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Comparing Proposals to Tax Some Profit in the Market Country

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Abstract

This paper compares and contrasts three specific proposals that allocate taxing rights to market countries: the OECD's "Unified Approach" ("Pillar One"), the United Nations' "Article 12 B"; and Devereux et al.'s "Residual Profit Allocation by Income". It aims to identify the similarities and differences of these proposals, and their consequent strengths and weaknesses. More specifically, the paper has two objectives. First, we aim to identify strengths and weaknesses that are particular to each proposal. We distinguish between features that are inherent to each proposal (that cannot be altered without altering its fundamental nature) and those that are not inherent (that can be altered without altering its fundamental nature). This exercise lays the foundations for the second objective: to show how these proposals can be improved by drawing on the most useful features of each other, or how alternative proposals can be designed by combining these features.

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1. Introduction

A primary function of the international tax system is to allocate taxing rights over business profit among countries. Politically sensitive and economically consequential, the fundamentals of the current allocation have been largely fixed for a century. But recently several proposals have been made to alter it. The common feature of these proposals is that they all seek to increase the taxing rights of the market country. We define the "market" country broadly as the location of either the direct or indirect purchaser (where the purchaser could be a business or an individual) of a good or service, or the user of certain digital platforms ("user");[1] we identify where there is an important distinction between these concepts and what they imply for the location of a market.

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[1] Users of certain digital platforms, such as social media platforms, search engines and online marketplaces are thought to create value for the businesses operating these platforms through their engagement and active contribution. See, for example, the discussion in HM Treasury, *Corporate tax and the digital economy: position paper*, November 2017, and HM Treasury, *Corporate tax and the digital economy: position paper update*, March 2018 ("Updated Position Paper"), both available at https://www.gov.uk/government/consultations/corporate-

This paper sets out to compare and contrast three specific proposals. The most well-known and most detailed of these proposals for reform is the OECD's "Unified Approach", or "Pillar One" ("P1"), which was agreed by 132 members of the Inclusive Framework in July 2021.[2] At the time of writing the most extensive version of this proposal was published in October 2002, and ran to 230 pages, but the brief statement released in July 2021 announcing the agreement ("July 2021 Statement") included some notable changes,[3] The statement only set out agreement on the headline points, with much technical detail – including on issues discussed in this paper - still to be resolved. The second is a new Article 12 B ("Article 12 B") which was approved in April 2021 by the UN Committee of Experts on International Cooperation in Tax Matters together with accompanying Commentary for inclusion in the 2021 version of the UN Model Tax Convention.[4] The third proposal discussed in detail in this paper is the Residual Profit Allocation by Income proposal ("RPAI"), as set out by Devereux et al (2019, 2021).[5] These proposals are not exclusive: a number of other proposals have also been made, as well as several variants of these, including proposals similar to those considered as part of the Inclusive Framework discussions,[6] or the UN proposal,[7] and proposals that reform the system more comprehensively.[8] However, focusing on these three proposals permits us to identify the key issues that arise in moving taxing rights in the direction of the market. We refer to other proposals where that is useful. In addition, Digital Services Taxes ("DSTs") will be used throughout as a useful reference point to the discussion,

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[2] This proposal combines and supersedes three proposals in a broadly similar vein put forward by the US (the "Marketing Intangibles" proposal), the UK (the "User Participation" proposal) and the G24 (the "Significant Economic Presence" proposal).

[3] OECD (2020) "Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint", OECD Inclusive Framework on BEPS, OECD (2021), "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy", OECD Inclusive Framework on BEPS.

4 United Nations Committee of Experts on International Cooperation in Tax Matters Twenty-second Session, Tax consequences of the digitalized economy – issues of relevance for developing countries, Co-Ordinator's Report 19-28 April 2021. E/C.18/2021/CRP .1. Although Article 12 B has been approved, we refer to it as a proposal in this paper.

5 Devereux, Michael, Alan Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön and John Vella (2019) "Residual Profit Allocation by Income", *Oxford University Centre for Business Taxation Working Paper WP19/01*; and by the same authors (2021)"Taxing Profit in a Global Economy, Oxford University Press.

[6] Becker, Englisch and Schanz, "A SURE way of taxing the digital economy", *Tax Notes International*, January 21, 2019, p. 309; Hongler and Pistone (2015), "Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy", *IBFD White Papers;* Graetz," A Major Simplification of the OECD's Pillar 1 Proposal", *Tax Notes Federal*, Vol. 170, January 11, 2021; Grinberg, "Design of scope limitations for OECD Pillar 1 work", *Tax Notes Federal*, June 15, JUNE 15, 2020.

[7] Brauner, Y., & Baez, A. (2015). Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy. *IBFD Whitepaper*.

[8] See for example, Avi-Yonah, Reuven S., Kimberly A. Clausing and Michael C. Durst (2009) "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split", *Florida Tax Review* 9, 497–553; Luckhaupt, Hagen, Michael Overesch and Ulrich Schreiber (2012) "The OECD Approach to Transfer Pricing: A Critical Assessment and Proposal", in Wolfgang Schön and Kai Konrad, eds., Fundamentals of Transfer Pricing in Law and Economics, Berlin and Heidelberg: Springer-Verlag, 91–121; and Schreiber, Ulrich and Fell, Lisa Maria (2017) "International Profit Allocation, Intangibles, and Sales-Based Transactional Profit Split", *World Tax Journal* 9, 1–18.

particularly as the various proposals that are currently being considered are partly intended to overcome the perceived downsides of DSTs.

While the proposals are broadly similar in *what* they seek to achieve, they differ, even significantly, in *why* and *how* they seek to achieve it. This paper addresses primarily the latter question. It largely sets aside the different rationales spurring, and the principles guiding, these proposals.[9]

Instead, the paper focuses on the design. In this, the three proposals have similar features, but they also differ significantly, including in their mechanisms, their interaction with the existing system and their implementation. These differences in design revolve around two issues at the heart of the three proposals, and, indeed, any proposal with the objective of reallocating taxing rights to market countries: the allocation of primary taxing rights to the market country, and the possible consequent adjustment of taxing rights in other countries.[10]

By examining these three proposals side-by-side this paper aims to identify their similarities and differences, and their consequent strengths and weaknesses. More specifically, the paper has two objectives. First, we aim to identify strengths and weaknesses that are particular to each proposal. We distinguish between features that are inherent to each proposal (that cannot be altered without altering its fundamental nature) and those that are not inherent (that can be altered without altering its fundamental nature). This exercise lays the foundations for the second objective: to show how these proposals can be improved by drawing on the most useful features of each other, or how alternative proposals can be designed by combining these features.

The paper proceeds as follows. Section 2 addresses some preliminary issues. It introduces in more detail the notion of "market" countries, briefly describes the three proposals, and sets out the evaluative criteria that we use in assessing their strengths and weaknesses. It also considers the strengths, weaknesses, and trade-offs of seeking reform on a unilateral, bilateral, and multilateral basis. Finally, it briefly raises the question of the extent to which

[9] Stated rationales vary. Some purport to identify "value" created in the country of the market (or more specifically the user), which it is claimed is not adequately taxed under the existing system, especially in the context of a digitalised economy. Different concepts of fairness have been used to justify a reallocation of taxing rights, although it is possible that such justifications are ad-hoc rationales for increasing the taxing rights of certain countries. A different approach is that allocating taxing rights to market countries is justified by the more prosaic rationale that there are benefits in allocating taxing rights to locations where relative immobile factors such as consumers and users are located. See Devereux et al (2021).

[10] Under public international law countries have the right to tax profit if they have a sufficient nexus with the person who earns the profit or the activity which generates it. In this sense, market countries already have a right to tax business profit. However, they are not allocated taxing rights over business profit under the existing system. Technically, this is because they have already agreed to cede primary taxing rights under the treaty or forego them under domestic law. In a strict sense, therefore, these proposals do not "create new taxing rights for market countries", but we use this and similar phrases in this paper to mean that they adjust the allocation of primary taxing rights in favour of market countries.

juridical double taxation (namely, double taxation which accrues where two jurisdictions seek to tax the same income of one person) is problematic. Section 3 analyses in more detail the allocation of taxing rights to market countries, including how much is to be taxed in these countries, what base is used to calculate the amount, and how the tax is collected. Section 4 analyses whether, and if so how, the different proposals prevent the double taxation of profit, by adjusting some of the current allocation of taxing rights. Sections 3 and 4 also apply the criteria set out in Section 2 to these respective features of the proposals. Section 5 considers ways in which these proposals can be improved, or new approaches developed, by combining different aspects of the proposals. Section 6 concludes.

