taxnotes® international
Volume 105, Number 13 ■ March 28, 2022

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Reprinted from *Tax Notes International*, March 28, 2022, p. 1539

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Reallocating Taxing Rights: Is 'Market' the Answer?

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In this article, Grageda reviews the market as a choice for the allocation of taxing rights and examines some of the central issues and questions related to this option, including the new OECD pillar 1 allocation keys. He also analyzes the concept of market and the allocable tax base and examines other alternatives to distribute taxing rights that could increase the chances of achieving an equitable distribution among all countries.

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International tax law has as its main function the allocation of taxing rights among states. Traditionally, such allocation has been based on two broad dimensions: source and residence.

Recently, however, the almost century-old tax allocation regime has been under scrutiny for its alleged failure to address new business models in the digital economy. The U.N., the OECD (through the largest assembly of countries ever formed for a tax endeavor), and scholars have devised proposals to reallocate income among states. Among them, the reallocation of taxing rights to market jurisdictions has been the most popular.

Questions concerning whether such an approach is justified and fair, and whether it can be successful in improving the international tax system must be addressed. With such a revolutionary reform proposal under consideration, there should be a legal basis to rationalize it. However, if an agreement is reached out of politics — without real improvement — it is likely that such a reform will end up being obsolete again before long.

This article provides a rationale for why the current system needs to be changed. It analyzes the market as a choice for the allocation of taxing rights and discusses some of the central issues and questions related to this option, including the new OECD pillar 1 allocation keys, showing that this is also not an issue-free advancement. It analyzes what should be construed as a market, the tax base subject to allocation, and how taxing rights could be distributed to increase the chances of achieving an equitable distribution among developed, developing, and underdeveloped countries.

This article does not touch on the administrative issues or less fundamental concerns around the market as a choice. Much has been said about the administrative concerns, compliance costs, subjectivity around sourcing rules tests, and dispute resolution issues. (Stakeholder responses to the February 4 consultation of the OECD on revenue sourcing and nexus rules are examples.) Instead, this article focuses on the elements that could undermine support for using the market (as currently defined) as a basis for redistribution without necessarily making a case for changing the attempted target of reallocating taxing rights to market jurisdictions.

This article proceeds as follows: Section I covers the issues of the existing system. Section II analyzes the market as an alternative for reallocating taxing rights, the benefits of this approach, and its potential justifying principles (or lack of the same). Section III describes some central problems arising from the distribution of income on a market basis and from some of the

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new allocation keys developed by the OECD, providing some tweaks that may be worth contemplating to increase the perception of this proposal as "fair." Section IV offers conclusions.

I. Issues of Existing Tax System

The current international tax system is built around malleable notions of residence, source, and transfer pricing that can face complex issues in their application.

The activities and thresholds that give rise to a permanent establishment, a key element of source taxation, have been subject to constant abuses such as splitting activities, fictional contractual restrictions, or commissionaire arrangements. Moreover, the PE concept has been vastly criticized by developing countries as inadequate to attribute income to host countries.

Worldwide taxation by residence countries raises concerns of double taxation upon the receipt or creation of foreign income (thus making it advantageous to defer distributions). In general, it creates a bias toward the use of debt financing. On the other hand, the transfer pricing system, even after being recently revised, still offers profit-shifting opportunities.

To tackle some of these issues, the OECD's base erosion and profit-shifting project tried to better allocate the profits of multinationals by developing the principle of value creation — which states that income should be attributed to where the activities and the control of the risks take place, as opposed to where a payment is made under a contractual obligation.

Yet this principle has two basic limitations. First, if income is taxed where the activity takes place, the activity can be moved. When entities of multinational groups are treated as independent bodies and contractual arrangements between them are recognized, profit-shifting opportunities are evident[1] — a multinational will be allowed to strategically locate ownership, assets, funds, or risks to achieve a favorable allocation of taxing rights.

Second, it cannot explain the current system or assign residual[2] profits. Residence countries can tax foreign passive income with no economic activity taking place therein. Also, residual profits can easily be moved offshore because value creation only controls the distribution of normal profits, and therefore cannot be used to accurately assign residual profit to specific locations.[3]

Moreover, in today's system, formed by domestic components, countries face trade-offs between raising more revenue or becoming more appealing to investors. Such an approach incentivizes economic distortions and competition for capital and economic activity between countries, causing them to relax their antiavoidance rules or to reduce their tax rates.[4]

The system, then, operates like a wrestling environment formed by independent participants competing for routine profits with a substantial residual output that could be structured to arise offshore and go untaxed.[5] By relying too much on the contractual allocation of DEMPE (development, enhancement, maintenance, protection, and exploitation) functions, assets, and risks, the arm's-length principle is vulnerable to manipulation.[6]

Take, as an example, a group with a subsidiary in a low-tax country that hires another group entity in the United States to develop a new face recognition software, which will be incorporated into some cameras to be manufactured in Vietnam to then be sold all around the world. If risks, executive decisions, and management come from the low-tax country, minor taxes will be levied on the profits and, under current transfer pricing rules, taxation will be aligned with value creation.

Based on the foregoing, if we evaluate the existing system under the five metrics developed by professors Michael Devereux and John Vella — which include economic efficiency, robustness

[1] Michael Devereux et al., *Taxing Profit in a Global Economy* (2021).

[2] It is recognized that residual and nonroutine profits are not the same from an economic standpoint, but here are used interchangeably for practical purposes.

[3] *See* Devereux et al., *supra* note 1.

[4] *Id*.

