified challenges to the existing international tax framework. It is, from necessity, a rather brief format for a much larger analysis.[14] The approach taken is to detail the key features of the current international tax framework[15] before identifying seven challenges to this framework posed by the digital and modern economy.[16] In part IV, the paper describes the OECD/Inclusive Framework's multilateral solution in broad terms, before attempting to assess whether the new framework will adequately deal with the challenges posed by the digital economy. The conclusion reached is that the OECD/Inclusive Framework's solution is a very positive step on the journey to a new international tax consensus much-needed for the 2020s and beyond.

2. HOW DID WE GET HERE?

2.1. The history of the 1920s compromise

To lay some foundational groundwork for the examination of the taxation of digitalised business, it is necessary to understand a little of the history of the

[13] KPMG, *Taxation of the Digitalized Economy: Developments Summary* (KPMG 2020) which states 38 countries have implemented, or are seriously contemplating unilateral direct taxes (such as DSTs, withholding taxes or digital PEs).

[14] C. Elliffe, *Taxing the Digital Economy: Theory, Policy and Practice* (Cambridge University Press, 2021) (forthcoming).

[15] Part 2.

[16] Part 3.

original “1920s compromise”.[17] Commentators trace the current international tax regime to the model originally developed as a result of the unification of Germany and applied in double tax treaties entered into by the predecessor states of the German Empire.[18] The first international double tax agreement was concluded on 21 June 1899 between the Kingdom of Prussia and the Austro-Hungarian Empire and it dealt with the double tax issue in a way that is very familiar to us all, by allocating taxing rights to the state of domicile (which of course we now think of as residence) concerning personal taxes, and the state of source concerning business and property taxes.[19]

In the years following the First World War the world was increasingly moving from a territorial system to a worldwide residence system and at the same time increasing rates of tax. This was necessary to pay for the enormous expenditure incurred by many economies around the globe. The resultant combination of juridical double tax and high tax rates led the International Chamber of Commerce conference held in Brussels in 1920 to initiate a request to the League of Nations to address the problem of double taxation. In turn, the Financial Committee of the League of Nations asked four economists to consider the economic consequences of double taxation (from the perspective of the equitable distribution of burdens and interfering with the free flow of capital), to propose any general principles to remove the “evil consequences of double taxation” and to ascertain whether such principles were capable of application to a new international convention.[20]

It is beyond the scope of this paper to discuss the history of the 1920s compromise in detail but some key points should be made.[21] The original 1923 Report by the

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[17] M. Graetz & M. O'Hear, *The 'Original Intent' of US International Taxation,* 46 Duke L.J., page 1026 (1997).This is the terminology employed by M. Graetz & M. O'Hear in their outstanding article on the history of the US tax policy and in particular the impact of T. Adams, a professor of economics at Yale and tax advisor to the Treasury Department and Treasury's principal adviser on issues of tax policy and administration.

[18] J. Hattingh, *On the Origins of Model Tax Conventions: 19th Century German Tax Treaties and Laws Concerned with the Avoidance of Double Taxation* (J. Tiley ed, Hart Publishing 2016) Studies in the History of Tax Law; and M. Evers *Tracing the Origins of the Netherlands' Tax Treaty Network,* 41 Intertax, 375 (2013).

[19] S. Jogarajan *Preclude to the International Tax Treaty Network: 1815-1914 Early Tax Treaties and the Conditions for Action,* 31 O.J.L.S. 4, page 679 (2011).

[20] G. Bruins et al., *Report on Double Taxation submitted to the Financial Committee: Economic and Financial Commission Report by the Experts on Double Taxation – Document EFS 73 F 19* (League of Nations 1924).

[21] See chapter 1.3 *The history of the 1920s compromise,* in Elliffe, supra n 14, at para. 1.3.

four economists[22] referred to above actually concluded that an exemption from source taxation (i.e. pure residence-based taxation) was the preferred international method, but conceded that such an outcome was unlikely, given that countries would insist upon source taxation. They, therefore, proposed an allocation of taxing rights between residence and source countries, so that some items of income, such as income from rents of land, were subject to source taxation while others were not (with the result that some income would be fully subject to residence-based taxation).[23] Following on from the 1923 Report further work was performed to thrash out a compromise between source and residence taxation.[24] An expanded group of countries were added to the group of Technical Experts[25] and developments took place of great significance including the introduction of the concept of a "permanent establishment" (PE). The consequence of all of this was that business profits in the draft bilateral convention contained in the report of the Committee of Technical Experts in 1927 (the 1927 Report) would be taxable only in the source state where they possess PEs.[26] As a result of this, the allocation of taxing rights originally determined in the 1920s and adopted as the framework for the international tax system can best be viewed as "an arbitrary compromise, albeit one that has come to be accepted by large parts of the international community".[27]

2.2. Taxing remote sales under the 1920s compromise

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[22] G. Bruins et al., supra n 20.
[23] G. Bruins et al., supra n 20, at paras. 41-42.
[24] League of Nations - Technical Experts from Belgium, Czechoslovakia, France, Great Britain, Italy, Netherlands and Switzerland, *Double Taxation and Tax Evasion* (League of Nations 1925); League of Nations - Technical Experts from Argentina, Belgium, Czechoslovakia, France, Germany, Great Britain, Italy, Japan, Netherlands, Poland, Switzerland, USA, Venezuela, *Double Taxation and Tax Evasion* (League of Nations 1927); and League of Nations - General Meeting of Government Experts, *Double Taxation and Tax Evasion* (League of Nations 1928).
[25] Expanding the group from 7 to 13 members.
[26] League of Nations - Technical Experts from Argentina, Belgium, Czechoslovakia, France, Germany, Great Britain, Italy, Japan, Netherlands, Poland, Switzerland, USA, Venezuela, supra n 24, at para. 10.
[27] M. Devereux & J. Vella, *Are We Heading Towards a Corporate Tax System Fit for the 21st Century?* (Oxford University Centre for Business Taxation 2014).

How a country imposes taxation on a non-resident multinational entity conducting a highly digitalised business in another jurisdiction narrows down to the question of what taxing rights are allocated to the source jurisdiction under the current international tax framework. Digitalisation allows business activities to be carried out remotely, enabling a multinational business to operate in a reasonably comprehensive way in the other jurisdiction without maintaining a physical presence or triggering any of the other PE thresholds. This carrying on of a highly digitalised business includes processing, analysing and utilising information where these processes can be performed across the border or automatically by machines. Where multi-sided platforms are concerned, the firm usually makes its money from advertising, subscription, or most commonly, commission. Even where services must be performed in the geographic location (such as accommodation or transportation) the multisided platform allows the two end-users sufficient control to enable them to perform key tasks in the negotiation of the contract, provision of the goods or service, and receiving payment, often quite independently of the firm operating the platform. This means that the multi-sided platform firm can remain physically remote from the end-users on either side of the platform and any activities they perform. The expanding customer base which is now worldwide (distance being a limited, or no, barrier to international trade using the Internet) together with the changing roles of staff has led to significant disintermediation of entities based in the customers' jurisdiction. This removal of the trading entity (disintermediation removing the need for a subsidiary or branch in the source jurisdiction) has significantly diminished the utility of the traditional method, which required physical presence for imposing corporate income tax.

Corporate tax paid by non-resident companies *doing business* in a jurisdiction (with due acknowledgement of the difficulties in defining exactly what "doing business" is) is likely to be an important part of the overall tax take for most jurisdictions. As discussed above, many jurisdictions take the view that the international tax framework currently does not allocate taxing rights to the source state in circumstances where the multinational is carrying on what can be described as "remote sales". In other words, that source taxing rights only arise with a multinational is trading *in* rather than trading *with* a country. This principle is well expressed in the United Kingdom's document on Corporate Tax and the Digital Economy as follows:[28]

> The overall principle underpinning that framework is to tax on multinational group's profits in the countries in which it undertakes its value-generating activities, such as where major operating decisions are made and where important assets and risks are controlled.
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> That is a principle that the government continues to support. It is not, for example, believe that another country should have a general right to tax profits that are UK business generates from a product that is designed in the UK, manufactured in the UK, marketed in the UK and then sold remotely to that country's customers.
>
> Equally, it does not believe that the UK should have a general right to tax the profits that a foreign business generates for a product that is designed in another country, manufactured and marketed in that country and then sold remotely to a UK consumer.

If the 1920s compromise is no longer effectively operate to tax highly digitalised businesses operating in a source jurisdiction, described as the "vanishing ability to tax business profits" in the seven challenges part below, then perhaps other alternatives are possible. The 19th century concept of PE could be updated with something more appropriate in the light of technological developments occurring in the 21st century. One such concept which was more than flirted with by the OECD is that involving "value creation".