2. Preliminaries

In this section we very briefly summarise the three proposals discussed in this paper.[11] We then set out and briefly discuss two important dimensions on which they differ: (a) how they seek to define the "market" country; and (b) whether the proposals could be – or are intended to be – implemented on a unilateral basis, as part of a bilateral tax treaty, or would require a multilateral approach. We briefly set out criteria by which we propose to evaluate the three proposals and related options, and finally, question the view that juridical double taxation is necessarily problematic.

2.1. The three proposals

2.1.1. The OECD's Unified Approach ("P1")

The Pillar One Blueprint published in October 2020 – subject to the changes announced in the July 2021 Statement - is by far the most detailed of the proposals discussed in this paper. The current proposal would apply only to MNEs with global turnover above 20 billion euros and profitability above 10%.[12] . The proposal would modify the existing international tax system, by adding a new taxing right to market countries. The taxing right would be based on a portion of the deemed "residual" (or non-routine) profit that is regarded as arising from the "sustained and significant" participation by the MNE concerned in market countries. The amount of the allocable profit is determined based on the consolidated financial statements of the MNE group and based on a profitability metric which deducts a fixed, and rather

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[11] The discussion on the precise form of the P1 proposal is ongoing and the precise form of the proposals may change.

[12] The July 2021 Statement explains that the turnover threshold is to be reduced to 10 billion euros, contingent on successful implementation including of tax certainty on Amount A, with the relevant review beginning 7 years after the agreement comes into force, and the review being completed in no more than one year. Extractives and Regulated Financial Services are excluded from the scope of P1. An empirical assessment of the consequences of alternative scoping rules for P1 is provided by Devereux, Michael and Simmler, Martin (2021) "Who will pay Amount A?", EconPol Policy Brief.

arbitrary, proportion of gross revenues (10%) to reward the "routine" activities within the group as well as further dividing the remaining residual profit between the portion allocable to market countries (20-30%) and the portion deemed to be allocable to other factors (such as capital and risk).[13] The amount allocable to market countries is referred to as "Amount A". This is divided between market countries based on the proportion of revenues that are deemed to be sourced in any particular state. Depending on the nature of the good or service being sold, the "market" may be taken to be either the location of the direct or indirect purchaser of the good or service, or the user.

As the new taxing right is designed to operate alongside the existing rules on income allocation based on the arm's length principle (ALP), this proposal also seeks to make an adjustment to the existing allocation to ensure that the new Amount A is not taxed twice. This would be based on identifying an entity in which residual profit is deemed to be allocated under the existing system and which has sufficient taxable capacity. Priority would be given to entities that had some connection to the market itself.

The proposal also includes a package of measures that are designed to improve the prevention and resolution of disputes (both in respect of the new taxing right and the existing system).[14] The proposal also includes measures that would introduce a fixed return for certain baseline marketing and distribution activities, though these measures are not discussed further here.

2.1.2. The United Nation's Article 12 B proposal ("Article 12B")

The UN's proposal is for a new Article 12B to be inserted into tax treaties. The new provision would apply to cross-border payments from automated digital services ("ADS"), (as defined by the OECD's Unified Approach work). There are three main elements to the UN proposal. First, Article 12B would permit source state withholding tax on payments from ADS (except where those payments already qualify as royalties or fees for technical services within Article 12 or 12A of the Model). Note that in this case, the source state is the state of the (direct) purchaser from which the payment is made, which may not be the state where an indirect purchaser or user resides. The rate of any withholding tax would be negotiated bilaterally

[13] The October 2020 P1 Blueprint states that: "At the level of a group or segment, the term "residual profit" for Amount A purposes refers to profit in excess of an agreed profitability threshold …. This differs from the transfer pricing concept of "residual profits", which are the profits (or losses) that remain after remunerating activities that can be reliably benchmarked using comparables." (p141, footnote 109) We use the term "residual" broadly in this paper.

[14] It is intended that the removal of unilateral measure such as a DSTs is a pre-condition of any agreement to this proposal.

with treaty partners, though the draft recommends what it regards as a modest rate in the order of 3-4% of the gross amount.[15]

Second, an alternative net basis of taxation may apply in the source state at the request of the owner of the relevant ADS income. This works on the basis that the profitability ratio (relevant annual profits divided by annual revenue) of that owner's ADS segment (or group accounts if there is no segment data) is applied to the gross revenue arising in the source state and 30% of the resulting net profits is then treated as the profits that are taxable in that state. Third, there is an exclusion from the new allocation of taxing rights under Article 12B where the relevant ADS income is attributable to a PE in the source state.

The UN proposal does not address in any detail whether and how, credit would be given by the country of residence of the recipient of the payment. Existing rules concerning credit given for withholding taxes would presumably apply.

2.1.3. Devereux et al's Residual Profit Allocation by Income ("RPAI")

The RPAI, proposed by Devereux et al (2021), is a version of a family of Residual Profit Allocation ("RPA") schemes that are based on dividing profit into its "routine" and "residual" components, and allocating different taxing rights for those two components. Unlike P1, the RPAI aims to allocate all residual profit to the market countries. It would also aim to do so for all MNEs above a de minimis – rather than a very high - threshold.. An important RPA scheme proposed by Avi-Yonah, Clausing and Durst, follows the same approach as P1 by defining residual profit in an arbitrary way with a fixed mark-up and apportions it to market countries by sales.16 Unlike these, the RPAI would use existing transfer pricing techniques, such as cost-plus, to identify routine[17] – and therefore also residual – profit.[18] Residual profit would then be allocated by "residual gross income", defined below.

As a consequence, the RPAI would also differ in how it would be administered. Unlike P1 and other RPA schemes, it would not start by apportioning total residual profit (or gross revenue). Instead, it would take a "bottom-up" approach. In a first step, all business functions and activities within a multinational business - R&D activities, manufacturing, general and administrative activities, sales and marketing activities and others - would be allocated a

[15] UN proposal commentary at para 15. The commentary (in para 16) considers various factors that should be taken into account in setting the rate.

[16] An important option, first proposed by Avi-Yonah, Clausing and Durst (2009), calculates routine profit through a fixed mark-up over costs and apportions residual profit to the market country entirely by sales.

[17] Under the RPAI "routine" profit is defined as the profit a third party would expect to earn for performing a particular set of functions or activities essentially on an outsourcing basis. Devereux et al (2021) p. 201. While the RPAI departs from the arms' length principle in many ways, the routine profit is measured following existing transfer pricing techniques – such as cost plus - that rely on public third party comparable outsourcing data.

[18] Residual profit is defined as the "profit earned by the business in excess of routine profit." Devereux et al (2021), p. 210. See further Box 6.2 at p. 202.

routine profit and taxed in the countries where these functions and activities are performed. In a second step, residual profit would be calculated in each market country as sales less the costs of sales, including any routine profit associated with those costs. Any costs that cannot be attributed directly to sales in a particular country would be apportioned to market countries on the basis of residual gross income (the income in each country before such non-attributable costs are deducted). Because the first step aims to allocate only routine profit to countries where functions and activities take place, there is no need for the residual profit allocated to market countries to be subsequently deducted from profit elsewhere.

2.1.4. Digital Service Taxes (DST)

This paper focuses on the three proposals outlined above. As DSTs will be used as a reference point in this discussion, we also introduce them briefly here. DSTs have been proposed and enacted on a unilateral basis and vary (sometimes significantly) from jurisdiction to jurisdiction. A DST typically seeks to tax in the market – often more specifically the country of the user but not that of the consumer - the gross revenues arising from certain digital business (such as those selling digital advertising space or data provided by users, or from digital intermediation activities). Concerns have been expressed that a proliferation of unilateral DSTs would lead to a decrease in tax certainty, excessive compliance burdens, double taxation, and high tax burdens on loss making businesses. There is also a real danger that the US, and perhaps other countries opposed to DSTs, could respond with retaliatory trade measures. The OECD has sought support for P1 by emphasising that failure to reach agreement on this proposal could lead to uncoordinated and unilateral measures, including DSTs, which, in the "worst-case scenario" it estimates could lead to a reduction of global GDP by more than 1 percent.[19]

2.2. Market countries

The "market" country is generally understood as the location in which a good or service is sold to a third party.[20] However, for these purposes, how the market country is defined should

[19] OECD/G20 Base Erosion and Profit Shifting Project, Tax Challenges Arising from Digitalisation – Economic Impact Assessment: Inclusive Framework on BEPS (Paris: OECD Publishing, 2020). This possibility made the headlines in news media around the world. See for example: S. Amaro, "Digital tax conflicts could wipe more than 1% off global GDP every year, OECD warns", CNBC, 12 October 2020; and L. Thomas, "A collapse of global tax talks could cost $100 billion, OECD says", Reuters, 12 October 2020.