[5] Richard Collier and Joseph L. Andrus, "Chapter 2: The Development of the ALP," in *Transfer Pricing and the Arm's Length Principle After BEPS* (2017).

[6] *See* OECD, "Addressing the Tax Challenges of the Digitalisation of the Economy — Public Consultation Document" (Feb. 2019).

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against avoidance, ease of administration, fairness, and incentive compatibility — the system almost blatantly fails all.

Economic efficiency is perhaps the feature the current tax system lacks the most. Under the current system, choices are distorted in several dimensions, including as follows: (1) the location of economic activities often depends on the tax advantages available in one country — even if activities there would have been more costly in the absence of a tax; (2) taxes influence decisions regarding legal formalities and raise the costs of capital; (3) tax systems treat salaries, dividends, and service fees differently thereby allowing these options to be selected based on convenience; and (4) debt is commonly preferred over equity.

Further, the system is not entirely robust against avoidance. The previously noted considerations and the constant adoption of general and specific antiavoidance rules verify this. It is too early to empirically evaluate BEPS, but to the extent tax is dependent on mobile factors, profit-shifting concerns will not be addressed.

Regarding administrability, considering all antiavoidance regulations, constant updates, allocation measures (for example, PE authorized OECD approach matters), information exchange needs, compliance costs, and the complexity of applying the rules, it may be said that the administrative constraints for both taxpayers and authorities are significant.

The existence of fairness is also questionable. Appraising fairness is a difficult task. Its meaning is perhaps whatever politics or any given country decides it to be at any given moment. And even when a tax seems fair at first glance, the incidence of the tax may differ with it being almost untraceable (except, at least theoretically, for taxes on economic rents).[7] Yet, in its commonsense meaning, it can be said that the current regime is not entirely fair. The biggest multinationals can get access to lower effective rates than local businesses. Current digital economy and transfer pricing rules allow for the offshore allocation of profits caused by embodied intellectual property assets,[8] giving digitalized businesses an advantage. There are chances for double taxation or double nontaxation. Wealthiest taxpayers have better access to tax arbitrage and deferral opportunities. And developing countries are disadvantaged in the allocation of worldwide income.

Finally, regarding incentive compatibility, multinationals have the incentive to shift their activities and profits to low-tax countries, and countries are motivated to increase their tax appeal before foreign investors. The system thus creates an incentive for various actors to compete with one another, therefore naturally posing a threat to its own survival.

Problems of the existing system are not limited to the world of the digital economy. Many authorities, like HM Treasury, have said that the current system does not consider the value generated by users of digital services, arguing that it is only fair to allocate taxing rights to where users are located. However, if we consider pharmaceuticals, the medical sector, financial intermediation, credit cards, newspapers, and the Internet of Things,[9] these businesses also rely heavily on user-generated content. The only difference is perhaps that these businesses do not monetize their user-generated content as easily.[10] Yet this is a matter of degree, not of principle.

Also, countries and organizations have said that digitalization made the criteria for nexus unsuitable[11] and made it possible for companies to actively engage in the economic life of a country without any taxable presence therein.[12] Others say the system is outdated because tech companies render their services or products automatically,

[7]In that case, the incidence should be on the owners of the business. *See* Devereux, "How Should Business Profit Be Taxed? Some Thoughts on Conceptual Developments During the Lifetime of the IFS," 40(4) *Fiscal Stud.* 591 (Dec. 2019).

[8]Clair Quentin, "Gently Down the Stream: BEPS, Value Theory and the Allocation of Profitability Along Global Value Chains," 13(2) *World Tax J.* 163 (July 2021).

[9]Itai Grinberg, "User Participation in Value Creation," 4 *Brit. Tax Rev.* 407 (2018).

[10]*Id*. at 409.

[11]*See* Clemens Fuest, "Chapter 4: Taxation in the Place of Value Creation: An Economic Perspective," in *Taxation and Value Creation* 89 (2020).

[12]*See* Jeffrey Owens and Gabriela Capristano Cardoso, "The Future of International Tax," *Tax Notes Int'l*, Aug. 9, 2021, p. 731.

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without any human intervention.[13] Finally, it has been argued that the digital sector has unfair competitive advantages because of its minimal tax burdens and its near effortless income-generating capabilities.[14]

However, those perceptions might not be justified. First, to operate, even digitalized businesses need a certain level of physical presence in a market. For example, many digital companies have personnel, engage in marketing activities, and use telecommunication infrastructure and terminals within that jurisdiction. Second, if no human intervention were involved, how could software or algorithms be created? Human intervention is needed just as much in the code generation process as it is needed in the design of a bottle of whiskey, a car, or a shoe.

Finally, the idea that digital companies are undertaxed is not obvious. If businesses rely less on local presence, they are less prone to be taxed in source states and more likely to be taxed in their residence states.[15] However, they are not forcibly untaxed or less taxed than traditional businesses. Perhaps the advantages are better suited to domestically implemented arrangements (for example, patent boxes).

Both digital and traditional economies share the same central issues — techniques to exploit disparity between tax systems, lack of guidelines to deal with residual profits, and an absence of an income distribution rule capable of halting avoidance practices.

Based on the foregoing, the digital debate must be left behind. The real challenge is justifying, for all business models, an alternative location of taxation. That is, we need to justify a new nexus to define which countries get an additional or new slice of the pie and how big such slice should be.