2.3. Taxing remote sales on the economic activity and value created in the market jurisdiction?

One of the most important and significant international tax debates is the adoption by the OECD and G20 of the mantra that "the profits are taxed where economic

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[28] Her Majesty's Treasury, *Corporate Tax and the Digital Economy: Position Paper* (Her Majesty's Treasury 2017) at para. 2.5.

activities take place and value is created".[29] This value creation principle originally was the touchstone for the BEPS project and was focused on preventing harmful tax competition, protecting corporate tax and consequently reducing (if not eliminating) aggressive tax planning by multinationals.

The European Commission expressed their view on this debate as follows:[30]

> The application of the current corporate tax rules to the digital economy has led to a misalignment between the place where the profits are taxed and the place where value is created. In particular, the current rules no longer fit the present context where online trading across borders with no physical presence has been facilitated, where businesses largely rely on hard to value intangible assets, and where user generated content and data collection have become core activities for the value creation of digital businesses.

The European Commission is articulating above the commonly held view that the international tax rules are no longer "fit for purpose". These views are largely

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[29] OECD, *OECD/G20: Base Erosion and Profit Shifting Project Explanatory Statement* (OECD 2015), at page 1.

[30] European Commission, *Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence* (European Commission 2018), at page 1.

shared by many other countries including the United Kingdom,[31] Australia[32] and New Zealand.[33]

Moving value creation from the touchstone of the BEPS project to becoming a guiding principle for taxing corporate profits has been criticised because it is a principle that has neither been widely agreed nor properly considered.[34] Commentators have justifiably criticised value creation for its vagueness and imprecision,[35] while at the same time pointing out that it could permit market or source countries to claim a share of the tax base if the impact of the market's consumer supply-based factors forms part of the creation of value, together with other infrastructural aspects such as the legal, physical and technological framework for doing business is considered. This is why Devereux and Vella argue, and they must be right, that it is not logical to, on the one hand, say that taxation should take place where value is created, and on the other hand, support the

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[31] Her Majesty's Treasury, supra n 28, at [4.2] which states "There needs to be broad international acceptance of the need to address the challenges that digital businesses create for the tax system and agreement on a process and timetable for achieving meaningful reform of the international tax framework."

[32] The Australian Government, *The Digital Economy and Australia's Corporate Tax System* (Treasury of Australia 2018), at para. 2.2; where the discussion recognises that foreign businesses have for decades operated business models where a majority of profit-generating assets and labour have been located offshore but notes "... increasing digitalisation an increasingly mobile intangible assets intensify this challenge, particularly in the sectors of the economy most affected by Digital disruption."

[33] New Zealand Inland Revenue Department, *Options for Taxing the Digital Economy: A Government Discussion Document* (Policy and Strategy of Inland Revenue 2019), at [1.4] which states "the digital economy provides many benefits to New Zealanders, and it is an important source of future growth for the country. However, it is under-taxation impacts the sustainability of Government revenues in the fairness of the tax system. It also distorts investment in favour of digital multinationals, which pay lower worldwide income tax compared with other industries."

[34] M. Devereux & J. Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System* (Oxford University Centre for Business Taxation 2017).

[35] J. Hey, *Taxation Where Value is Created and the OECD/G20 Base Erosion and Profit Shifting Initiative,* 72 Bull. Intl. Taxn. 4/5, page 203 (2018); and S. Morse, *Value Creation: A Standard in Search of a Process,* 72 Bull. Intl. Taxn. 4/5, page 197 (2018), A.J Martin Jimenez, *Value Creation: A Guiding Light for the Interpretation of Tax Treaties?,* 74 Bull. Intl. Taxn. 4/5, (2020), R.M.Kysar, *Value Creation: A Dimming Lodestar for International Taxation?,*74 Bull. Intl. Taxn. 4/5, (2020).

proposition that remote sales can never result in value being created in the source state.[36]

2.4. Radical new taxing rights allocated to the market jurisdiction-introducing the 2020s compromise

Given that the majority consensus of countries have conventionally seen the existing rules on international tax leave remote sales outside the framework of source-based taxation for foreign-owned entities making such sales to a customer in another jurisdiction, it is a truly radical step to propose new taxing rights to the market jurisdiction. The current thinking from the OECD, however, does exactly that and indicates that a new consensus may arise which would allocate more taxing rights to the jurisdiction of the consumer and/or the user: "...in situations where value is created by business activity through (possibly remote) participation in that jurisdiction that is not recognised in the current framework for allocating profits".[37]

The current OECD/ Inclusive Framework proposal suggests that a new taxing right may emerge for market or source countries simply because of the presence of the customer and/or digital user in the market jurisdiction. The most profound change in the 2020s compromise is, therefore, a movement towards destination-based taxation arising from an allocation of residual profit of a multinational enterprise to the marketplace or source jurisdiction.[38] This paper will briefly discuss how these new rules operate,[39] but to evaluate them it is first necessary to identify the major problems and challenges of the existing international tax framework.

3. THE SEVEN BIG PROBLEMS WITH THE 1920S COMPROMISE

3.1. Introduction

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[36] M. Devereux and J. Vella, supra n 34.

[37] OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* (OECD 2019), at page 23.

[38] Taxation in the place of destination rather than taxation in the place of origin.

[39] In Part 4.

This discussion identifies seven big problems with the 1920s compromise.[40] Not all these issues are exclusively concerned with the digital economy. Some have been simmering away for some considerable time. The OECD has, correctly, taken quite a broad approach in their proposals for tax reform. It is not just a case of the OECD Secretariat attempting to deal just with the consequences of the digitalisation of business in isolation from other parts of the modern economy. Rather, a key conclusion from the OECD's work is that:[41]

> ... because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes.

Recognising that it is not possible to ring-fence the digital economy means that changes to the tax system of the 1920s compromise might need to be much broader than just focus on multi-sided platforms and remote sales. Business already uses technology to a greater or lesser extent but there is an increasing trend to utilise highly digitalised business models. For example, and there are many, take the way airlines carry on the business. They provide a classic service of passenger travel, physically carrying people. This is not, at least at this stage, remotely digital. Their booking services, however, together with ticketing, boarding passes, pricing, luggage and loyalty schemes all employ highly digitalised features. Airlines also use multi-sided platforms to enable you to book other services such as hotel accommodation, rental cars, parking and taxis, none of which are directly provided by themselves. This is a good example of a modern business integrating traditional services and multi-sided platforms which can enable remote sales and the generation of income without physical presence. There is no limitation on the possibility of connecting customers on one side of the multi-sided platform (passengers *booking* airline tickets) to service or goods providers on the other side of the platform (hotel accommodation providers).

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[40] It is immediately conceded that there might be more, or less, then these seven challenges. Nonetheless, as discussed in Elliffe, supra n 14, at chapter 3.

[41] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Panel Report* (OECD Publishing 2015), at page 11.

3.1.1. The first challenge: The Vanishing Ability to Tax Business Profits

The vanishing ability to tax business profits is a compound challenge. It can be split into two components. The first is one of nexus or taxing rights. Without a taxable presence in a jurisdiction, there is no taxation under existing rules. The second component concerns the allocation of income. Even if the first challenge is overcome, it is important that a fair allocation of income occurs, so that the source or market jurisdiction receives a sensible allocation of income. As discussed above, the commonly held view is that the permanent establishment (PE) definition has not kept pace with technological developments and that a 19th-century concept is not fit for purpose in the 21st century.[42]

The first component of this challenge, namely establishing a nexus to a taxable presence, is that digitalisation allows business activities to be carried out remotely, enabling a multinational business to operate in a reasonably comprehensive way in a jurisdiction without maintaining a physical presence or triggering any of the other PE thresholds. This carrying on business includes processing, analysing and utilising information where these processes can be performed across the border or by machines automatically. The expanding customer base which is now worldwide (distance being a limited, or no, barrier to international trade using the Internet) together with the changing roles of staff has led to significant disintermediation of entities based in the customers' jurisdiction. This removal of the trading entity (disintermediation removing the need for a subsidiary or branch in the source jurisdiction) has significantly removed the traditional method of establishing a taxable nexus which required physical presence for imposing corporate income tax. As will be described in the next part of this paper, under the OECD/Inclusive Framework's Pillar One, a new taxing right (or nexus) will be established which allocates part of the residual profit of the multinational enterprise to the market jurisdiction.

Unlike the nexus issue, the second part of the challenge posed by the vanishing ability to tax business profits is not caused by a gap in the existing rules (which is

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[42] W. Schön, *10 Questions about Why and How to Tax the Digitalised Economy,* 72 Bull. Intl. Tax. 4/5, page 278 (2018).

one way to view the lack of physical presence/PE threshold problem), but more with a concern with the current international tax framework rules concerning the allocation of profits.

The allocation of profits is a twofold issue which is described below. The first and most difficult problem is trying to work out how much profit should be allocated to the market jurisdiction in respect of activities carried on by the multinational there. This is relatively uncharted territory if, and when, we have a new taxing right deemed under the introduction of the new Pillar One nexus rules. Furthermore, as this new taxing right is introduced it is also necessary to ensure that the existing rules work adequately insofar as the current transfer pricing regime allocates profits to low risk distributing entities.