[20] A distinction should be made between the allocation of taxing rights under two guiding principles. If Co A resident in A sets up a permanent establishment (PE) in B and sells goods and services to consumers there, under the existing system (at least some) taxing rights over the profit of Co A will be allocated to B. But this is not an allocation of taxing rights to a "market country". Taxing rights are allocated to B as a result of the presence of the PE, and not the purchasers, in B. Under an allocation of taxing rights to market countries, B would be allocated taxing rights over the profit of Co A as a result of the mere presence of purchasers in B and irrespective of whether Co A operates a PE in B. In a sense, B is a "market" country in both cases because purchasers are found there, but for the purposes of the allocation of taxing rights there is an important conceptual difference between the two. See Devereux et al (2021), page 13 and pages 168-173.

more generally depend on the rationale for the reform – for example, whether the intention is to identify where "value" is created, or whether it is because it contains a relatively immobile factor (the final customer or user) that can be used for the purposes of allocating taxing rights. In the latter case, for example, the market country could be taken to be (normally) the country of residence of the final customer or the user.

As noted at the outset, in this paper we use the term "market" broadly to include countries where either a direct or indirect purchaser (where the purchaser could be a business or an individual) of a good or service, or a user of certain digital platforms is found.[21] The distinction between purchasers and users is important in the case of certain highly digitalised businesses – such as social media services, internet search engines and online marketplaces. To see this, consider a social media business (S), resident in country A, that remotely sells advertising space to a wine producer (P), resident in country B. The advert appears on the phone of a user, resident in country C. We may refer to country B as the "market" country on the grounds that the purchaser of the service is located there. Alternatively, we may use the term "market" country to mean instead country C, where the user is located. (Of course, in many cases, these may be the same country, but that it not necessarily the case). We aim to avoid any ambiguity by being clear where appropriate as to whether we are referring to the location of the purchaser or the user in such cases.

A second example of a related distinction between the direct and indirect purchaser of a good or service is in the case of a "centralised purchasing" strategy of a multinational company. Consider a situation where W Co, resident in country W, is the parent company of a construction group with operations and subsidiaries in countries X, Y and Z. Even abstracting from tax reasons, W Co may choose just one of these subsidiaries to offer a "centralised purchasing" strategy for the group as a whole. For example, X Co may purchase heavy machinery from an independent company, G Co, for use throughout the group. In this case, X Co is the direct purchaser of the machinery, but Y Co and Z Co will be the entities making use of the machinery, and hence the indirect purchasers in our terminology. If G Co's profit is partly taxed in the "market", then it makes a difference whether the "market" is defined to be where the direct purchaser is located (X), or where the indirect purchasers are located (Y and Z). If the former approach is chosen, then W Co and G Co would benefit from locating the purchasing subsidiary in a low-tax country.

[21] In setting out revenue sourcing rules for online intermediation platform services, P1 proposes that here should be a 50:50 split between the purchaser and the seller of a good or service. However, in this case, we are interested in the service being provided to the purchaser or seller by the platform; in this sense even the seller is a "purchaser" of those services. P1 also makes finer distinctions, for example, between the real-time location and the ordinary residence of the user (i.e. the viewer of the advertisement).

A third, and again related, example is where a company sells consumer goods via an "independent distributor", which again may be a profitable strategy even in the absence of taxation. Suppose, for example, that A Co, resident in A, manufactures smart phones to sell to consumers in B. If A Co sells its phones directly to the consumers then, under the proposals discussed in this paper, part of its profit will be taxed at B's tax rate. However, it is possible that A Co sells its phones to C Co, an independent company located in country C, which sells the phones on to consumers in B. In this case, if the "market" is defined to be the location of the direct purchaser, then under these proposals, part of A Co's profit would be allocated to country C. In this case, there would be an incentive for C Co to locate in a low-tax country. The effect of this could in principle be mitigated by again defining the "market" to be the country of the indirect purchasers – country B. This requires looking through the set of transactions to identify where the indirect purchasers are located. This may be difficult, especially if the intermediate company, C Co, adds some value to the phones before selling them on.

Under the existing system, the countries of the direct or indirect purchasers, and users are not allocated taxing rights simply by virtue of the fact that they may be thought to constitute the location of the market. In that sense, the proposals discussed in this paper are radical departures from the existing system. It is clear from the discussion already, though, that the precise definition of the "market" may have important consequences. In section 3 we discuss these issues in more detail.

2.3. Unilateral, Bilateral, and Multilateral Approaches

The existing allocation of taxing rights can be altered unilaterally, bilaterally or multilaterally. Achieving multilateral reform is the most difficult because countries have different interests and preferences, and so achieving consensus may be problematic. Unilateral reform is in principle the least difficult - although the prospect of retaliatory measures and international political pressure may complicate the picture in practice. But multilateralism is necessary to achieve ambitious reform of the current system (P1 and RPAI), because doing so requires amending the existing treaty network. If multilateralism cannot be achieved, then the options that remain available are bilateral reform broadly within the system of existing treaties (such as is proposed in the case of Article 12B), or unilateral reform outside the system through the introduction of stand-alone taxes (DSTs).

P1 involves significant change within the existing system, and the RPAI involves even more comprehensive change. From a technical perspective, it might be possible – if challenging – to implement either proposal unilaterally. But it would not be possible from a legal perspective, because the implementation of these proposals requires the amendment of a number of provisions in existing treaties. These include Articles 5 (PE threshold rules), 7 (PE attribution rules) and Article 9 (transfer pricing rules) for both P1 and the RPAI. Such amendment would most likely be achieved within a reasonable timeframe through a multilateral treaty, following the model of the Multilateral Instrument ("MLI") adopted to implement BEPS actions.

Pairs of countries that have treaties in place could agree reform through a less extensive bilateral amendment of those treaties. The UN's proposed Article 12 B does this by permitting source states to withhold tax on payments for services from ADS; this is naturally limited to the country of the purchaser, rather than the user. However, while this change can be undertaken on a bilateral basis, its widespread adoption would be more likely in practice to require a multilateral treaty along the lines discussed above.

To the extent that it is not bound by treaties, a country could also unilaterally exercise increased taxing rights as a market country. This could be done through the imposition of a withholding tax or even a direct tax. However, many countries do have extensive treaty networks to consider, and if market countries were to unilaterally impose tax on the *profit* of a non-resident company they would be in breach of their treaty obligations. Countries have sought to side-step this constraint by imposing a separate tax – DST - on the *gross revenues* of non-resident companies.[22] Whether this is successful from a legal perspective is open to question.[23] It depends on whether a DST falls within the ambit of existing treaties, which in turn depends on the interpretation of treaty provisions modelled on Article 2 of the OECD Model setting out the taxes covered by each treaty.[24] It may be argued that a DST is "identical or substantially similar" to a corporate income tax, thus falling within the ambit of Article 2(4). It may be argued instead that DSTs fall within the ambit of Article 2(2) as a tax on "elements of income". If either of these arguments is correct, and clauses corresponding to these provisions in the OECD Model are included in a relevant tax treaty, then DSTs would breach existing treaties as they would apply in excess of the limitations on adopting countries' taxing rights provided for in tax treaties.

[22] Note however that the UK's DST includes a safe harbour that allows businesses in loss positions, or with very low profit margins on their UK digital services activity to elect an alternative basis of charge. As a result, qualifying businesses in a loss position will not have to pay the DST, and those with low margins will have to pay the DST at a somewhat reduced rate of tax. Finance Act 2020 s.48; HMRC, Digital Services Tax Manual, DST43400.
[23] Questions have also been voiced about their compatibility with EU and World Trade Organization (WTO) law, see references in footnote 13 below.
[24] The UK insists that its DST is compatible with its treaty obligations. HMT and HMRC, Digital Services Tax: (November 2018), Ch.10., see For commentary on this issue see for example G. Kofler and J. Sinnig, "Equalization Taxes and the EU's 'Digital Services Tax'" in W. Haslehner, G. Kofler, K. Pantazatou and A. Rust (eds), Tax and the Digital Economy: Challenges and Proposals for Reform (Wolters Kluwer, 2019), R. Goulder, "The futility of challenging DSTs under international law", Tax Notes International, 22 June 2020; R. Ismer and C. Jescheck, "Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model?" (2018) Intertax 46(6/7) 573; and C. Forsgren, S. Song and D. Horvath, Digital Services Taxes: Do They Comply with International Tax, Trade, and EU Law? (The Tax Foundation, June 2020); R. Shiers and J. Stoel, "Is the DST compatible with the UK's international obligations?" [2019] (1463) Tax Journal 12.