In this respect, a consideration of the most important elements of a system is necessary. Among these, three are noteworthy: fairness, economic efficiency, and robustness against avoidance. The first is a key ingredient for broad acceptance of any law or reform, and the other elements are needed to guarantee the functionality of a system that can be satisfied from a more limited utilitarian perspective.

When justifying an allocation of income in favor of markets, fairness may take precedence over the other two elements. Although it is true that what may be considered fair to one country might not be fair for another, fairness is a fundamental force behind human interaction; it can therefore serve as a driving force behind actions and structural norms. Public awareness of unfair events would prompt the public to advocate for change. By contrast, an economically inefficient aspect of a tax system would not necessarily spark the same need. The administrative costs and political barriers associated with the adoption of pillar 1, for example, cannot be overcome without fairness as their flag. Therefore, it is reasonable to consider that the prominent issue regarding market allocation should be fairness, and specifically fairness in terms of inter-nation equity.[16] A very challenging task, even more so when the reform is likely to create winners and losers.

There are four locations in which profits may be taxed: (1) the owner's place of residence; (2) the ultimate parent's residence; (3) the location of economic activities and assets; or (4) where sales are made.[17] So, between the four alternatives, what makes the market the best choice? The next section tries to answer this question. It examines whether reallocating primary taxing rights to destination countries resolves these issues; in particular, it considers whether this approach could be considered fair and whether it is capable of generating a system less subject to manipulation.

[13]European Commission, Proposal for a Council Directive Laying Down Rules Relating to the Corporate Taxation of a Significant Digital Presence, COM(2018) 147 final (Mar. 2018).

[14]Ministère de L'Économie et des Finances, Projet de loi relative àla taxation des grandes entreprises du numérique (May 2019).

[15]Matthias Bauer, "Digital Companies and Their Fair Share of Taxes: Myths and Misconceptions," ECIPE Occasional Paper 03/2018 (2018).

[16]The type of approach that would require an agreement among countries with different preferences and concepts of fairness. For a discussion of inter-nation equity, see Nancy H. Kaufman, "Fairness and the Taxation of International Income," 29 *Law & Pol'y Int'l Bus.* 145 (1997-1998).

[17]Devereux, *supra* note 7, at 596.

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II. Market as Alternative

The notion of imposing taxes at the location of consumption is as old as the VAT. However, the idea of allocating taxing rights over business profits to destination jurisdictions has been seriously entertained only recently. Although it could be said that the real driver of market-focused proposals was countries' appetite for a bigger bite of the profits of a few digital giants, their underlying rationale was sufficiently animated by the improvements it could bring into the system, specifically for economic efficiency and robustness against avoidance.

The international community has developed various proposals with the market as the banner. The destination-based cash flow tax,[18] the residual profit allocation by income (RPAI),[19] and the formulary profit split[20] are examples of the most discussed doctrine.

Further, the OECD (through pillar 1) and the U.N. (through the newly created article 12B of the U.N. model tax treaty), perhaps pondering the political boundaries and challenges that more radical reforms like digital services taxes and similar taxes could entail, have each proposed a more moderate reform to grant taxing rights to market jurisdictions.

Pillar 1, which has caught more attention, would confer a new taxing right to market or user countries and allocate part of the global profits of multinationals on the basis of a formulary apportionment. The U.N. proposal would allow the source state of the direct purchaser to withhold tax from payments for automated digital services and would provide for an alternative tax payment on a net basis. The RPAI, on the other hand, allocates all residual profits to market countries based on sales in each jurisdiction by using existing transfer pricing rules to separate residual from routine profits.

No specific criticism is developed around each of these proposals. Instead, the benefits, rationale, and legal basis for reallocating primary taxing rights to market jurisdictions is explored more generally, issues to which we now turn.

A. Benefits

The use of the market as an alternative has two principal foundations: the economic activity that already takes place in these countries,[21] and the fact that among all options to locate taxing rights, the market is the most immovable alternative and the least prone to avoidance.[22]

The reason is that, as opposed to other elements like profits, assets, or employees, the consumer's location is rather immobile, and therefore much less subject to abuse. Individuals wouldn't change their location to reduce the tax of a third party. Multinational entities wouldn't have control of the source or amount of income,[23] and the location of the MNE's affiliates or other factors would become irrelevant.

In the world of VAT, for example, there is commonly no competition between rates among countries because the VAT is levied on a destination basis. Evidence of the benefits of a tax based on destination is what happened in Europe after the VAT reform in 2015, which mandated the collection of VAT on electronically delivered business-to-consumer services in the final consumer's country of residence, as opposed to the location of the provider.

Before the reform, studies showed that multinationals in the business-to-consumer services sector reallocated their operations and reported sales in countries of convenience to benefit from lower VAT rates around the EU. Microsoft used a subsidiary in Luxembourg to charge Skype fees to European consumers. If Microsoft had charged a French customer through a French subsidiary, the after-VAT revenue would have been much lower (with a

[18] Notion first discussed by Devereux and Stephen Bond, "Cash Flow Taxes in an Open Economy," Centre for Economic and Policy Research Discussion Paper 3401 (2002).

[19] *See* Devereux et al., "Residual Profit Allocation by Income," Oxford University Centre for Business Taxation Working Paper 19/01 (2019).

[20] *See* Reuven S. Avi-Yonah, "Slicing the Shadow: A Proposal for Updating US International Taxation," SSRN (Sept. 9, 2021).

[21] This means reallocating taxing rights to market countries as jurisdictions of origin and as locations where customer-based intangibles are created and IP protected. *See* Devereux et al., *supra* note 1, at ch. 4.