The problem can be illustrated as follows: a multinational enterprise with a highly digitalised model has been making remote sales to a large consumer market. Concerned about the tax risk associated with their structure and the possibility of attack under expanded definitions of permanent establishment and the amendments to the PE article brought about by Action 7 of the BEPS Action Plan, the multinational restructures and establishes a limited risk distributor (LRD) in the large consumer jurisdiction. This local affiliate is structured so is to have no ownership interest in intangible assets, does not perform DEMPE functions, and does not assume any risks related to assets. A modest allocation of profit is allocated to this LRD entity.[43] One can immediately see that addressing the nexus problem through the allocation of an Amount A[44] must be supported by actions to deal with the allocation of profits to entities such as LRDs (referred to subsequently as “the restructuring risk”) but the issue is more fundamental, namely how much profit do you attribute to the activities carried on in the market jurisdiction? In other words, it is necessary to consider both the restructuring risk and a sensible basis for determining the fundamental taxing right so that the correct amount of profits are allocated to the market jurisdiction in circumstances where there is activity over a certain threshold justifying taxation.

[43] OECD, supra n 9, at page 13, see the description of the issue.
[44] OECD, *Public Consultation Document Secretariat Proposal for a ‘Unified Approach’ Under Pillar One* (OECD 2019), see where Amount A is an amount of taxable income allocated to the market jurisdiction under the proposals contained in Pillar One of the OECD/Inclusive Framework’s “Unified Approach” described in greater detail in Part V of this paper.

3.1.2. The second challenge: The Use of Data, the Contribution of Users, and the Measurement of their Value

How data is used and the contributions of users in highly digitalised businesses are seen as a critical part of highly digitalised businesses. This challenge is one of the most “specifically” digital challenges and it is (at least) three phenomena which are all interconnected. The first is the use of data. Technology permits the remote collection, storage and use of data. Sometimes this is subject to analysis or analytics and can occur directly with the user or indirectly through a third-party. This can sometimes be with either the express consent of the user or sometimes the consent is implicit. However it is collected, the use of data has enabled highly digitalised multinational enterprises to deliver superior customer experiences. The best example of this is a highly targeted advertising to those people who have identified themselves through their data as “great targets” for the product or service of the advertiser.

Integral to the capture and use of data is the role of the user which is the second aspect of this challenge. The activities undertaken by users have been a particular feature of some of the already implemented or planned digital services taxes (DSTs). Some jurisdictions implementing DSTs have regarded the participation of the user as a critical part of the digital services model. This is because, in many cases, such users are not under the control of the multisided platform but operating independently and yet they are still:

- contributing to the creation of the brand of the multisided platform (examples of this include quality reviews, feedback and endorsements); and
- generating valuable data through their active interaction and depth of engagement with the platform; and
- expanding the customer base through their social networks which has the effect of increasing potential users while reducing marginal costs (also known as the direct and indirect network effects).

Finally, the third part of this challenge is the difficulty in measuring what profits or value are created by these activities. Considerable complexity and uncertainty exist in this matter. Lines have been drawn between active and passive users, and some academics have helpfully commented on this.[45] In the design of the UK government's digital services tax, for instance, they excluded the mere collection of data from the scope of the tax preferring to concentrate on more active user participation and the depth of engagement of users.[46]

3.1.3. The third challenge: The Reliance on, and Mobility of, Intellectual Property

The enormous growth in many highly digitalised businesses, according to Wolfgang Schon, is attributable to two major factors.[47] The first factor is the economies of scale created by these businesses particularly as it relates to the network effect. Often this is achieved through the role of user participation in the business which is discussed above. The second major factor is the use of, or reliance upon, intellectual property which is used to analyse data and create complex algorithms (a process or set of rules to be followed in calculations or other problem-solving operations). Using intellectual property in this way to process information enables highly digitalised (and other) businesses to interact with customers in a tailored and individually responsive way. The problem from a tax perspective is that this intellectual property is extremely hard to value and can be transferred from one jurisdiction to another without a great deal of legal, financial or physical effort.

This is very problematic from a tax perspective and leads Schon to observe that:[48]

> multinational firms are therefore able to choose at will the location of central functions and value drivers, including jurisdictions which are neither the country where the ultimate consumer resides nor the country where the parent company is resident.

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[45] J. Becker & J. Englisch, *Taxing Where Value Is Created: What's 'User Involvement' Got to Do with It?* 47 Intertax. 2, page 162 (2019).

[46] Her Majesty's Treasury, *Corporate Tax and the Digital Economy: Position Paper Update* (HM Treasury, Mar. 2018) at paras. 2.37-2.40.

[47] W. Schön, supra n 42, at page 278.
[48] W. Schön, supra n 42, at page 278.

The obvious tax consequence is that intellectual property is located in, and sometimes moved to, entities based in low or no tax jurisdictions within the multinational group. As a consequence of the relocation of this intellectual property profits are shifted to such favourable tax jurisdictions.

3.1.4. The fourth challenge: The Characterisation of Transactions and Income

This challenge recognises that many new digital products and services have a question mark over their classification and this characterisation is frequently both a matter of domestic law and the definition of various categories contained in the relevant treaty. This is a broader challenge than might be first imagined. For example, the income of people called "influencers" could be characterised as business profits or income to which Article 17 might apply with dramatically different tax consequences.[49]Even if special domestic law provisions or special treaty outcomes such as that provided in Article 17 do not apply, then the more ordinary business income outcomes may not be straightforward. Accordingly, transactions might be classified as business profits (if they are regarded as the provision of goods or services), technical services (in which case some treaties may regard them in a special category as royalties, or in the alternative as ordinary services and so business profits), or royalties (this is particularly the case where the treaties define royalties to include payments for the rental of commercial, industrial or scientific equipment).

The tax treatment for these various types of characterisation differs enormously. Business profits, under the 1920s compromise, are not taxable in the source state unless there is a permanent establishment. Royalties may have domestic withholding taxes applied but they are conventionally deductible. Technical services may fall into either category (business profits or royalties) depending on both the domestic law and treaty analysis. As the OECD discussed in the 2015 Final Report on addressing the tax challenges of the digital economy,[50] there is a

[49] S. Kostikidis, *Influencer Income and Tax Treaties*, 74 Bull. Intl. Taxn. 6, (2020)
[50] OECD, supra n 41, at para. 272.

need for a careful examination of the rationale behind existing rules to ensure that there is not an arbitrary tax outcome for substantially similar transactions.

3.1.5. The fifth challenge: The Failure of Transfer Pricing with Certain Multinational Enterprises and their Transactions

The suitability of the transfer pricing regimes around the world was a key part of the BEPS project. The final report on BEPS Actions 8-10[51] contained nearly 200 pages of revisions to the OECD Transfer Pricing Guidelines.[52] Despite these substantial revisions, the overriding impression is that the changes to the transfer pricing rules post BEPS still leave much to be desired. Paul Oosterhuis and Amanda Parsons describe the application of the arm's-length standard as "plagued with difficulties and weaknesses".[53] The complexity and sustainability of the changes have been questioned,[54] their susceptibility to controversy[55] as indeed has the fundamental nature of separate entity accounting (inherent in the arm's-length standard) for its inability to "attribute the effects of integration and synergies".[56]

At the heart of these concerns is the fact that multinational enterprises that employ complex value chain structures generate profits beyond those that an independent, arm's-length and separate entity approach would realise. The profits attributable to such synergies and economic rents created from such sophisticated ways of doing business cannot, therefore, be allocated under traditional arm's-length principles and, additionally, there are no arm's-length entities to allocate them to.

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[51] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10-2015 Final Reports* (OECD Publishing 2015).
[52] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing 2017).
[53] P. Oosterhuis & A. Parsons, *Destination-Based Income Taxation: Neither Principled Nor Practical?* 71 Tax. L. Rev. page 529 (2018), where they state: "For example, the challenge of accurately pricing intangibles, the fact that the arm's-length standard does not account for efficiencies that are achieved when transactions occur on an intercompany rather than third-party basis (as described by Coase), as well as the overall complexity of applying the arm's-length standard, have each week in the application of the standard."
[54] R. Collier & J.L. Andrus, *Transfer Pricing and the Arm's Length Principle After BEPS* (Oxford University Press 2017); see chapters 7 and 8 for greater detail.
[55] J. Andrus & P. Oosterhuis, *Transfer Pricing After BEPS: Where Are We and Where Should We Be Going,* TAXES The Tax Magazine, page 104 (2017).
[56] J. Hey, supra n 35, at page 206.