The potential ambition of each proposed reform is therefore linked to its legal framework. At one extreme, a government could potentially unilaterally introduce a tax on gross revenue which stood outside the taxation of corporate profit and thus leave the remaining system unchanged. To introduce a reform that requires only bilateral agreement – as the UN proposal intends – might be argued to be more feasible than one that requires multilateral agreement. But that naturally limits the scale of the reform. P1 and RPAI approaches both represent more sweeping reforms than the UN proposal and require multilateral agreement. The RPAI also clearly goes beyond P1.

2.4. Evaluative Criteria

In assessing the strengths and weaknesses of these proposals, and elements of the proposals, we use criteria for what would be a good tax system. In particular, we use the criteria set out and developed by Devereux et al (2021) and used by them to evaluate the existing system and various alternatives: economic efficiency, fairness, ease of administration, robustness to avoidance, and incentive compatibility. In addition, we also take account of the transition costs of reforming the system.

We take these five criteria to be relatively uncontroversial, although there may be disagreement as to their relative importance. Three are straightforward, in principle at least. Economic efficiency refers to the costs which may be imposed on society by taxation which affects the behaviour of economic agents. If, for example, a more costly approach is taken to implementing a business plan because of its tax advantages, then the higher costs incurred represent a cost to society as a whole, which will be reflected in higher prices or lower incomes, or both. Inefficiencies can result from distortions to, for example, the choice of the locations of functions and activities, the scale of investment, and competition between firms within specific markets. The costs of administration – under which we include costs borne by both tax authorities and taxpayers – are also a clear cost to society. We include robustness to avoidance as a separate criterion, although it overlaps considerably with other criteria.

Identifying a "fair" tax is rather more controversial. It includes at least two dimensions – fairness amongst taxpayers who are ultimately made worse off by the tax, and fairness amongst governments that receive the tax revenue. Both are difficult to evaluate, as discussed at length by Devereux et al (2021). Briefly, on fairness amongst taxpayers, even if we could agree on how progressive the tax should be, and how it should be allocated among individuals resident in different countries, we still face the almost impossible task (in most cases) of identifying who actually bears the tax burden – something that is likely to differ according to conditions in the various markets in which the MNE operates. Much has been written also, on how revenues should be allocated amongst countries based on fairness – the notion of allocating tax rights to where value is created is one attempt to define a principle for guidance here. For many reasons, we do not find that convincing.[25] But we do not offer an alternative principle; rather we take the position that there are many factors that could be taken into account in determining a fair, or unfair, position. As a result, we focus primarily on the other four criteria.

The final criterion is perhaps more unusual: incentive compatibility.[26] By this we mean that individual states do not have an incentive to undermine the system, imposing costs on other states. The existing system does not exhibit incentive compatibility; as states compete for inward investment, or for taxable profit, there is pressure to reduce their effective tax rates to make themselves more attractive. That imposes costs on all states, both in the possible loss of investment and revenues, and also constraining tax rates. This is not true of all taxes; for example, there is little competition in rates of VAT; we discuss this further below.

2.5 Double taxation

It is widely accepted that one of the purposes of treaties is to avoid juridical double taxation. The RPAI naturally avoids double taxation in the way that it first determines routine profit, leaving the remaining profit as a "residual". But the P1 and the Article 12B proposals both seek to add a layer of tax on top of the existing system. To avoid double taxation they therefore both aim to make an offsetting adjustment to taxable income elsewhere. We discuss how they do so at length in Section 4.

However, the notion that double taxation is a significant problem is one that should be addressed. Taxpayers may think it unfair. But this appears to be a concern simply over the number of times a tax is levied on income. Instead, both fairness and economic efficiency considerations would point to a consideration of the overall tax paid.

The case for concern about double taxation is weakened much further in comparison to taxes on revenue rather than profit or income. Take DSTs, for example. These are typically designed to be taxes on revenue, *not* income, and hence it is argued that they are likely to fall outside the treaty network, as discussed above. DSTs have been introduced on this technical basis, even if they give rise to double taxation in a very real sense, and they are not credited against

[25] The authors have previously outlined a number of reasons to doubt the coherence and usefulness of the notion of value creation. See Michael P. Devereux and John Vella, Value Creation As the Fundamental Principle of the International Corporate Tax System European Tax Policy Forum Policy Paper, 2018 and Richard Collier, The Value Creation Mythology. Chapter 6 in W. Haslehner & M. Lamensch (Eds), Taxation and Value creation, EATLP International Tax Series, vol. 19, Amsterdam: IBFD, 2021, forthcoming. For a, more positive view, see, for example, S. Langbein and M. Fuss, The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard, The International Lawyer, 2018, vol. 51 (2), pp. 259-409 and R. Petruzzi et al., Transfer Pricing and Value Creation, Series on International Tax Law, Linde Verlag, 2019.
[26] For more on this criterion see Devereux et al (2021), pages 55-57 and 123-127.

other taxes. Yet, ironically, if DSTs were altered to be more generous, by giving relief for costs, then they would become taxes on profit, and therefore likely be subject to treaty provisions and concern about double taxation. Yet there is no economic rationale for a tax on revenue to be treated differently from a tax on profit.

One alternative approach to both the P1 and Article 12B proposals is that neither of the new elements of tax introduced should be creditable against other taxes. That would of course greatly simplify their implementation. But it would seemingly introduce juridical double taxation. One possible justification for this approach could be to regard the new taxes as akin to "excess profit taxes" which have been proposed as a contribution to paying for the costs of the covid-19 pandemic. This approach would offer a major simplification and effectively make Section 4 of this paper redundant.

However, we should also note that a lack of creditability may not imply double taxation. That depends on how a multinational is structured, and the transfer prices it uses. Consider the marketing and distribution safe harbor ("MDSH") element of P1, for example. This caps or removes the Amount A allocation when the existing transfer pricing system properly books adequate residual profits in the market.

But we could take this further and consider the case in which transfer prices are adjusted from their present level to achieve the same result as Amount A. That would probably imply lower prices at which the distribution arm of the multinational purchases final, or near-final, goods from other parts of the business. But that in turn will automatically reduce taxable profit in other parts of the business, thereby avoiding double taxation.

A question then arises as to which elements of the business are likely to see a reduction in their taxable profit to offset the additional profit allocated to the market country. If at least a routine rate of return is allocated to each separate entity within the multinational, then ultimately transfer prices must be adjusted in such a way that the reduction in taxable profit must occur in entities to which residual profit is currently allocated. That is precisely what the P1 proposal aims to do. But in this case it would be achieved by manipulation of transfer prices.

3. Taxing in the market country

The three proposals analysed in this paper vary considerably in their allocation of taxing rights to the market country. This section sets out the different approaches in this respect; it leaves all issues with respect to the consequent impact on other countries to Section 4.

We start in Section 3.1 by focusing on five aspects of differences between the proposals: their scope; how they define the market country; how the tax base is determined; the overall size of the allocation to the market country; and the procedures for collecting the tax. An important issue here is that many of the key features of each proposal are not necessarily inherent to each proposal. To take just one example, the definition of the market employed by the P1 and RPAI proposals could be narrowed to apply only to the direct purchaser. This raises the question, to which we return in Section 5, of whether it is possible to mix-and-match the proposals; to identify and use the better features of each proposal without necessarily supporting one proposal over the others. In preparation for such a discussion, in Section 3.2, we evaluate each of the choices made against the criteria set out in Section 2.

3.1. Comparing the proposals

3.1.1. Scope of allocation to market country

The UN Article 12B proposal is intended to apply to businesses in the Automated Digital Services (ADS) sector only. In this, it is broadly similar to most DSTs. The October 2020 version of P1 also applied the tax in the market country to Consumer Facing Businesses (CFB) but it would only apply to businesses with an annual consolidated group revenue above a threshold (which is not specified in the Blueprint document, but which was at the time thought to be around €750 million). But the July 1 Statement announced a change to the scope of P1, so that it applies to all MNEs with global turnover above 20 billion euros and profitability above 10%.[27] Only the extractives and regulated financial services industries are excluded from the scope of P1. By contrast, the RPAI proposal is intended to apply to all businesses above a de minimis threshold.