[22] Jinyan Li, "The Legal Challenges of Creating a Global Tax Regime With the OECD Pillar 1 Blueprint," 75(2) *Bull. Int'l Tax'n* 84 (2021). The residence of the shareholders represents another immobile alternative, yet their residence is difficult to discern, and given how greatly divided the participation of big companies is, following this alternative is impractical. *See* Devereux, *supra* note 7, at 611.

[23] *See* Devereux et al., *supra* note 1, at ch. 4.

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French VAT rate of 20 percent), offering the same service at the same rate. The studies showed that the revenue of Microsoft's subsidiary in Luxembourg steadily declined after the VAT reform of 2015.[24]

These are powerful reasons to explore the reallocation of primary rights to market countries. However, if we do it considering only these two foundations, the reform might appear to be constructed under a purely utilitarian perspective, almost like an antiabuse rule. Along these lines, regardless of the tax principle supporting the change, if adopted in this manner, it will be apologetic as opposed to legal sustenance. In fact, no specific principle deals with the fair allocation among jurisdictions. Hence, we can only try to adapt existing principles to justify, post-facto, a shift to market jurisdictions.

B. Potential Justifying Principles

Good principle candidates to justify recalibrating the international tax system include economic allegiance, ability to pay, value creation, and the benefits principle.

Economic allegiance of business profits justifies taxation based on the nexus between those profits and the places contributing to the production of wealth[25] — the location of the "economic interest"[26] according to the four economists in 1923. Just as the 2020 pillar 1 blueprint observes, "The scope tests seek to capture those large MNEs that are able to participate in an active and sustained manner in the economic life of market jurisdictions."

However, if, as accepted by the same OECD, many MNEs have no or insignificant physical presence in a country, the customers and users would have to be seen as an extension of the MNEs through which they participate in the economic life of a country. This might be true for user or consumer inputs — for example, free labor or prosumers (that is, individuals that consume and produce), but not so much for pure buyers. Moreover, this approach emphasizes the contribution of the consumer or user, but not the market country itself. To explain that connection (MNE to market) we may need to rely on the benefits principle.

The benefits principle establishes that any person who benefits from public services should pay taxes in proportion to the amount of public services enjoyed.[27]

In this sense, it is argued that customers may be deemed to create an indirect use of the country's services on behalf of MNEs abroad — because without them consumers could not enjoy the MNE's services (for example, telecom towers, streets, cable lines, and so forth). Basically, the argument is that MNEs are using local infrastructure to provide their services to consumers. Yet tourists use those assets as well, and they are not directly taxed for using them while in the country.

The idea that companies like Uber or Airbnb are "using" the roads or real estate of a country would be misleading. The car and real estate owners are the beneficiaries of those public services. As intermediaries, the benefits absorbed by such MNEs from a jurisdiction are much lower. In that sense, there may be a disconnect between the degree of allocation of taxing rights compared with the amount of public goods enjoyed by the foreign MNE through customers. The benefits principle would not be able to explain such imbalance. Besides, the economic spillover MNEs leave in market jurisdictions through VATs, employment, and increased income taxes could already outweigh the benefits withdrawn from the country.[28]

Another approach is to compare users with natural resources like oil[29] or to regard them as productive intangible assets,[30] as if the market

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[24]For the whole analysis, see Marcel Olbert and Ann-Catherine Werner, "Consumption Taxes and Multinational Tax Planning in the Digital Age — Evidence From the European Service Sector," SSRN (Sept. 8, 2021).

[25]*See* Li, *supra* note 22, at 91.

[26]That is, production and situs of wealth and place of residence or enforcement of legal rights.

[27]Wolfgang Schoen, "Chapter 7: Value Creation, the Benefit Principle and Efficiency-Related Allocation of Taxing Rights," in *Taxation and Value Creation* 155 (2020).

[28]*See id*. at 160.

[29]"Corporate Taxation in the Global Economy," IMF Policy Paper 19/007, at 15 (Mar. 2019).

[30]Johannes Becker and Joachim Englisch, "Taxing Where Value Is Created: What's 'User Involvement' Got to Do With It?" 47(2) *Intertax* 170 (2019).

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were a source state. Yet it is difficult to see a customer as an item "produced" by a state or one whose economic capability was the result of the services provided by a state. Many customers could have derived their economic power, skills, and education from outside the relevant country.

Even if any of the aforementioned premises are accepted, the benefits principle may respond to whether an MNE can be taxed in one country, but not how much. That is, it does not answer the question of what constitutes a fair sharing of cross-border revenue.

The ability-to-pay principle, which provides that the tax burden should be distributed according to a taxpayer's economic power, is also insufficient to justify a reallocation of taxing rights to the markets. Its use in this sense could only be understood in the context of a redistribution of international welfare. However, given its nature it couldn't link a profit to any geographical point,[31] and so it wouldn't determine the location to which the taxing right should be redistributed.

Further, a principle no longer used but clearly behind the scenes of every debate, is that the allocation of taxing rights must be aligned with value creation. Prima facie value creation generally means actual business activities, like sales, workforce, payroll, and fixed assets, in contrast to the place where contractual or formal profits are booked.[32] However, in the wake of the discussion of digitalization, value creation started to become stretched and subject to a Frankenstein-like kind of transformation until it became unrecognizable. In fact, the new connotation could contradict the first one. Now, in the context of the digital economy, value creation can occur separately from where actual business activities take place.[33]

The mutated principle is based on the simple notion that value couldn't be generated without a market and therefore taxing rights must be split in favor of markets.[34] This is highly controversial for two main reasons: The customer's contribution cannot be assessed in the same way as the production side (for example, research and development or marketing), and the true value generated can be different from the price paid.