This breakdown of the ability to allocate profits is the theoretical problem, but the practical issue is equally problematic. Many countries, particularly in the developing world, are deeply distrustful of the methodology regarding it more as an art than a science and one that they do not have the tools to interpret accurately. The costs involved in administering the regime and managing disputes are rapidly rising. Consequently, the likelihood of disputes and significant costs arising to both taxpayers and administrations is high.

There are concerns in many countries about the required expertise, databases and experience in dealing with complex transfer pricing matters. There are numerous transfer pricing problems particularly dealing with highly digitalised businesses, but the concern is broader than the digital economy.

3.1.6. The sixth challenge: The Inadequacy of Residence-Based Taxation

The failure of source taxation to adequately deal with the carrying on/out of digitalised businesses in a jurisdiction without establishing a nexus and hence a taxable presence[57] can be compounded by the inadequacy of residence-based taxation. Challenges created by problems in residence taxation include, first, the mobility and ease of establishing corporate residence.

International tax planning has relied, in part, on the ability to create subsidiary companies located in favourable tax jurisdictions. With careful attention to detail, it has been possible to establish such tax residence for both domestic and tax treaty purposes. Tests such as incorporation, central management and directorial control are a mixture of formal and factual elements which are often somewhat arbitrary and certainly capable of manipulation. Such residency requirements are sometimes curiously difficult to administer in practice, especially when there is a breakdown in communication between the tax director of a company and other management, resulting in unexpected outcomes and unanticipated tax risks. The usual dual resident tie-breaker test, the effective place of management, has also been the subject of criticism for its ambiguity and lack of precision.[58] Coupled with

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[57] Detailed in the first challenge above.

[58] J.Avery Jones, *2008 OECD Model: Place of Effective Management What One Can Learn from the History,* 63 Bull. Intl. Taxn. 5, page 183 (2008).

the challenges of taxing digitalised businesses in source countries due to a lack of nexus, it is easy to see why Action 1 was such a controversial and political touchstone. Multinationals operating a digital business can organise themselves so that they have historically been able to pay tax in a low tax jurisdiction through the use of subsidiaries resident in that jurisdiction.

Secondly, the ability to separate shareholder taxation from corporate taxation exposes another inadequacy in residence-based taxation. Nearly all jurisdictions impose tax on a company as separate income from the tax on distributions made to the shareholders. The reason for this is that if tax was not imposed at the corporate level there would be very limited tax paid. Although most jurisdictions provide for some form of integration or relief, corporate tax remains as a very significant contribution to total tax in the business area.[59] The challenge arising from this separation of taxation is linked to the first point above. If shareholders are not subject to tax on the profits made by the company, it is possible to ensure that there is substantial deferral. Before the recent changes in international taxation in the United States, US-based multinationals could aggregate their foreign subsidiaries earnings in relatively low tax jurisdictions without further US taxation. In many respects, much of the BEPS project was focused on multinationals doing such activities. One important mechanism to overcome this challenge is the use of controlled foreign companies (or CFC) regimes which can attribute profits from a company to shareholders.[60]

The 1920s compromise enabled large digital multinationals to establish entities (usually subsidiaries) in low/no tax jurisdictions to derive profits which were neither taxed by the country of source (no nexus), nor the country of residence of the corporation (low or no tax in that jurisdiction), nor the country of residence of the shareholders of the corporation (because of the inadequacy of controlled foreign company rules). The issues concerning residence-based taxation have been present for a significant time. So, while only the first part of this trifecta of tax phenomena (lack of source taxation) owes much to the digital economy, the growth in highly digitalised businesses has made the remaining two residence tax

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[59] R. Vann, *Taxing International Business Income: Hard Boiled Wonderland and the End of the World*, 2 W.T.J. 3, page 295 (2010), and Part I of the Appendix.
[60] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report* (OECD Publishing 2015).

issues (residence of company and shareholders) more important than they have traditionally been.

3.1.7. The seventh challenge: Competition by States.

It is easy to lose sight of an important problem with our existing international tax framework. Countries can, and do, compete with one another to attract economic activity and, sometimes, to favour domestic businesses. The problem that the BEPS Project sought to address, was in part due to the active competition of countries to attract or retain investment, and in some cases, tolerance towards legitimate, if aggressive, tax planning. For example, listed amongst a category of major BEPS Risks in the area of direct taxation in the analysis by the Directorate-General for Internal Policies which was requested by the European Parliament's Special Committee on Tax Rulings, are the preferential tax regimes including patent boxes and tax rulings.[61] The study notes:[62]

> The fact that governments create incentives and mismatching opportunities in their fiscal policies as seen by some as "healthy" tax competition by MNEs and they believe that only tax harmonisation would bring an end to it. As investors expect MNEs to maximise their post-tax earnings (and not pre-tax earnings), they find it natural that MNEs are responding to government's incentives.

The BEPS Project has seen greater cooperation from a huge number of countries who are members of the Inclusive Framework, but consistent with the above observation and the advice to the European Parliament are the comments written in 2014 by Devereux and Vella as follows:[63]

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[61] Directorate General for Internal Policies, *Tax Challenges in the Digital Economy* (European Parliament 2016) at sec. 3.4.1.
[62] Directorate General for Internal Policies, supra n 60, at page 29.
[63] M. Devereux & J. Vella, supra n 27.

> If countries acting in their own interests believe that they have an incentive to undermine the international consensus, then that international consensus cannot provide a stable long-run system. There is ample evidence that countries have been doing precisely that. Furthermore, quite beyond the current uncertainty surrounding the outcome of the OECD BEPS initiative, even if it is successful in its own terms the BEPS initiative will not eliminate these competitive forces.

It seems obvious and clear that these issues of competition and the possibility of undermining international consensus remain relevant in the current project to reform potential changes to the nexus and profit allocation rules. The OECD/G 20 are leading this project and attempting to manage members of the Inclusive Framework to undertake a coherent and concurrent review of "the profit allocation and nexus rules that would consider the impacts of digitalisation on the economy, relating to the principle of aligning profits with underlying economic activities and value creation".[64]

It does seem as though there has been some evidence of greater cooperation amongst the approximately 130 members of the Inclusive Framework but the challenges are numerous. In addition to the important technical work carried out by the OECD, there is a level of political engagement and endorsement which go beyond these technical issues and "will have an impact on revenues and the overall balance of taxing rights".[65] Any proposals and developments are made by the OECD on a "without prejudice" basis[66] meaning that there is a great deal of "wait and see" by members of the OECD/G 20 and the Inclusive Framework.

Tax competition by States is not necessarily seen as a problem by all people. It is seen sometimes as a healthy opportunity to attract investment to a jurisdiction, resulting in improving productive capacity, infrastructure, skills and output. When taken to its logical conclusion, however, tax competition can present the risk of the "race to the bottom" in corporate tax revenues. This necessarily means that

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[64] OECD, supra n 8, at para. 397.
[65] OECD, supra n 37.

[66] OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy - Policy Note* (OECD 2019), as approved by Inclusive Framework on BEPS.

the financial requirements of the state would need to come from other sources - such as consumption taxes, capital taxes and income taxes connected with labour and individual residence.[67] From the perspective of a so-called international tax framework, tax competition is a potentially destructive force because it does not encourage harmonisation or consistency.

3.2. Conclusion

The above seven challenges represent, in the view of the author, those residual issues remaining largely unresolved post the initial BEPS project. Whether they are a complete list or whether they are more, or less, serious than described is, of course, debatable. What is agreed, by the OECD/Inclusive Framework at least, is that the 1920s compromise requires some further work and they are working towards a consensus-based long-term solution in the form of what might be described logically as “the 2020s compromise”.

The Inclusive Framework approved a Policy Note on 23 January 2019 which advanced two proposals (termed pillars), both on a “without prejudice” basis:[68]

- Pillar One addresses the broader challenges of the digitalised economy and focuses on the allocation of taxing rights. To do this, there is a need to review the profit allocation and nexus rules, while raising questions of where tax should be paid (and how much) in a world where enterprises can be heavily involved in the economic life of a jurisdiction without significant physical presence.
- Pillar Two looks at the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with the ability to tax when income has been allocated (or diverted) to a jurisdiction which has a lower rate of tax.

The next part of this paper will outline the key elements of the 2020s compromise.

4. THE OECD’S MULTILATERAL SOLUTION IN A NUTSHELL

[67] Assuming the expenditure is consistent between years and ignoring the effect of the government borrowing.
[68] OECD, supra n 65.

The 2020s compromise is named by the OECD as the “unified approach” because none of the three options proposed in the Public Consultation Document could be agreed upon, but it draws upon elements of each of these three alternatives.[69] The 2020s compromise has new nexus rules, eliminating the requirement that it is necessary to have a physical presence in a jurisdiction to establish a taxing right. It also has new profit allocation rules made up of a three-tier combination of amounts developed in Pillar One (named, perhaps unimaginatively, Amounts A, B, and C). These components are related only by the fact that they are part of the same international tax compromise agreement and that they are designed to operate together as a new framework. Consequently, the three components of Pillar One and the rules in Pillar Two are aimed at different features of the international tax system.