The rationale behind these differences is not entirely clear. The UN proposal, like DSTs, is targeted specifically at certain highly digitalised businesses – that proposal is therefore presumably not intended as a general reform of the allocation of taxing rights. The scope of P1 proposal had been informally described as "the mother of all issues", and the back and forth on this point and the change announced in July 2021reflects the differing views held by IF members, and the changing views of some members, in particular the US. The RPAI is firmly based on the view that moving taxing rights to the market country would be beneficial for all sectors.

Note, though, as indicated above, that the proposed scope of these proposals is not inherent to them. It would be possible to narrow the scope of the P1 and RPAI proposals, and to extend the scope of the Article 12B proposal. These changes would have an impact on the proposals'

[27] As noted in footnote 12, there is a planned review which could result in the lowering of the threshold to 10 billion euros.

feasibility as well as their economic efficiency and their robustness to avoidance. We discuss these issues below.

3.1.2. Definition of market country

We have already discussed the notion of the "market" in Section 2.2, distinguishing between the locations of a direct purchaser, an indirect purchaser, and a user. The three proposals interpret the notion of the "market" differently from each other.

The UN's 12B proposal is that "income from automated digital services arising in a Contracting State may also be taxed in the Contracting State in which it arises" (para 2), and it defines such income as "any payment in consideration for any service provided on the internet or an electronic network requiring minimal human involvement from the service provider" (para 4). The proposal is therefore for a withholding tax on any payment made by the direct purchaser of a digital service, although the Commentary also leaves open the possibility of the tax being levied through direct assessment of the vendor.

The tax would be therefore presumably collected by the country where the purchaser is located.[28] This would seem to preclude looking through a set of transactions to identify where the indirect purchaser of the digital services or user may be located. The Commentary goes into some detail to define automated digital services; however – and in great contrast to the P1 proposal - there is no detailed discussion as to the "source" of the revenue. The discussion does, however, appear to confirm the principle that the Contrasting State in which income arises is determined by the location of the direct purchaser.[29]

At the other extreme, the October 2020 Blueprint for P1 set out in some detail an almost bewildering range of different revenue sourcing rules for determining the location in which the tax on "Amount A" should be levied, depending on the nature of the good or service being provided.[30] P1 sets out a "principle" for each type of income that it identifies.[31] There is no explanation of the overriding principle that can explain the more specific "principles" but the approach seems to be based on the lead principle that revenue is to be treated as derived from the jurisdiction where a good or service is used or consumed rather than from the location of the paying customer. For digital advertising services, the market is (broadly)

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[28] Leaving aside what "located" mean in this context – for example, whether it depends on the ordinary residence of the purchaser.

[29] One different approach to P1, for example, is that the "source" of the data is not relevant (para 4).

[30] See OECD (2020), Section 4.2. More specially, the rules determine whether any nexus revenue threshold test is met in a particular state, and also what revenues/ profits are allocated to each market jurisdiction. Revenue sourcing rules are not new – various international and domestic rules already exist. Examples include the OECD 2017 International VAT/GST guidelines and the UK's DST. There are also corporate income tax rules that determine the state in which revenue arises – e.g. US and Canadian state corporate income tax rules, and the EU Commission's proposed Common Consolidated Corporate Tax Base (CCCTB).

[31] These are linked to a range of possible indicators to identify the appropriate jurisdiction.

declared to be the location of the user (as is the case of most DSTs). For sales of data, it is the country of the user that is the subject of the data being sold. For online sales platforms, there is a 50:50 split between the two sides of a transaction (purchaser and seller), both of whom are in effect purchasing services from the platform. For the sale of digital content, it is the country of the immediate purchaser. For a business purchaser of cloud computing, it is the country of the user of those services. For CFB, P1 broadly identifies the market as the place of final delivery of a good to the consumer, or the place of enjoyment or use of a service. Of course, as the scope of P1 was broadened beyond ADS and CFB by the July 2021 Statement, a wider set of revenue sourcing rules are required, with the considerable design, implementation and administration challenges that will bring.

The RPAI proposal is different again in how it sets out the nature of the "market". Unlike P1 proposal, it does not discuss revenue sourcing rules in any detail. However, it does set out an overriding principle for determining revenue sourcing rules. That is, as far as possible, the market should be determined by a factor that is as immobile as possible. This principle would yield a set of revenue sourcing rules rather similar to that proposed by P1. For example, income from digital advertising would be allocated to the country of the user, and sales of goods through an intermediate distributor would, as far as possible, be allocated to the indirect – or final – purchaser. As the scope of the RPAI is not limited to particular sectors, a comprehensive set of revenue sourcing rules will be required as will be required for P1 following the change in scope.

As discussed below, the definition of market has a considerable impact on the performance of the proposals under the evaluative criteria. P1 and the RPAI could adopt a narrower definition of market to include only direct purchasers, although that would be less in line with their stated or presumed guiding principles. The Article 12 B proposal appears much less amenable to a broad definition of market to also include indirect purchasers and users. The definition of market adopted in DSTs depends on their guiding principle. DSTs which seek to tax the value created by users for highly digitalised businesses will necessarily define market as the location of users.

3.1.3. Determination of the tax base

The proposals differ significantly in how they determine the tax base.

The Article 12B proposal begins with a tax on gross revenue, or on a specific payment made by a purchaser in the country. As noted above, however, an alternative net basis may be requested by the recipient of the income. This works on the basis that the profitability ratio (relevant annual profits divided by annual revenue) of the recipient is applied to the gross revenue arising in the source state and 30% of the resulting net profits is then treated as the profits that are taxable in that state. This is equivalent to a form of formulary apportionment, where 30% of global profit is allocated in proportion to sales in market countries. A third possibility arises to the extent that the business of the MNE in that state can be allocated to a local PE, in which case there is no additional tax other than that normally due on the profits attributed to the PE.

The tax base of P1 could hardly be more different, as it is based on a formulary apportionment allocation of part of the consolidated financial profit of the MNE group. The approach determines "residual" profit as the remainder having deducted a fixed proportion of gross revenues (10%) to account for the "routine" activities within the group. It then allocates a fixed portion of this residual amount to market countries (20-30%). This is allocated on the basis of the proportion of revenues in each market country.

The approach of the RPAI is much broader. It allocates all "residual" profit to the market country, although this is based on a very different calculation to P1 and as a result, the measurement of residual profit may differ between the P1 and RPAI proposals. First, the RPAI identifies routine profit in each part of the MNE, largely based on existing transfer pricing techniques. Residual profit is the remaining profit, which naturally accrues to the market country as measured by total revenue arising in that country less all costs and routine profit associated with the goods and services sold in that market.

3.1.4. Overall size of allocation to market country

A separate, though, related issue, is the resulting size of the allocation to the market country for each proposal, for those businesses which lie within their scope. For this, the key element of comparison is that the Article 12B proposal suggests a rate to be applied to gross revenue of 3-4%. Even though this is a low rate, it is a particularly broad base, unrelated to profit - still less to residual profit. This clearly matters in comparison to the proposals that are based on net profit.

Abstracting from the difference in determining residual profit, the RPAI would assign a greater share of profit to the market state than P1. The relative allocation of the UN proposal is more uncertain. To compare these approaches, consider a simple example. Suppose a MNE has global sales of 1,000 and global profit of 150, and so has an overall rate of profit of 15% of sales. Suppose that the threshold for determining routine profit under P1 is 10%, and that P1 allocates 20% of residual profit to market countries in proportion to sales. P1 would then allocate profit of 10 to market countries in total. If the 10% rate of return for routine profit were also the result of the RPAI approach, then then RPAI would allocate profit of 50 to market countries.

If the primary UN approach is taken, with a withholding tax rate of 3-4% of gross revenues in the market country, then Article 12B would allocate 30-40 of profit to market countries, again on the basis of sales. If the second (profit-based) approach were taken, the UN would allocate 45 to market countries on the basis of sales. In this example, the UN proposal would allocate a smaller share of profit to market countries than the RPAI.

However, it is clearly possible for the reverse to be true. Suppose, for example, that total profit was only 100, but that sales were still 1,000, implying that there was no residual profit at all. Then neither P1 nor the RPAI would allocate any profit to the market countries. Article 12B would again allocate 30-40 on its primary approach, and in this case, 30 on its second (profits-based) approach. The allocation under the UN proposal is therefore less sensitive to the overall rate of profit (and hence the degree of residual profit).

Once again, however, the issue of the size of the allocation to the market country is not inherent in each proposal. For example, the proportion of profit allocated to the market country by P1 could be varied – and need not even be limited to residual profit. The tax rate on revenues under Article 12B can also be varied.