The price is a mere proxy for the value created.[35] The value to a purchaser is commonly higher. Moreover, in many scenarios the price and value will be even more distant. A person can exploit specific circumstances such as a powerful market position, and companies may have strange ways to maintain value such as destroying their excess inventory.[36]

Market could even be part of the production side under the argument that the market into which a manufacturer sells its products is a business decision and the company is assuming a risk when choosing specific markets. Moreover, common sense might argue that a consumer absorbs and consumes, rather than creates, value. Regardless, this principle is unable by nature to allocate rights outside the functions, assets, and risks.[37]

A different subdivision of this principle is that users create value — like any other employee or production asset — through their provision of free content and inputs to a firm, which are then integrated into the firm's production chain, for example, to sell advertising.[38] This would include a hotel in Dubai advertising through U.S. media platforms to potential guests in Mexico.

Although this can be perceived as more radical because it places value creation where no business activity takes place, it may have the best

[31] Xiaorong Li, "A Potential Legal Rationale for Taxing Rights of Market Jurisdictions," 13(1) *World Tax J.* 44 (Feb. 2021).

[32] *See* OECD, "BEPS Actions 8-10: Transfer Pricing."

[33] *See* Devereux et al., *supra* note 1, at ch. 3.

[34] A consortium of the biggest digital companies said in this respect that innovation and production create value, consumption does not, and that either way, a commercial transaction between a supplier and a purchaser is an exchange of value for value. *See* OECD, "BEPS Tax Challenges of Digitalisation: Comments Received on The Request for Input, Part I," at 34 (2017). The issue with that statement is that profits must come from somewhere.

[35] Werner Haslehner, "Chapter 2: Value Creation and Income Taxation: A Coherent Framework for Reform?" in *Taxation and Value Creation* 39 (2020).

[36] "Burberry Burns Bags, Clothes and Perfume Worth Millions," BBC, July 19, 2018.

[37] Richard Collier, "Chapter 6: The Value Creation Mythology," in *Taxation and Value Creation*, at 131 (2020).

[38] *See* HM Treasury, "Corporate Tax and the Digital Economy: Position Paper" (Nov. 2017).

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grounds to support a reallocation of rights under the new logic of value creation.[39] Yet others could argue that user-created information also supports an allocation to residence countries. User-created information is only valuable when it is monetized; and for that to happen, business decisions must be made and platforms or algorithms must be programmed and maintained, sometimes at considerable cost. If those decisions and costs are made in the residence state, it could make more sense to allocate taxing rights to the locations of the MNE instead of to user countries.[40]

With this background of blurry applicable principles, it may be worthwhile to simply justify market allocation based on its performance relative to economic efficiency, robustness against avoidance, and incentive compatibility, as Devereux has acknowledged. After all, our system is full of utilitarian approaches. Corporate tax is the clearest example. But one issue left to be analyzed is whether this outweighs the problems it creates and if this can be appreciated as a fair or equitable alternative.

III. Problems

The following discussion is focused only on the main issues around market allocation in general. It does not address each proposal individually and obviates any administrative or implementation issues like panel reviews, coordination and controversies among authorities, collection from nonresidents, or book-to-tax conformity problems.

A. Definition of Market and Sourcing Rules

The very first issue is what should constitute the market for purposes of an allocation.

The OECD's VAT and GST guidelines define the market as the jurisdiction in which business use or final consumption takes place. Pillar 1 defines it based on the kind of revenue-generating activity, generally making this determination on a transaction-by-transaction basis,[41] but roughly, it would include the place where the good or service is ultimately used or consumed (rather than the jurisdiction in which it was paid), where users are located, or where data or content are collected. In cases in which there is no reliable indicator, the market is determined by certain proxies or allocation keys.[42]

The U.N. proposal, on the other hand, defines market jurisdiction as the location where the payers are located. Academics, like Devereux and Vella, establish that it should be determined based on the consumer's place of residence, a more immobile location, or if not practical, the place of purchase.

Based on the foregoing, the market may depend on the location of the final or ultimate consumer, the immediate purchaser, the place of residence of the consumer, or the place where the user is located. Improvements in economic efficiency are shared by all. However, each definition has different implications.

If the market is the location of the direct purchaser, there could be incentives to sell to a low-profit or third-party intermediary purchasing entity in a low-tax country. Or there could be incentives to avoid intermediaries altogether. Pillar 1 and the RPAI, for example, mitigate this by looking through the direct purchaser. But that in turn makes administration more burdensome.[43]

Identifying customers is not easy in all business models. The OECD's newly-issued draft revenue sourcing rules attempt to address some of the main issues through a convoluted set of allocation keys, expecting them to provide a reasonable approximation of the market jurisdiction. The draft, in fact, recognizes that the commercial reality in cases particularly related to

[39] *See* "Facebook: Daily Active Users Fall for First Time in 18-Year History," BBC, Feb. 3, 2022.

[40] Li, *supra* note 31, at 47.

[41] For example, a transaction could include a click on an online advertisement. Although an approach like this could sound hugely burdensome for MNEs, source rules establish that the MNE is not required to retain data on every item and transaction; rather it is only required to have a system capable of evidencing a reasonable approach in applying a control framework to source income.