4.1. Pillar One

Turning first to Pillar One. Amount A is the most controversial and it is focused on providing a solution to the existing problem in the 1920s compromise which has been highlighted by highly digitalised businesses such as multi-sided platforms. Accordingly, Amount A breaks new ground in proposing new taxing rights without the requirement of physical presence in the source or market jurisdiction. Amounts B and C continue to require a taxable physical presence in the source jurisdiction which has long been the case under the existing international tax framework.[70]

4.1.1. What is Amount A?

Amount A will apply to both highly digitalised businesses and consumer-facing businesses. Highly digitalised businesses are those “that provide automated and

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[69] R. Collier, *Public Consultation Meeting on the Secretariat Proposal for a ‘Unified Approach’ under Pillar One* (discussion by Richard Collier presented to an OECD Public Conference 2019); and OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy Public Consultation Document* (OECD Publishing 2019) at [11]. The three options proposed on 13 Feb. 2019 by R. Collier were the "user participation", "marketing intangibles", and the "significant economic presence" proposals.
[70] OECD, supra n 44, at para 50.

standardised digital services to a large and global customer or user base".[71] Highly digitalised businesses such as these provide their services to customers remotely using little or no local infrastructure or physical presence. The second group of "in scope" businesses are those businesses that generate revenues from selling goods or services, directly or indirectly, to consumers. These are known as "consumer-facing businesses" but under the Inclusive Framework's statement of January 2020, this group of businesses is now separated from the highly digitalised group referred to above.[72] These businesses are more traditional, less affected and disrupted by digitalisation. They manufacture and sell products through physical distribution channels as they have done for many decades. To enhance their business offering, these businesses increasingly use "digital technology to more heavily interact and engage with their customer base".[73] Accordingly, these consumer-facing businesses focus on building and sustaining relationships with individual customers, targeting their marketing and branding to these customers, frequently by collecting and exploiting individual customer data.

These in-scope businesses will have a share of deemed residual profit allocated to market jurisdictions using a formulaic approach, i.e. the new taxing right. This is calculated using the following four steps:

1. Identify the multinational group's profits;[74]
   These profits are expected to be drawn from the consolidated group financial accounts.
2. Separate out the amount of profits attributable to routine functions;[75]
   This is performed using an approach broadly consistent with rewarding routine functions performed under the residual profit split method in conventional transfer pricing.
3. Attribute a portion of the non-routine profits to the market jurisdiction;[76]
   After identifying the portion of routine profits in step two, the non-routine profits (sometimes described as residual profits) are divided up so that

[71] OECD, *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* (OECD 2020) at para. 18.
[72] OECD, supra n 71, at paras. 18–19.
[73] OECD, supra n 71, at para. 19.
[74] OECD, supra n 44, at para. 53; and largely confirmed in OECD, supra n 71, at para. 43.
[75] OECD, supra n 44, at para. 54.
[76] OECD, supra n 44, at para. 57.

factors attributable to the marketplace receive part of the non-routine profits. These factors include marketing intangibles (brand and customer loyalty, customer lists, customer data and elements related to the consumer relationship and factors associated with users' engagement, contribution and network effect). The portion of non-routine profits attributable to other factors such as trade intangibles, capital and risk would not be included within Amount A.

4. Allocate the deemed income based on the non-routine profits attributable to market jurisdictions to those eligible jurisdictions;[77]

   The final step in the calculation of Amount A involves allocating the non-routine profits attributable to market jurisdictions to the various jurisdictions based on factors, such as sales. In other words, if a company makes fifteen per cent of its worldwide sales in a certain country, they would receive fifteen per cent of the non-routine profits attributable to market jurisdictions.

As you can see from the above steps, Amount A is, therefore, a new taxing right over a portion of "in-scope" multinational groups' deemed non-routine or residual profits. The existing international tax framework rules (the 1920s compromise) will apply to the deemed routine profits applicable to the activities performed by the companies in the countries concerned.

There are several very innovative features to the new "2020 international tax compromise" concerning the deemed income under Amount A. These include:

- The creation of a new taxing right which reaches into the market jurisdiction and reflects activities (to do with marketing intangibles and the user base) carried on by certain businesses in that jurisdiction. This is a fundamental change from the position reached in the OECD Model Treaty as a result of the 1920s compromise (taxation rights did not extend to the market on the sale of goods and services but were essentially retained by the country of residence and production.

- The consequential need to change the nexus requirements for taxation so that the above new taxing right could be established even in the absence

[77] OECD, supra n 44, at para. 60.

of any physical presence in the market jurisdiction. This enables the taxation of remote sales of goods and services.

- The starting point of the multinational groups consolidated profits. This is a fundamental difference as previously the international tax system has operated on a strict separate entity accounting system attributing worldwide profits to particular entities (mostly companies) in the multinational group located in particular jurisdictions.
- The use of formulas and agreed proportions to allocate taxing rights rather than individual arm’s length computations. For example, as detailed above there is a split between routine and non-routine profits which will be agreed (perhaps on an industry by industry basis) as part of the new consensus. This purports to be broadly analogous to the existing transfer pricing rules concerning routine profits and in that sense attempts to keep a status quo with existing international transfer pricing rules. The use of agreed percentages is, however, an innovative and controversial measure but if it can be implemented it is possible to see significant improvement in reduced international compliance costs for business, easier administration by tax authorities, and the possibility of a better regime for dispute resolution.

4.1.2. What is Amount B?

The second component in the Inclusive Framework’s Statement and the OECD Secretariat’s Proposal is also controversial but for different reasons. This part of the proposal suggests making a new fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction. The fixed return reduces compliance costs and provides certainty, benefiting taxpayers and tax administrations and reducing the risk of double taxation. In essence, the quantum of income calculated under Amount B is a fixed return on either sales or earnings before tax. It is a matter of negotiation with the OECD Secretariat Proposal suggesting:[78]

[78] OECD, supra n 71, at para. 63.

> Whilst the distinction between marketing and distribution activities and others performed by an MNE group will, in most cases, be clear, there will be some borderline issues. Therefore, a clear definition of the activities that qualify for the fixed return would be required. The quantum of the fixed return could be determined in a variety of ways: it could be (1) a single fixed percentage; (2) a fixed percentage that varied by industry and/or region; or (3) some other agreed method.

It is suggested by the OECD Secretariat Proposal that the use of this simpler formulaic approach, while still being broadly consistent with the arm's length principle and the existing calculation of profits under Article 7 of the OECD Model Treaty, would overcome some of the areas where tension has increased.[79] The tensions are different for Amount A and Amount B. In the case of the former it is an intense pressure caused by non-taxation for remote highly digitalised activities. In the latter, the tensions are concerned with the lack of precision in transfer pricing and the consequential disputes arising.

4.1.3. What is Amount C?[80]

The final component in the unified approach can be regarded as a "top-up" to "correct" the outcome arrived at through the application of Amount B in situations where Amount B has been too arbitrary resulting in an unacceptable position from an arm's-length perspective. Amount C thus allows taxpayers and tax administrations to retain "the ability to argue that the marketing and distribution functions taking place in the market jurisdiction go beyond the baseline level of functionality and, therefore, warrant a profit above the fixed return contemplated under Amount B".[81]

4.2. Pillar Two

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[79] OECD, supra n 71, at para. 18.

[80] Please read this component with some care and attention to current announcements as according to a note in Tax Notes International by Ryan Finley and Stephanie Soong Johnston, entitled *New Detail on OECD's Pillar 1 Proposal Emerges in Draft Report,* Tax Notes Int'l, 6 August 2020, the draft Pillar One blueprint report does away with the concept of Amount C due to a potential for double counting income.

[81] OECD, supra n 71, at para. 30.

The second pillar of the OECD's Programme of Work,[82] which was adopted by the Inclusive Framework on BEPS at its meeting of 28-29 May 2019,[83] focuses on unresolved base erosion and profit shifting (BEPS) issues.[84] Even after the comprehensive reforms proposed by the BEPS project there was a desire amongst members of the Inclusive Framework to go further to combat the continued risk of profit shifting to entities subject to no or very low taxation. Accordingly, in the Policy Note approved by the Inclusive Framework, an agreement was reached:[85]

> … to explore on a "without prejudice" basis taxing rights that would strengthen the ability of jurisdictions to tax profits with the other jurisdiction with taxing rights supplies a low effective rate of tax to those profits.

The Policy Note highlights that the tax issues concerning problems arising from the rapidly growing digitalised economy are more than the allocation of taxing rights between residence and source countries which is the primary focus of Pillar One but extends into the "larger landscape"[86] picture where multinationals have been legitimately structuring their affairs to take advantage of no or very low taxation. Under Pillar Two, the continued risk of profit shifting is countered through two new (but inter-related) rules which "provide jurisdictions with the right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of affective taxation."[87] These new rules include an income inclusion rule and a tax on base eroding payments.