3.1.5. Collection of the tax

A final point of comparison concerns the nature of the collection of the tax.

The Article 12B proposal is primarily envisaged as a withholding tax. In the case of a business purchaser, this would presumably be levied as a withholding tax on the purchaser. However, this approach is unlikely to be feasible where, for example, a company N seeks to sell a digital product – for example, streaming music or television – to individual consumers, which would imply that there could be millions of individuals with responsibility for remitting the tax. One alternative option could be that the tax is collected at the level of the credit card company which operates as an intermediary between the purchaser and seller, but that raises issues of its own. This difficulty may be one reason why the Commentary also leaves open the possibility of the tax being levied through direct assessment of the vendor.

The P1 and RPAI proposals would in general be levied on the entity that receives the income, even if those entities are non-resident. This gives rise to clear challenges, but countries do have experience of collecting tax from non-resident entities with no physical presence within their borders, albeit in more narrowly defined circumstances. Dependent agent PEs have long given rise to similar collection challenges, but there have been further instances in recent years. The UK, for example, extended withholding tax on royalties to certain payments made in connection with profits derived from UK sales, regardless of where the payer is based, meaning that payments made by a non-UK entity may be caught.[32] The UK's DST casts an even broader net and taxes businesses providing social media, search engines and on-line platforms on revenues attributable to UK users wherever they arise. HM Treasury dismissed concerns on collecting the DST by noting that the UK has "significant experience of collecting tax from businesses with no physical presence in the UK in areas such as VAT" and concluding that it "does not therefore see collection as a significant issue".[33]

3.2. Evaluation

We now turn to evaluating the proposals. We do not delve too far into details; this is intended to be a comparative exercise, identifying the strengths and weaknesses of the key features of each proposal. The analysis is not intended to generate a ranking of the three proposals. Rather it is an analysis of their features: for example, what are the strengths and weaknesses of extending the scope of the tax to smaller companies or to additional sectors, or extending the reach beyond direct purchasers to indirect purchasers and/or users, or raising the overall allocation to the market country? We focus primarily on four of the criteria set out in Section 2: economic efficiency, incentive compatibility, robustness to avoidance and ease of administration; we make only brief comments on fairness in passing.

3.2.1. Economic Efficiency

A starting point for evaluating these alternatives from the perspective of economic efficiency is the point emphasised by Devereux et al (2021) – that the less mobile are the factors that determine the location of the tax base, the less distortion there will be to the location choices of multinationals (MNEs). If the "market" is defined to include an indirect purchaser or user who would not move in response to the tax liability of the MNE, then the location of the market is fixed, and the location of other elements of the MNE would be irrelevant to the allocation to the market country. That is, to the extent that the location of the market is indeed immobile, then there is a clear benefit from the perspective of economic efficiency to allocate as much profit as possible to the market country.[34]

Relative to the existing system, in which there is no systematic allocation to the market country *per se*, all the proposals considered in this paper might be seen to improve economic efficiency. However, they clearly do so to different extents.

[32] Finance Act 2019, s. 15 and Schedule 3, Offshore Receipts for Intangible Property.
[33] HM Treasury, Position Paper update, above fn.43, paras 4.49 and 4.50.
[34] Note that these considerations do not depend on the notion or measurement of residual and routine profit. Here we are simply concerned with maximising the application to market countries. Mis-measuring, say, residual profit matters only to the extent that it may imply a smaller share of profit is allocated to the market country.

First, the benefits depend on the scope of the tax, which would need to be as wide as possible to generate the greatest improvements in economic efficiency. In this respect, restricting the scope to ADS, or only to very large multinationals, limits the benefits in terms of economic efficiency. Second, limiting the allocation to the market, for example, to only a part of residual profit also weakens the benefits in terms of economic efficiency.

Second, the benefits also depend on the definition of the market, and the tax base. The Article 12 B proposal is based on the location of the direct purchaser. The incentives thereby created depend on whether the withholding tax is based on gross revenue, or a measure of net profit. If based on gross revenue, then there is a clear disincentive to use an intermediate purchaser, since there would be a cascading of the tax. Suppose, for example, that company A sells its product to consumers in country B via an independent distributor in country C. In this case, a withholding tax on gross revenue applied in both B and C would have a cascading effect. C may levy a tax on the sale to the intermediary and B may also levy a tax on the sale to the final consumers.

This effect is likely to be mitigated by the option of the net basis of taxation. However, the net basis creates problems as well: If company A is highly profitable and the intermediary is not, then if the tax is levied in the country of the direct purchaser, there is a clear incentive for the intermediary to locate in a low-tax country.[35] This effect is mitigated under P1 and RPAI proposals to the extent that they look through the direct purchaser to the indirect purchaser or user, who might be thought to be less mobile.[36] Of course, that raises issues of administration, which we discuss below.

A final issue relating to economic efficiency is that if the tax in the market country is based on revenue, then – at least to the extent to which it is not fully credited against a tax on net income – it is likely to affect decisions with respect to the scale of investment; revenue will be taxed, but there will be no relief for costs. However, if it is not restricted to a base on economic rent, a tax on net income is also likely to affect investment.

3.2.2 Robustness to avoidance

Issues of avoidance are closely linked to those of efficiency. For example, if an existing independent distributor changed its location because of the tax, then that would generate social costs which would be an economic inefficiency. However, if the independent distributor only came into existence as a device to shift the location of the "market" for tax purposes, then this would be a case of avoidance. The same is true for the "centralised purchasing" strategy, described in section 2.2 above.

[35] This problem does not arise under a Destination Based Cash Flow Tax ("DBCFT"). See Devereux et al (2021).
[36] See Devereux et al (2021), pp. 203, 240-241, and 243-244.

The implications for design are then very similar. Defining the "market" for tax purposes as based on an immobile factor is beneficial both for economic efficiency and robustness to avoidance. To the extent that the market is defined as including the location of the indirect purchaser or user, then the incentive to use an independent distributor is negated, and the location of any existing distributors should not be affected. Again, there is a trade-off with the costs of administration, since the "market" in this case is more difficult to define. As noted above, the incentive to use an independent distributor or a centralised purchasing strategy does not arise if tax base is gross revenue as under the Article 12 B proposal.

Drawing somewhat arbitrary lines between activities that are within, or outside, scope not only increases administrative costs but can also stimulate avoidance if there is an incentive to declare an activity on one side or other of the boundary between activities.

3.2.3 Incentive Compatibility

Reducing the tax-induced incentive for an MNE to change the location of its functions and activities is beneficial for economic efficiency, and also makes the system more robust to avoidance. It also indirectly affects tax competition and the incentive compatibility of the tax system.

To see this, assume that governments aim to set their tax rates by balancing the marginal benefits of attracting more tax revenue (by raising the tax rate) and attracting inward investment (by lowering the tax rate). Then let us consider the case in which at least some taxing rights are moved partially away from the state where functions and activities take place to market countries.[37]

The tax base in the former state is now lower. This has two effects. First, it implies that a one percentage point reduction in the tax rate has a smaller impact on government revenues. Second, it also implies that the MNE is less likely to change its location decision in response to the tax rate cut. In principle, that could leave tax rates higher or lower than before the tax reform. Overall, however, it seems likely that the diminished role of taxation in the state where functions and activities take place will reduce the competitive pressure the state is currently under to lower its tax rate.

[37] Post-BEPS, it is less likely that profit would be moved away only from countries that have no functions and activities given the significant emphasis in the BEPS output on aligning the location of profits and the location of value-adding functions and activities (as, for example, in the new transfer pricing approach relating to the risk framework – see OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, (OECD Publishing, 2017) at para. 1.60)

By contrast, the tax base in the market country has increased. Generally, however, the trade-off described above does not occur in market countries - at least to the extent that third party customers are immobile – because a higher tax rate in the market country would not affect the locations of different parts of the business. There should therefore be only very weak tax competition in market countries. This gives much greater freedom for countries to levy higher tax rates where they host markets, compared to profits allocated there because an MNE's functions and activities take place there.

In sum, at least to the extent to which the market is defined as far as possible as where an immobile purchaser or user is located, we would expect limited competition over tax rates in market countries. In general, we would also expect less competition in other countries, simply because there is less at stake in those countries, since the tax base there has diminished.