[42] *See* OECD, "Tax Challenges Arising From Digitalisation — Report on Pillar One Blueprint" (Oct. 2020); and OECD, "Public Consultation Document: Pillar One — Amount A: Draft Model Rules for Nexus and Revenue Sourcing: 4 February 2022-18 February 2022" (Feb. 4, 2022).

[43] Collier, Devereux, and John Vella, "Comparing Proposals to Tax Some Profit in the Market Country," 13(3) *World Tax J.* 5 (2021).

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third-party distribution arrangements, components, and intangible property will make it challenging and sometimes impossible for a MNE to link revenue to a specific market.

To illustrate the kinds of issues being addressed, imagine that Moët Hennessy Louis Vuitton (known as LVMH) sells champagne or bags to consumers in Latin America through an unrestricted independent distributor in Panama. Countries in Latin America should get a slice of the profit of LVMH, not of the Panama distributor. But LVMH in that case will not have any information regarding the purchasers or the income of the Panamanian distributor.

In another example, consider the oil and natural gas industry or companies that manufacture components. If those goods are used or assembled by one company and then sold to a wholesaler that will ultimately sell the final product to customers, how could these energy and manufacturing enterprises get the information to apply these rules?

Or even more relevant, at what point is a good considered "finished"? For example, chemicals produced from oil that will eventually turn into baby bottles. Pillar 1 sourcing rules would require an oil and gas company to trace the chemicals from the refining plant to where the finished product is sold.[44] Similar issues arise with digital companies providing cloud services through centralized access points in other jurisdictions or with services or intangibles used by related recipients abroad through internal agreements.[45]

In that sense, to make it possible to source income in some supply chain cases, the OECD developed regional, low-income-country, and global allocation keys to try to sort out the source of the income.

According to the pillar 1 proposed sourcing rules, an allocation key may only be used: (1) when it is permitted by the relevant sourcing rules; (2) when after reasonable steps there is no reliable indicator available; and (3) after knocking-out jurisdictions in which it could be reasonably assumed the revenue did not arise. "Reasonable steps" is a term that has yet to be defined, but it is acknowledged that, by virtue of competition or privacy reasons, there will be cases in which it is just not possible to obtain this information. The OECD published comments to its consultation on the revenue source rules on February 22; many expressed concerns about the subjectivity this entails.

Absent a reliable indicator, the income will be distributed to the region in which the independent distributor hands out the goods (regardless of the geographical proximity of the countries), based on the regional allocation key, if the MNE can demonstrate the income arising from it.

Under the regional allocation key, the revenue will be distributed in proportion to a jurisdiction's final consumption expenditure compared with the final consumption expenditure of all countries in the region, as published by the U.N. Conference on Trade and Development. Any remaining revenue will be treated as arising in a low-income-economy jurisdiction or lower-middle-income-economy jurisdiction, as defined by the World Bank, based on the low-income-jurisdiction key. Under that key, revenue is deemed to arise from a country in proportion to its share of final consumption expenditure divided by the total final consumption expenditure of all low-income or lower-middle-income economies in the world (except when the MNE demonstrates that there is no chance that income could have derived from a specific market).

Finally, if no low-income jurisdiction involvement is demonstrated, the remaining profits are distributed under the global allocation key, which would mean that the revenue would be distributed to all countries (except for the ones in which the MNE has demonstrated the revenue did not arise) in proportion to the final consumption expenditure or GDP.

In the example above, assuming no reliable indicator is identified, if LVMH can demonstrate that all income was derived from Latin America, then the regional allocation key will distribute the revenue to all countries where the independent distributor distributed the goods in proportion to their final consumption expenditures. If only part

[44] *See* answers to consultation on revenue sourcing and nexus rules — OECD, "Tax Challenges Arising From Digitalisation: Public Comments Received on the Draft Rules for Nexus and Revenue Sourcing Under Pillar One Amount A" (Feb. 22, 2022).

[45] Devereux et al., *supra* note 1, at ch. 5. *See* also Amazon's response to the consultation.

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of the income can be demonstrated as coming from that region, the rest will be allocated to all low-income countries in the world based on the low-income-jurisdiction key and, to the extent those are absent, the revenue will be allocated to all countries through the global allocation key based on their final consumption expenditures. In this regard, the rules don't mention whether the countries of the MNE should be included.

Aside from being administratively frightening, this could still favor big consumer markets (as explained in the next section). On the other hand, it could create a forecasting disadvantage for in-scope MNEs because accurate projections regarding their after-tax profitability in the medium and long term may not be possible — given that each year the proportions of final consumption expenditures may vary between countries, and therefore also the tax rates, payable income taxes, and amounts of foreign tax credits.

Moreover, there are other provisions and allocation keys in the draft sourcing rules that could be unsuitable. For example, the provisions for large business consumers source revenue based on headcount. This may not properly represent the location in which cloud services are used. The employees may only be present in jurisdictions in which there is no cloud usage and so the revenue would be sourced to jurisdictions other than where the services are used.

Even when consumers could be identified, reporting and identification systems need to be implemented to avoid the possibility of final consumers pretending they are businesses.[46] Special considerations must be made regarding the use of credit card or payment companies' information; the friction that can be caused with customers that receive information requests; contractual nondisclosure obligations; and privacy laws (for example, the EU General Data Protection Regulation).[47]

Furthermore, if the market is defined based on the tax residence of the customer, the issues around the residence concept will be inherited. This may not be an exaggeration. With the mobility issues that may arise because of the pandemic, double tax residence issues will become more common. The proposed source rules of pillar 1 appear to define residence based on the location of the business or individual (that is, the physical premises from which the business operates and, in the context of an individual, the place where an individual is habitually located). Those rules evidently share similar issues with the ones faced by the traditional residence definition rules.