4.2.1. The income inclusion rule

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[82] OECD, supra n 8.
[83] Subsequently approved by the G20 Finance Ministers and Leaders at their respective meetings in Japan in June 2019.
[84] OECD, supra n 66, at para. 1.2, as approved by the Inclusive Framework on BEPS on 23 Jan. 2019.
[85] OECD, supra n 66, at para. 1.2.
[86] OECD, supra n 66, at para. 1.2.
[87] OECD, supra n 8, at para. 7.

The income inclusion rule extends residence-based taxation so that the income of a foreign branch or a controlled entity becomes subject to tax in circumstances where the effective rate of tax in the source jurisdiction is below a minimum rate.

In broad terms, it is envisaged that the income inclusion rule would operate as a minimum tax. It is envisaged that it would operate in a similar, but supplementary, way to a jurisdiction's controlled foreign company (CFC) rules. A shareholder in a foreign corporation which was not subject to an effective rate of tax above a minimum rate would be required to "top up" their proportionate share of the underlying foreign corporation's profits.

The effect of the income inclusion rule is to ensure that the income of the multinational group is subject to tax at a minimum rate which reduces the incentive for the group to allocate profits for tax reasons to low tax entities. Thus, according to the Pillar Two Public Consultation document:[88]

> The income inclusion rule would have the effect of protecting the tax base of the parent jurisdiction as well as other jurisdictions where the group operates by reducing the incentive to put in place intra-group financing, such as thick capitalisation, or other planning structures that shift profit to those group entities that are taxed at an effective rate of tax below the minimum rate.

4.2.2 Base erosion payments

The proposed second new rule is a tax on base eroding payments. Broadly, these types of rules operate to reduce the risk of tax-free deductible payments being made from a jurisdiction to another related party in a low tax jurisdiction. Existing examples of such rules are those contained in many domestic rules dealing with thin capitalisation, interest allocation and earnings stripping regimes, all of which are designed to place limitations on the amount of interest income allowable as an expense in the jurisdiction of the paying entity.

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[88] OECD, *Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two Public consultation document* (OECD Publishing 2019) at para. 11.

These proposals are broader and they contemplate two components:

- *an undertaxed payments rule*
  This rule would either deny a deduction for payments or impose source-based taxation such as withholding tax, in respect of any payments made to a related party where the related party does not pay tax at a minimum rate; and
- *a subject to tax rule*
  This rule would apply to tax treaties which would have the effect of only granting treaty benefits if the item of income was subject to tax at a minimum rate. While the subject to tax rule would apply to related parties, the OECD Secretariat's proposal also contemplates exploring its application to payments made to unrelated parties insofar as Articles 11 and 12 (interest and royalties) of the OECD Model Convention are concerned.[89]

5. Assessing the 2020s Compromise

5.1. Introduction

Having identified the key components of the 2020s compromise, albeit briefly, we can now analyse whether the proposed changes will have the potential to address the major challenges currently found in the existing international tax framework. Some of the proposals are designed to address particular challenges arising from the digital economy while others address wider issues. For example, one can immediately see that the proposals in Pillar One address some of the problems such as the vanishing ability to tax business profits through the lack of physical presence (and the inadequacy of the permanent establishment rules in the 21st century). Furthermore, the proposal in Pillar One also addresses how users, arguably, form a significant and integral part of a business model through their establishment of content, participation in the network effect, validation and review work as well as contributing their data.

[89] OECD, supra n 88, at para. 29.

While the proposals in Pillar One seek to address these first two significant challenges, namely the vanishing ability to tax business profits and the use of data, and the contribution of users, they also assist in two of the other challenges, namely the characterisation of transactions and income and to a certain extent the failure of transfer pricing, but there are many challenges which Pillar One does not address whereas, arguably, Pillar Two does. Overlaying the proposed solution on the challenges shows us which areas are being addressed by which proposals together with any possible omissions.

5.2. Dealing with the vanishing ability to tax business profits

The response proposed by the 2020s compromise to this problem is without a doubt the most significant new development in international tax in 100 years. Very clearly, the deemed income arising under Amount A is designed as the response to the challenges posed by highly digitalised businesses and multi-sided platforms. Amount A is the most revolutionary part of the OECD Secretariat's proposal because it posits new taxing rights without the requirement of physical presence in the source or market jurisdiction.

5.3. The nexus requirement of vanishing business profits

In simple terms, the response deals with this critical challenge. Amount A is specifically targeted at the vanishing ability to tax business profits. It does so by using formulae to allocate income to the market jurisdiction based on a portion of the residual "super profit" after the allocation of all routine profits.

To make sense of the unified approach proposal to introduce a concept such as Amount A, it is helpful to compare the approach under Amount A to the three original Inclusive Framework proposals (namely, user participation, marketing intangibles and significant economic presence).

All three proposals had the same "over-arching objective" which was:[90]

[90] OECD, supra n 69, at para. 11.

> to recognise… value created by business's activity or participation in user/market jurisdictions that are not recognised in the current framework for allocating profits.

The different solutions considered the problem from different perspectives, one emphasising the contribution made by users, another to the contribution made by marketing intangibles, whilst the third considered that sustained interaction with the jurisdiction via digital technology and other automated means could constitute a significant economic presence.

All three proposals recognise that it is possible to have active participation in a business in a jurisdiction without physical presence due to technological advancement in the business models. The characteristics of highly digitalised businesses, being able to achieve "scale without mass" through the utilisation of the network effect, the reliance on intangible assets and the role of data and user participation enable "remote" participation in a domestic economy through digital means without a taxable physical presence.[91] The OECD justify taxation on the principle that business profits should be taxed in the countries in which value is created.[92]

As previously discussed, value creation is an imprecise and difficult concept to use as a principle of taxation. Arguably, it is not a principle *per se* but it could be used as a justification for taxation (the "forgotten question" in the words of Klaus Vogel).[93] If the Inclusive Framework is seeing the value creation concept simply to justify the right to consider the taxation of entities deriving income from cross-border activities in the digital age (establishing a nexus) in the absence of physical presence, and at the same time recognising that the existing rules do not permit this due to the consequences of constraint arising from the 1920s compromise, then it is submitted this is an acceptable policy from a theoretical perspective.

One of the problems for the Inclusive Framework is that none of the three proposals were universally acceptable and hence the need to have a unified

[91] OECD, supra n 69, at para. 12.
[92] OECD, supra n 69, at para. 58.
[93] K. Vogel, *The Justification for Taxation: A Forgotten Question* 33 Am. J. Juris. 1, page 19 (1988).

approach which incorporates key features of all three individual approaches. The approach in Amount A, without ascribing a policy rationale from any one of the three alternatives, deals with the first challenge of nexus. The further refinement proposed in early 2020 which splits automated digital services and consumer-facing businesses refines this nexus requirement making the former subject to tax after meeting a revenue threshold, while the latter requires some additional requirements such as a physical presence or targeted advertising. In this respect, it is possible to see more influence in the automated digital services limb coming from the "user participation" proposal. In the alternative concerning consumer-facing businesses, one can see the influence coming from the "marketing intangibles" proposal. Amount A not only answers the challenge of nexus posed by the digitalisation of the economy, but it goes further into other businesses involved in utilising marketing intangibles with consumer-facing businesses.

5.4. The allocation of profits requirement of vanishing business profits

As the OECD notes the establishment of a new taxing right in respect of remote sales requires a new method to quantify the appropriate amount of profit reallocated to the market jurisdiction (furthermore to be split amongst the market jurisdictions if the multinational is trading in more than one jurisdiction which of course is highly likely).[94] The Programme of Work considered three separate "conceptually underpinned" methods for determining the amount of profit and loss subject to the new taxing right.[95] These are:

1. The modified residual profit split method;
2. The fractional apportionment method; and
3. Distribution-based approaches.

The modified residual profit split method (MRPS), according to the OECD:[96]

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[94] OECD, supra n 37.

[95] OECD, supra n 37, at paras. 22-35.
[96] OECD, supra n 37, at para 28.

> "allocates to market jurisdictions a portion of an MNE group's non-routine profits that reflects the value created in markets that are not recognised under the existing profit allocation rules".

The steps in the MRPS are exactly (or resemble very closely) those carried out under Amount A: (i) determine the total profit to be split; (ii) remove routine profits; (iii) determine the portion of the non-routine profits attributable to the market jurisdictions; (iv) allocate (iii) to the relevant market jurisdictions using an allocation key.

The fractional apportionment method is also represented in parts of the above steps, (particularly (i), (iii) and (iv)), allocating part of the global non-routine profits to a particular market jurisdiction using an allocation key.

The distribution-based method applies a simplified approach to specify a baseline profit in the market jurisdiction for marketing, distribution and user-related activities. The proposal in suggesting Amount B involves making a new fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction and accords with this method.