3.2.4 Ease of administration

Considerations of economic efficiency and incentive compatibility point to advantages from levying the tax on net income and defining the market country as that of the location of the direct or indirect purchaser or user. Unfortunately, considerations of the cost of administration tend to point in the opposite direction. Overall, administration considerations also point to a limited scope. Considerations of robustness to tax avoidance point to levying the tax on revenue or defining the market to include direct or indirect purchaser or user. To examine this, we consider each of the issues raised in Section 3.1 separately. However, the overall size of the allocation to the market country seems to raise no specific issues other than those discussed below.

3.2.4.1. Scope of allocation to market country

Restricting the scope of the tax in terms of the sectors to which it applies can cut both ways with respect to administrative costs. On the one hand, restricting the scope to ADS and/or CFB means that it is not necessary to apply the tax to businesses in other sectors. To some extent these two sectors appear to have been chosen in the October 2020 Blueprint version of P1 in order to minimise administrative costs,in particular those relating to revenue sourcing rules. ForCFBs it is likely easier to know and have access to data on their underlying markets. ADS presents a tougher challenge, which the October 2020 Blueprint partly addressed by the increased flexibility in the rules relating to these businesses.[38] As the scope of P1 was extended in July 2021, further complex revenue sourcing rules will need to be designed and administered to cover additional sectors brought into scope. On the other hand, restricting the scope of a proposal means that it becomes necessary to police the boundary between activities that are in scope and out of scope for the purposes of the tax. We can certainly

[38] It is notable that the discussion of revenue sourcing issues in the Blueprint relating to specific CFB issues takes up 5 pages whereas the corresponding discussion of ADS requires 17 pages.

expect there to be tax planning around this boundary. This trade-off arises in the context of the Article 12 B proposal. Applying the tax only to ADS reduces the administrative burden in some ways (e.g. applying a withholding tax to B2C transactions or collecting tax from non-resident businesses through direct assessment) but requires policing of the boundary.

The scope of P1 is limited by a very high threshold that offers unambiguous administrative advantages. Indeed, a high threshold might even be critical to the feasibility of this proposal. It is unlikely that the certainty process – discussed below – can be operated to the increased number of businesses that would come within scope were the threshold to be reduced dramatically.

The RPAI proposal suggests that its scope should not be limited by r business type or size (save for a de minimis threshold). That necessitates a comprehensive set of revenue sourcing rules that, again, are likely to be complex and costly to administer. On the other hand, these revenue sourcing rules would not be layered on top of the existing morass of complex rules, as the RPAI would obviate the need for many existing rules. Of course, one could also restrict the scope of the RPAI, but that has the downsides described above – and the existing complex rules would have to be maintained for out-of-scope businesses.

3.2.4.2. Definition of market country

In terms of administrative costs, there is a clear advantage for drawing the definition of the market narrowly to include only the location of a direct purchase by a resident individual or business. Then there is no need to look through a set of transactions for an indirect purchaser or user. That is the approach of the Article 12B proposal, which permits the approach of using a withholding tax on payments made. Even then, however, and as noted above, there are complications when a very large number of purchases are made by individual customers – especially when these are digital services rather than goods have to be shipped across borders. It is perhaps for this reason that the Commentary also leaves open the possibility of levying the tax through direct assessment.

But costs would be even higher when the market is defined broadly. Consider again the case in which company A sells its product to consumers in country B via an independent distributor in country C. Country B may want to tax the profit of company A, rather than the profit of the distributor in C. But company A may have no presence in B, and information on the relevant profit may be hard for the tax authority to come by. Chains of intermediaries would make collection even harder. And this would be exacerbated to the extent that the intermediary also makes some contribution to the value of the final good sold. The more substantial the intervention is, the weaker is the case to look through the intermediary.

The inclusion of users in the broad definition of market can be challenging, as there may not even be a payment in the country collecting the tax. This would arise, for example, if L Co, a social media company, sells advertising services to M Co, resident in M, for adverts to appear on the electronic devices of users in N. In such a case where the users constitute the relevant market, N would be seeking to tax part of L Co's profit arising from sales in M.

3.2.4.3. Determination of the tax base

Abstracting from these issues, in general, costs of collection are likely to be lower when the tax base is gross revenue, rather than a measure of net income, residual profit or part of residual profit. That is simply because gross revenue is more easily observable – there is no need to take account of costs. That represents an advantage of the Article 12B proposal over the RPAI proposal on these grounds.

However, the P1 proposal is based on a completely different approach, using consolidated financial accounting data. If the allocation of Amount A to different market countries for a specific multinational was identified by a single tax authority, then all market countries should in principle be able to rely on the assessments made by that tax authority. That element of P1 proposal seems to minimise the costs of collection.

3.2.4.4. Collection of the tax

Beyond the issues already discussed, many details of the nature of the collection of tax are important. For example, the indicators used to source revenue could permit an online advertising provider to determine the location of where its advertising is viewed using: (1) an IP address; (2) the location of a device; (3) the information a user provides when they register for a service; (4) a user's phone number; (5) a user's credit card details; or (6) a combination of the above. Taxpayers could be given some discretion to determine which source of information was most appropriate for them, subject to appropriate checks and balances.

This hints at another challenge in applying revenue sourcing rules. They will likely require information that is not currently available to taxpayers, meaning that new reporting requirements will need to be devised and operated. This may be especially problematic where the entity responsible for remitting the tax is non-resident. In many cases it would be necessary to ascertain if the information required could even be obtained or is valid[39] and to confirm no problems arise under data protection rules, such as the EU's General Data Protection Regulation (GDPR). Finally, there is a clear possibility of disputes arising between states on the application of revenue sourcing issues, and therefore mechanisms to manage such disputes will be required.

[39] Note the problems with IP addresses from VPNs, meaning other mechanisms might be needed – see Blueprint at pp. 84-87.

4. Adjustments to avoid double taxation

There is significant variation in the degree to which the proposals include, or indeed need, specific measures to deal with double taxation of income as a consequence of the taxing rights they each allocate to the market state. Assuming that the aim is to avoid double taxation, such measures are needed under the UN Article 12B and the OECD P1 proposals because these proposals take the current allocation of taxing rights as a starting point, though they differ significantly on how they would be implemented.

This is not required under the RPAI, because it does not take the current allocation of taxing rights as its starting point. Instead, the RPAI reallocates taxing rights over the total profit of a multinational in a consistent and comprehensive manner. It starts with the allocation of routine profit to countries where functions and activities take place, and the remainder – the residual profit – is then allocated to market countries. The design principle of the RPAI that the routine and residual profits will always sum to 100% of the MNE group profits removes any concerns relating to double taxation and obviates the need for any explicit double tax adjustment mechanism.

The three proposals may also be contrasted with the position of DSTs. Under a DST there is generally no mechanism to adjust for the double taxation that may be deemed to arise when revenues subject to a DST are also taxed as business income in the state of the recipient.[40] This perhaps reflects the position discussed above that a conventional view of "double taxation" does not see DSTs as generating double taxation (or, at least, not double taxation that requires addressing). However, from an economic perspective, such a view seems inconsistent with treating the Article 12B proposal (in its form as a tax on gross revenue) as requiring relief for double taxation.

Notwithstanding these points, there are two central issues in comparing the different approaches of the Article 12 B and P1 proposals. The first is where the measure of relieving double taxation actually operates – that is, which country gives up taxing rights in favour of the new taxation in the market? The second is the condition for giving credit against the market country taxation. Specifically, would credit be limited to the tax liability on only residual profit, or would the credit be extended to the tax liability on any profit? We address these two questions in turn. In each case, we take the issues of taxing in the market country, discussed in Section 3, as given, and focus only on the extent to which there is also relief for that taxation.

[40] This is because the primary adjustment mechanism is to be found in Article 23 of the OECD and UN Model Tax Conventions and, as indicated earlier, DSTs are generally designed to operate outside the treaty framework. A DST may however rank as a deductible expense in the computation of profits subject to the corporate income tax.

4.1 Two central issues

4.1.1. Which country gives credit?

The assimilation of the Article 12B taxing right within the treaty framework implies that mechanisms are in principle already available to alleviate double tax relief. Specifically, there are two main methods to eliminate international juridical double taxation: (i) the exemption method (a version of which is found in Article 23A of the OECD and UN Models); and (ii) the credit method (Article 23B of the OECD and UN Models).[41]

Under the exemption method, the residence jurisdiction – that is, the country of the recipient of the income - does not retain secondary taxing rights over the income or profits derived from the market state as the income or profits are simply exempted from tax. In this case there is no further relief for the market country tax.

However, as a practical matter, in situations involving Article 12B it seems likely that the credit method would be the more commonly applied of the two methods.[42] Under the credit method, the residence jurisdiction (that is, the state to which income or profits are paid from the market state) retains secondary taxing rights over the income received but credits any taxation in the market country on that income against any tax chargeable on that income in the residence state.