Lastly, a significant issue arises from the number of detailed rules for determining the source of income that are to be administered and enforced for different categories of transactions to determine that profits were properly allocated. A fact that could taint those allocations is the perhaps simplistic but noteworthy idea that a big part of the sales of an MNE could come from tourism, which, for example, pre-COVID-19 accounted for two-thirds of luxury brand sales in Europe.[48]

B. Distributional Fairness

The notion of allocating taxing rights to market or user jurisdictions is supported by the premise that it would achieve a more egalitarian distribution of wealth between developed and developing countries. The 2020 pillar 1 blueprint establishes that the "new nexus rules intend to protect the interests of smaller jurisdictions and their desire to benefit from the new taxing right."[49] Yet transferring taxing rights to market jurisdictions may fail to do so.

This is explained by the smile-shaped value chain theory.[50] Under such theory, valued items within the production chain (such as research, development, and the design of a product) are on one end of the spectrum, and the other most valued items (such as marketing and advertising) on the other. The least valuable items, such as materially productive activities and labor, are in the middle.

[46] Devereux et al., *supra* note 1, at ch. 5.

[47] *Id*.

[48] "The Luxury Markets of France and Italy Heavily Impacted by the Ban on American Tourists," CPP Luxury (Aug. 17, 2020). *See also* "International Tourism Revenue, Percent of GDP in the European Union," The Global Economy (last accessed Feb. 25, 2022).

[49] *See supra* note 42.

[50] *See* Quentin, *supra* note 8, at 169.

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Globally, the activities up the sides of the smile curve are generally located in wealthier countries, whereas the production of raw materials, manufacturing, and other functions at the center are disproportionately located in poorer countries where manual labor is cheaper.[51] Basically, highly rewarded executives could be located in the MNE headquarters; the marketing may be located in countries with purchasing power; and the manufacturing operations could be spread all over the southern hemisphere, wherever labor costs are lower.

Evidence of this can be found in the World Bank's response to the February 2019 pillar 1 consultation, in which it observed that "while some of the jurisdictions we work with [developing economies] represent significant markets in their own right, and markets that are increasingly digital, their value by comparison to developed markets is going to be smaller because their consumers have less purchasing power" and because "production of raw materials and manufacture, is a proportionately more significant part of their economies."[52]

Therefore, if emphasis is placed on allocating taxing rights to market countries, accomplishing distributional fairness may be compromised at least in the sense it has been bragged about. In this regard, it may even promote inequity.

To counteract such effects, at least to some degree, a question arises as to whether sharing taxing rights with user countries under modified transfer pricing rules — treating users as part of the production side like any other input — may potentially leave low-income countries better off. That is, instead of including users as part of the market for residual distribution or apportionment purposes, consider them as another item in the production side of the value chain. That would give countries where users are located the right to tax an income in the same manner as it would have been payable by a multinational for those same inputs. In the end, the amount of value generated from a user base should be higher than the value received from the market, and thus greater amounts of money would be flowing to poorer countries. User-generated value should be higher because with the same data obtained by a digital company from the same number of people, it can produce any number of sales to different kinds and quality of customers in any number of markets.[53]

Some could argue that users are not controlled as employees, and therefore their activity cannot be attributed to the firm, or that users have no intention to increase the profit of the company. However, that is not obvious. Even poor reviews provide valuable information that increases the attractiveness of the platform. Regarding the first point, users can be viewed as they already are under pillar 1 and other proposals — as inputs or contributors — comparable to the service providers the company would have paid to be able to sell a product (for example, advertising). What photographers or biologists are to a documentary or a magazine, or a paid volunteer is to pharmaceutical companies, users can be to digital companies and other MNEs.

The fact that users are not paid should not be an impediment. User data could be understood as purchased in a barter-type transaction in exchange for a free service — the price of which could be close to the costs incurred to maintain the platform or to conduct studies for a particular drug. As an analogy, if a restaurant offers free playgrounds and childcare to attract parents, a digital platform like Instagram would be the restaurant, the free playground and childcare would be the service it offers, the children would be the users, and the parents would be the market country. The cost of the playground and childcare would be the amount of the allocation that could be going to user jurisdictions.

The bet here is that if users are considered part of the production chain, the share allocated to the user jurisdictions' should increase — even if they would no longer be part of the residual profits reallocation. In this regard, experts have said that the base of residual profits is expected to be generally smaller; therefore, a tax on residual profits would be more favorable to business.[54] To

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[51] *Id.*

[52] OECD, "Public Comments Received on the Possible Solutions to the Tax Challenges of Digitalisation" (2019).

[53] This is different than amount B, which is only focused on marketing and distribution activities in market jurisdictions.

[54] Stephen E. Shay, "The Deceptive Allure of Taxing Residual Profits," 75 *Bull. Int'l Tax'n* 527 (2021).

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the extent this is true, user countries may be receiving a bigger slice if users are seen as part of the production chain.

C. Choosing the Tax Base

The tax base subject to allocation to market countries can lack supportive rationale depending on the kind of profits to be distributed: routine or nonroutine.

If only nonroutine profit is subject to reallocation, it would be necessary to make a connection between the market country and the residual profits. This would be problematic because residual profits, by definition, are not directly attributable to any specific economic factor.[55] Sales are relevant for routine profits but if we want to allocate part of the residual profit to the market jurisdiction it cannot be done without a certain degree of arbitrariness[56] or without showing political bias.