So, it is clear that Amount A has elements of these first two methods (MRPS and fractional apportionment), while Amount B utilises the third method on a distribution basis.

The challenge of allocating profits to the new taxing right is embraced by the formulation of Amount A. In allocating a proportion of these residual profits to the market jurisdiction this breaks new ground. Furthermore, the proposal relating to Amount B has numerous administrative and certainty-related benefits but also can deal with the restructuring risk (the possibility that the multinational ceases remote sales and restructures to a buy-sell arrangement with a limited risk distributor "LRD" whereby profitability is limited based on the limited functions performed by the subsidiary). This enables the international tax work framework to draw a baseline on profitability for LRD entities.

Amount A is not targeted exclusively at digital businesses but extends to customer-facing entities. This is justified on the grounds of neutrality (that it is not just highly digitalised businesses exclusively the carry on remote sales) and reflects the idea that a multinational investing in its brand in the market jurisdiction (or investing in users located in a market jurisdiction) can be subject to tax based on that activity in the market jurisdiction.

Under the current proposals, the application of Amount B to distributors is neither limited by threshold nor by activity.[97] Accordingly, this is a much more significant change than one proposed to deal with the restructuring risk referred to above. The reasons for making this change are pragmatic and driven by the business community with the trade-off of the possibility of increased tax in return for certainty and dispute prevention and resolution.

Even though the restructuring risk would necessitate something similar to the application of Amount B to LRDs involved in highly digitalised businesses, nonetheless it is clear that the wide application of Amount B goes way beyond dealing with the challenges of the digitalised economy and highly digitalised business models. It, therefore, should be seen as part of a broader 2020s compromise.

5.5. Dealing with the use of data, the contribution of users, and the measurement of their Value

One of the three proposals put forward in the Public Consultation Document for consideration by the Inclusive Framework was the user participation proposal.[98] The user participation proposal was very firmly focused on dealing with this particular user data and participation challenges. Amount A is, therefore, the component of income deemed to be derived (or allocated) to the market jurisdiction where the MNE does not have a physical presence in the jurisdiction but is carrying on a *"consumer-facing business"* in a remote manner. The OECD Secretariat's Proposal makes it clear that it is intended to address the challenge of the use, creation and valuation of data:[99]

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[97] OECD, supra n 44.
[98] OECD, supra n 97, at paras. 17-21.
[99] OECD, supra n 97, at para. 15.

> *The approach covers highly digital business models but goes wider* – broadly focusing on consumer-facing businesses with further work to be carried out on scope and carve-outs.

The Secretariat's Proposal suggests that:[100]

> These features could be said to be relevant for any business, *but they are most relevant for digital centric businesses which interact remotely with users*, who may or may not be their primary customers, and other consumer-facing businesses for which *customer engagement and interaction, data collection and exploitation,* and marketing and branding is significant, and can more easily be carried out from a remote location. *This would include highly digitalised businesses which interact remotely with users, who may or may not be their primary customers, as well as other businesses that market their products to consumers and may use digital technology to develop a consumer base.*

This deemed income in Amount A, therefore, responds to the challenge that these new digitalised businesses can successfully interact with their customers (consumers) and users without the need to establish any form of physical presence in the jurisdiction in which the customers are based.

5.6. Responding to the challenges of reliance on, and mobility of, intellectual property

The major heavy lifting on this challenge is provided by Pillar Two and not Pillar One. This is because the challenge is not so much related to the allocation of income or questions of nexus but relates to profit shifting and the location of profits. "Certain members"[101] of the Inclusive Framework believe that profit shifting occurs through the use of intangibles, as well as in other ways such as capital structure and intragroup financing. Whilst the use of intangibles to shift

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[100] OECD, supra n 97, at para. 19.
[101] OECD, supra 97, at para. 53.

profits is particularly prevalent in the digital economy, the other capital and financing activities are not so limited but extend to all multinational businesses.

Both the rules of Pillar Two can be of assistance in response to challenge the use, and mobility, of intellectual property. If intellectual property is located in a low tax jurisdiction and held by a related entity there (owned by the parent multinational), then the income inclusion rule could apply.

Alternatively, if a deduction is claimed by the multinational in respect of a royalty paid for the use of intellectual property where it is owned by a related party then the undertaxed payments rule (or the switchover rule if a treaty benefit, such as reduced withholding tax, is being utilised).

As currently proposed these rules will deal with some aspects of current concerns with the location of intellectual property in low/no tax jurisdictions. If the intellectual property is located in a high tax jurisdiction then Pillar Two will not apply.

5.7. Dealing with the characterisation of transactions and income

There does not appear to be any particular targeted work in this area by the Programme of Work, but it is interesting to reflect on the impact that both Pillar One and Pillar Two proposals will likely have on this issue. For example, where income has been characterised as business profits and previously not subject to tax because of the lack of nexus to a permanent establishment, then Amount A will lead to new taxing rights. The formulae used to determine the amount of the deemed income does not seem to be susceptible to this characterisation. Furthermore, if the income under any of these characterisations is derived by a related entity in the multinational group which is based in a low tax jurisdiction, then the income inclusion rule should apply. Additionally, where the characterisation takes the form of a deductible payment and is made to a low tax jurisdictions related party then the undertaxed payments rule may have application.

The 2020s compromise will necessitate further work and an in-depth examination of the consequences of the characterisation of transactions. At this stage, it seems that the OECD Secretariat's Proposals provide some solutions to these difficult problems of characterisation.

5.8. The Failure of Transfer Pricing with Certain Multinational Enterprises and their Transactions

Both Pillar One and Pillar Two have components that have an impact on the challenges posed by transfer pricing. Concerning Pillar One, the profit allocation rules radically depart from the existing international tax framework in several ways. These include using formulaic calculations in a modified residual profit split methodology and elements of formulary apportionment, allocating profits to the marketplace jurisdiction, ignoring the single-entity concept, and significant to this challenge, departing from the arm's length principle.

How does the 2020s proposal address the challenge of transfer pricing? We can see this in the various components as follows:

- Pillar One, Amount A: As already discussed there are two principal objectives behind Amount A, the establishment of a new nexus together with a formulaic allocation of profit to the new taxing rights suggested for the market economy. It is the second component in particular which is relevant to this discussion. The "new" allocation of profit rules suggest that a part of the non-routine residual profit should be allocated to the market in which the product or services are consumed. Amount A can be seen as quite a radical change as the existing international tax framework which has traditionally suggested that there is no entity to which an arm's-length profit can be attributed. These traditional rules would also not identify, necessarily, any functions carried on in the market jurisdiction to which profit could be allocated. Amount A controversially suggest both the new taxing right and an amount of profit determined by way of a formula which most likely will not reflect an arms-length amount of profit.
- Pillar One, Amount B: Amount B suggests making a new fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction. Amount B, it will be remembered, emerged from practical solutions proposed by business to the original public conference

on the taxation of the digital economy, and it pragmatically suggests the use of a formula or a fixed amount to determine such marketing and distribution functions. There are two major advantages to the use of Amount B - it can act as a backstop to the creation of a limited risk distributor introduced into a multinational structure to avoid the application of Amount A and at the same time, it pragmatically provides for a relatively certain fixed amount of income, potentially avoiding disputes and expensive transfer pricing documentation and advice. In any event, the use of Amount B, whilst bearing a relationship to the determination of an arm's-length amount, is likely to be a simplified formula or proxy for a more detailed calculation and so a departure from the arm's length principle.

- Pillar One, Amount C: The final component in the proposal by the OECD Secretariat is the additional amount (Amount C). This amount gives tax administrations, primarily, but also taxpayers, the ability to "correct" the outcome arrived at through the application of Amount B in situations where Amount B has been too arbitrary and come to an unacceptable position from an arm's-length perspective. Amount C can be seen therefore as a retention of the arm's length principle in certain circumstances. Some concerns have been raised that this component reopens the complexity and cost of the determination of an exact arm's-length amount.
- Pillar Two, the income inclusion rule: By introducing a requirement that income derived by entities within a controlled group (i.e. branches or subsidiaries which are related to the multinational parent) are taxed at a minimum rate, the international tax system would overcome the risk of transfer pricing profits to low tax jurisdictions. Effectively, this income inclusion rule operates as a backstop to prevent the operation of profit shifting structures or transactions to re-allocate profit to related parties in low/no tax jurisdictions. This is effectively a significant potential curtailment of aggressive tax planning using transfer pricing.
- Pillar Two, the undertaxed payments and subject to tax rules: By imposing a withholding tax (or in the case of a double tax treaty preventing favourable tax benefits of lower withholding tax rates) or denying deductions for payments made to a related entity in a low/no tax jurisdiction

the use of arm’s-length transfer pricing techniques to reduce taxable profits in higher tax jurisdictions are also impacted.

The comprehensive response across a range of different areas means that the OECD Secretariat’s proposal goes a significant way to counter the challenge of transfer pricing posed by the digital economy.

5.9. Tackling the Inadequacy of Residence-Based Taxation

Pillar One is primarily concerned with source-based taxation. Arguably, Pillar Two is primarily concerned with residence-based taxation. The income inclusion rule operates as a type of worldwide controlled foreign company regime meaning that the incentive to incorporate a subsidiary or establish a branch in a low tax jurisdiction is removed because any profits that were not subject to a minimum tax (for example 15 per cent) are required to be included in the parent company’s return and tax paid on a “top-up” basis. The consequence is that the income inclusion rule bolsters residence-based taxation and reduces the tax planning advantages of incorporating a subsidiary in a low tax jurisdiction and diverting or shifting profits to it through a variety of different techniques.

Similarly, if deductible payments are made from the parent jurisdiction to a related entity based in a low tax jurisdiction then the undertaxed payment rule or the subject to tax rule could apply. This would mean that either the payment would not be deductible or there would be withholding tax imposed (even overriding the reduced rates in a double tax agreement).

5.10. Influencing competition by states

The creation of a new taxing nexus and the allocation of taxing rights to the market or the source country might be viewed through one lens as a fundamental change to the international tax framework which is largely about the taxation of highly digitalised businesses and the vanishing ability of the source state to tax business income generated in their jurisdiction (the first challenge described in this chapter). Pillar One focuses on this issue. It may also be possible to regard this potential change to the international tax framework through the lens of tax competition. Some multinationals based in highly developed countries have currently, or previously, structured their affairs to pay virtually no tax in the source jurisdiction, and little, in their residence jurisdiction. Recent domestic legislative amendments in the United States have improved the position of that country to impose a tax on their multinationals doing business overseas.[102]

Looking at the proposed changes in Pillar One through the light of consistency in taxation, between source and residence countries, and between consumer states and developing countries as opposed to highly digitalised and developed countries with significant multinational enterprises, the proposed response in this Pillar can be seen as one addressing tax competition. That is perhaps a surprising conclusion as superficially the changes have everything to do with the allocation of taxing rights and nothing to do with tax competition per se. It is just that the allocation of taxing rights under the existing regime favours certain highly digitalised and develop jurisdictions and not others, and the response proposed by the OECD Secretariat seeks to address that imbalance.

In the case of the proposed changes in Pillar Two, it is possible to see the challenge of tax competition addressed more directly.

The income inclusion rule, which is designed to eliminate the advantages of incorporating a subsidiary in a low tax jurisdiction (or operating a branch in that jurisdiction) has the effect of bolstering the parent jurisdiction's residence-based taxation. One would expect this to reduce the opportunity for countries to offer low tax or incentive-based regimes to attract profit and investment shifting through the operation of tax competition. A multinational may not see the same advantage in operating part of their international group through a low tax jurisdiction if they are obliged to pay away some of the advantage gained through the structure to their parent jurisdiction by way of a "top-up" tax.

This is also a valid proposition for the second set of rules in Pillar Two. The undertaxed payments rule and the subject to tax rules are designed to discourage payments made to related entities in low tax jurisdictions by either disallowing the deduction or imposing withholding tax. A classic example involves a multinational

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[102] US: An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. no. 115-97, 115 Cong. The law is more commonly known as the Tax Cuts and Jobs Act1 (TCJA), was enacted in Dec. 2017:

establishing a special-purpose subsidiary to hold intellectual property and then paying deductible royalties to that entity which would enjoy both a deduction in the (high tax) parent company or operating subsidiaries whilst the royalty income was subject to low or no tax in the subsidiary. If the deduction is disallowed, or withholding tax is imposed then the benefits of the structure are largely eroded. The utilisation of such entities is likely to diminish as does the prospect of international tax competition.

5.11. Some other perspectives

This article is not intended to be a critique of the OECD Secretariat's programme of work and its resultant two Pillars. Others have written with that objective in mind pointing out areas of concern and, on occasions, omission.[103] The focus of this article is to test whether the 2020s compromise deals adequately with the problems identified, which leads us to the last concluding part of this study.

6. CONCLUSION

This paper examines the response proposed by the OECD Secretariat to the challenges to the international tax framework proposed by the digital economy. The challenges are very different. Some challenges, such as the allocation of taxing rights and the taxable nexus, are relatively recent taxation consequences arising from the enormous success of the digitalisation of the economy and the massive business advantages that occur from phenomena such as the network effect, the use of data, the role of users and the ability of a business to identify customer needs and the value of the customer to the business. Other challenges, such as some issues in tax competition and transfer pricing, are more generic and long-standing. Many of the broader challenges are addressed by Pillar Two in its broad-brush remedies against base erosion and profit shifting - a backstop to the

[103] See for instance the work of the IBFD's Task force on the Digital Economy, P. Pistone; J.F. Pinto Nogueira; B. Andrade Rodríguez; A. Turina , *The OECD Public Consultation Document "Secretariat Proposal for a 'Unified Approach' under Pillar One": An Assessment,* 74 Bull. Intl. Taxn. 1, (2020); and by the same authors,*The OECD Public Consultation Document "Global Anti-Base Erosion (GloBE) Proposal – Pillar Two": An Assessment,* 74 Bull. Intl. Taxn. 2, (2020); see also U Schreiber, *Remarks on the Future Prospects of the OECD/G20 Programme of Work – Profit Allocation (Pillar One) and Minimum Taxation (Pillar Two),* 74 Bull. Intl. Taxn. 6, (2020) and BJ Arnold, *The Evolution of Controlled Foreign Corporation Rules and Beyond,* 73 Bull. Intl. Taxn. 12, (2019).

more specific actions detailed in the 15-point Actions adopted at the end of the first BEPS round.

The overriding impression is that it is difficult to address the specific challenges posed by the digital economy without reference to the broader issues. Therefore, the proposals need to be as broad as they currently are: dealing with issues broader than those posed specifically by the digital economy.

The various proposals in Pillar One are the most far-reaching international tax reforms for 100 years. Why are they seen as being so radical? There are three major reasons (at least) why this is so:

- They revise the allocation of taxing rights. Some of the proposals allocate more taxing rights to the market or user jurisdictions. The Inclusive Framework suggests that this reallocation of taxing rights reflects situations where value is created by business activity through participation in the user or market jurisdiction that is currently not recognised in the existing rules.[104] This is controversial because the market has not traditionally been seen as a sufficient link to create a nexus for taxation.[105] The factors involved in the production of income associated with supply, rather than demand (obviously linked to the market) have historically been the factors where income has been located.
- They override the limitation on taxing rights determined by reference to a physical presence (of a person or situs). This has generally been accepted as a cornerstone of the current rules, with the definition of permanent establishment having a long-standing history dating back to the 1920s compromise. An increasing number of countries have voiced their dissatisfaction because of the failure of: [106]

> "the existing profit allocation and nexus rules [to] take into account the increasing ability of businesses, in certain situations, to participate in the economic life of a jurisdiction without an associated or meaningful physical presence."

[104] OECD, supra n 97, at page 2.
[105] OECD, supra n 69, at page 8.
[106] OECD, supra n 37, at para. 11.

- They challenge the arm's length principle. The vulnerability of the international corporate tax system is in part ascribed to "limitations of the arm's length principle" in a report to the Executive Board of the International Monetary Fund (the IMF Report).[107] Some of the proposals require a reconsideration of the current transfer pricing rules as they relate to non-routine returns, and other proposals would require modifications going beyond non-routine returns. These suggestions, "in all cases, ... would lead to solutions that go beyond the arm's length principle."[108]

No one is underestimating the difficulty of this task. This is because, first, as discussed above the Inclusive Framework are trying to revisit some long-standing and fundamental tenets of the international tax system. The existing system, for all its faults, has had a remarkably long tenure. The new solution reflects a balance between precision and practicality (remembering the wide gulf of capabilities between the largest and most developed countries and the smallest and developing countries) with a sound conceptual and logical economic basis. The rules should neither result in taxation where there is no economic profit nor result in double taxation.[109] In short, dealing with the corporate tax implications of digitalisation and new business models is potentially such a fundamental change in the tax system, that it has been described as "highly contentious, politically and intellectually".[110]

The 1920s compromise was forged in the context of the significant worldwide deficits which had arisen as a result of the First World War. There was a common need to forge an international agreement to prevent the evils of double taxation. The 2020s compromise might be forged on the anvil of the Great Lockdown as countries collectively struggle to deal with the challenges and problems exposed by the burgeoning digital economy.

[107] IMF, *Corporate Taxation in the Global Economy* (IMF 2019).
[108] OECD, supra n 66, at page 2, as approved by Inclusive Framework on BEPS.
[109] OECD, supra n 66, at page 3.
[110] IMF, supra n 107, at page 14.