The idea behind a distribution of residual profits only is that it would be painless. That is, these are high enough returns that they may be taxed without distorting pretax economic decisions.[57] If routine profits are taxed, business decisions are likely to be distorted and capital export neutrality could be hindered as market countries may have lower or higher tax rates. However, if the distribution of the tax base is limited to residual profits, the component of normal returns (by following the current regime) will be subject to the same issues discussed in Section I and thus the efficiency claims will be, at least partially, undermined.[58]

The problem is that the identification of the level of residual profits depends on the kind of return one is putting it up against — risk-free, normal, or routine.[59] Each has a different meaning with economists unable to agree on one. Since the distribution mechanism should be designed to apply to all taxpayers without distinctions for practical reasons, the deemed residual return in many cases will be wrong.[60]

Furthermore, a total allocation to markets may be unjustified because the residual profit could respond to the benefit provided by a specific country (namely, location-specific rents). Sometimes an allocation based on the factor that caused the residual benefit may be possible.

Many things can lead to residual profits: political interventions, innovations, natural monopolies, market power, scarcity caused by regulation or natural limits,[61] synergistic benefits of an integrated MNE group (for example, combined group purchasing creates market power),[62] and the level of intangible assets.

Whoever has such an edge would be expected to earn such residual returns. Hence, if the origin of the residual profit can be pinpointed to the efforts or conditions existing in one particular jurisdiction, would a total reallocation to the market country be justified? It's doubtful. Of course, granting taxing rights of residual profits derived from, say, political interventions, could reintroduce competition concerns to the system, because countries will substitute the race to the bottom for specific incentives. However, considering the particular features of the region, some advantages are just natural. For example, tequila, wine, or champagne producers get their edge at least partly from their location. Therefore, there should be grounds to not treat all residual profits the same.

The idea of allocating taxes to where the residual profit is immobile or where it clearly originated — for example, the rent earned from extracting natural resources — has been criticized in the sense that a business that extracts a resource in one country may have market power in another. However, this might not curtail the importance of the origin country. If there were other businesses extracting the same resource in

[55] Devereux et al., *supra* note 19.

[56] Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation," 15(1) *Va. Tax Rev.* 95 (1995).

[57] Shay, *supra* note 54, at 1.

[58] *Id.*

[59] Routine return is the amount necessary to compensate an unrelated person for performing routine functions. Risk-free return is the return that can be earned independently of investment or market risk. The investment is assured of being repaid. The normal return is the return above which the investor will earn the minimum necessary to cause an investor to make the investment. *Id.;* and James Mirrlees et al., "Chapter 17: Taxing Corporate Income," in *Tax by Design: The Mirrlees Review* 406 (2011).

[60] Shay, *supra* note 54, at 3.

[61] Gregor Schwerhoff, Ottmar Edenhofer, and Marc Fleurbaey, "Taxation of Economic Rents," 34(1) *J. Econ. Surv.* 401-405 (Oct. 2019).

[62] Collier and Andrus, *supra* note 5.

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the country perhaps the residual profits wouldn't even exist.

D. Other Issues

A transfer of taxing rights from residence to market countries implies that a reduction in the tax rate of the former would have a smaller impact on government revenue. Conversely, however, this implies a higher impact in the market country if its rate is higher. Therefore, if we combine the fact that the tax rates applicable are the ones of the market states, and the fact that a tax on residual profits is allegedly harmless, big market countries will have an incentive to raise their tax rates or take other unilateral action to enhance their taxing rights,[63] as it could represent easy money. In the context of pillar 1, this would increase the pressure to issue FTCs in the countries of the paying entities.

Lastly, allocating taxing rights based on the weight of sales and customers may affect internation equity for all taxes considered. The potential issue is that — considering VAT — there is a risk that the allocation overall could not be balanced.[64]

IV. Conclusion

The weakening of the old international tax regime responds not only to issues brought by the digital economy but to more fundamental issues around the operation of the current rules. This calls for a reform, with the potential to improve the system vulnerabilities independent of the political and economic interests of G-7 or G-20 countries.

In that sense, reallocating taxing rights to market countries provides a suitable answer, and from the perspective of economic efficiency and robustness against avoidance, there is just not a better candidate. However, it raises issues as to whether it would accomplish a fair and balanced distribution among *all* countries. Whether this is a fair move in the international tax arena remains to be seen. In theory, however, it appears to continue to satisfy the needs of some prominent OECD members.

Regarding principles, these may not even be worth looking into — as they would only serve as a post-facto rationale rather than a real reason to require a change. The benefits that a reform like this could bring are indeed a sufficient foundation for the more important driver — the push by some countries for a greater share of tax revenue.

However, a shift toward that path will lead us to unnavigated waters. The effects of the taxation of residual profits have yet to be seen in practice, and there are issues to consider around the tax base and the definition and role of users, aside from all the implementation issues that could require a whole different analysis.

Unfortunately, if this alternative ends up leaving an unbalanced distribution against southern hemisphere countries with more labor power than purchasing power, future reforms also will be unlikely to accommodate their interests. What we have learned from BEPS and these three years of pillar discussions is that reforms respond more to economic pressures than to normative considerations. ■

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[63] Devereux et al., *supra* note 1, at ch. 3.

[64] Haslehner and Marie Lamensch, "General Report on Value Creation and Taxation: Outlining the Debate," in *Taxation and Value Creation*, at section 1.2 (2021).

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