In the case of the tax levied as a withholding tax on the gross revenue in the market country, the revenue subject to that tax would be subject to tax as income, net of costs, in the residence country. If the tax in the market state is lower than in the residence state, there will be further "top-up" taxation in the residence state. If the tax in the market state is higher, then any market state tax charged in excess of the residence state tax will be unrelieved and the residence country will receive no tax at all as a result of the application of Article 12B.[43]

By contrast, the P1 approach seeks to deliver a "comprehensive" solution to the elimination of double tax in two steps. First, it would identify the relevant "paying entity or entities", which are those entities regarded as owning the income which is taxed in the market states. Second, methods to eliminate double taxation would be applied in respect of the identified paying entities. Given that the primary taxing rights over the Amount A income vest with the

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[41] Adjustments to address double taxation are obviously not needed where the tax charge under Article 12B is disapplied by reason of the relevant ADS income being attributable to a PE in the state of the payor (para 5).
[42] This is because the income brought within Article 12B will generally be business income deriving from activity (relating to the provision of the ADS) in the residence state.
[43] This could be the case where, for example, a limited risk distributor makes a relatively slim profit from the production and distribution of a product or service giving rise to income from ADS, after paying a royalty to an affiliate in a third country relating to intangibles used or exploited in its ADS business.

market states, the double tax relief mechanism would be delivered in the states of the paying entities: these states either exempt the Amount A income from tax or alternatively tax it but allow a credit for the market state tax, therefore using the same exemption and credit methods under Article 23 of the OECD and UN tax conventions as described above in relation to Article 12B.[44]

The most critical part of the P1 approach is the process by which the identity of the paying entities is determined. This is an area in which the OECD is considering alternative simplified approaches following the recent consultation process. The position of the 2020 Blueprint is a relatively complex four-step approach, the core elements of which are: (1) identifying the entities generating residual profits by means of a qualitative activities test (relating to, for example, the bearing of economically significant risks or the ownership of key intangibles); (2) the application of a profitability test to ensure those entities have enough income to absorb the Amount A tax liability; (3) the allocation of the tax liability, in order of priority, to those entities that have a connection with the markets where Amount A is allocated; and (4) the allocation of any shortfall in capacity on a pro-rata basis to the remaining entities in the group.[45]

4.1.2. Whether credit is given against all profit or only residual profit

The second key difference between the Article 12 B and P1 proposals with respect to the credit against the market country tax is whether the tax is credited against all profit, or only residual profit.

The operation of the tax credit mechanism under Article 23 B of the OECD and UN Models would not be constrained by any distinction based on whether the income was characterised as routine or residual. In theory, this means that tax charged in the market state should be fully creditable against the tax charged in the residence state on that income. As a practical matter however, states may seek to resist that result as ceding primary taxing rights to the market state may mean that they lose the ability to tax businesses operating within their jurisdiction as explained above.

By contrast, P1, is intended to work on the principle that credit should be given against identified residual profit. The rationale for this approach seems to be that, since the tax base

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[44] For a detailed description of the approach adopted, see OECD (2020), *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/beba0634-en at Chapter 7, Elimination of double taxation. This also notes that the credit method could be applied either jurisdiction by jurisdiction (which means applying the credit limit separately by reference to each market) or using a blended approach (which would allow tax in low tax markets to be blended with tax in high tax markets, allowing a higher measure of credit relief).

[45] This is a highly summarised account of the approach. The discussion of the approach in the Blueprint is several pages long.

in the market country is measured as a fraction of residual profit, then the country giving credit should be the country where that residual profit is currently taxed. This rationale for the P1 approach can be questioned. It seems to depend on the notion that the income re-allocated to the market country actually reflects residual profit, as opposed to the more practical notion that taking a fraction of residual profit as reflected in the consolidated group accounts is simply a convenient mechanism for implementing the re-allocation of some taxing rights to the market country. In any case, the methods proposed in P1 to estimate residual profit for taxing in the market country are not the same as the methods used to determine where the residual profit is currently taxed.

4.2. Evaluation

We now turn again to evaluating these approaches against our criteria. As in Section 3, we do not focus specifically on fairness. There are several issues which we discuss below which might be thought to affect fairness – for example, whether there may be an element of double taxation under the UN 12B proposal. However, we discuss such issues in the context of the other criteria – in this case, economic efficiency.

One important issue which does not arise under the other headings, however, is sovereignty. P1 proposes a novel panel-based mandatory binding dispute prevention process to provide tax certainty, a process which includes identifying which countries are to make the necessary adjustments. Some countries may view this as a threat to their sovereignty and therefore unfair and the matter may make reaching a consensus on P1 problematic. [46]

4.2.1. Economic Efficiency

A starting point in considering efficiency is whether moving some taxing rights to the market country reduces distortions to location choices. In principle, taxing profit in the market is beneficial because individuals are relatively immobile, although as we have discussed above, that depends to some extent on how the "market" country is defined. Here though we focus on where existing taxing rights are moved away from. If the profit is currently taxed in countries where functions and activities take place (as is likely to be the case under the Article 12B proposal, for example), then moving it to the market country would result in some efficiency gain because the move reduces the incentive to locate real economic activities in low tax countries. But if the profit is currently taxed in a tax haven where little real economic activity takes place, then allocating taxing rights over this profit to market countries will not result in efficiency gains. Consider the example where an MNE has a parent company in A, R&D and manufacturing in B, and holds its IP in tax haven C. If the residual profit currently arises in C (where there are only modest functions and activities), then reallocating taxing

[46] Jinyan Li, The Legal Challenges of Creating a Global tax regime with the OECD Pillar One Blueprint, forthcoming in *Bulletin for Int'l Taxation*, February 2021.

rights over the residual profit from C to an immobile market country will address profit shifting concerns but its impact in reducing distortions to location choices of real economic activity may be quite limited.

A second issue is the extent to which the reform results in double taxation, or more accurately an increase in overall tax liabilities. To the extent that distortions to investment decisions increase with the proportion of profit paid in tax, double taxation of profit is likely to increase distortions and hence economic inefficiency. Although the Article 12B proposal is more likely to result in double taxation, the implementation of P1 could also raise the overall level of taxation. This will occur due to the additional market state tax in cases where the "paying entity" is subject to a low rate of tax in the state in which it is resident. Double taxation does not arise under the RPAI; however, again, the overall level of tax could rise relative to the existing system.

These considerations raise two further issues.

The first is the extent to which the possibility of double taxation under the Article 12B proposal could be mitigated. Options include allowing credits to be carried forward and to be transferred to other countries. These are discussed in Section 5 below. MNEs may also address this problem themselves by moving profit to the relevant residence country. Consider the simple example given above where an MNE has a parent company in A, R&D and manufacturing in B, and holds its IP in tax haven C. Sales are made from the parent company in A to consumers in D. If the residual profit of the MNE is currently declared in C, then there may be insufficient taxable income in A to provide a full credit for the tax levied in D. This may incentivise the MNE not to shift profit to C. If so, such a reaction does not appear abusive; on the contrary, it could be argued that it unwinds planning that may have been abusive.

The second issue is the extent to which a rise in taxation would actually result in additional distortions if the base which is subject to a higher rate of tax is residual profit, as in the P1 and RPAI proposals. In principle, it is well understood that a tax that falls only on economic rent should be non-distortionary. Whilst residual profit cannot be equated to economic rent,[47] there is clearly a similarity between the two concepts. It could plausibly be argued that a higher tax applying to residual profit (or, in the case of P1, part of residual profit) would generate few, if any, economic distortions. But this point can be taken further; if that is true, then it is not clear that P1 needs to have any credit mechanism to reduce double taxation. Clearly, such a mechanism will have significant administrative costs; but the benefits - at least for the purposes of economic efficiency - are unclear.

[47] The concepts of residual profit and economic rent are not identical, and in any case the measurement of residual profit in the P1 and RPAI proposals is somewhat arbitrary. See Devereux et al (2021) page 202.

4.2.2. Robustness to avoidance

There seem to be no obvious problems in the mechanism for the avoidance of double taxation with respect to robustness to avoidance, either for the Article 12B or the P1 proposals.

Indeed the P1 mechanism is likely to strengthen the system's robustness to avoidance if it allocates taxable profit away from entities with little or no economic substance, typically located in tax havens. Consider the case above where an MNE has a parent company in A, R&D and manufacturing in B, and holds its IP in tax haven C. Residual profits are located in A and C, but not B. Let us suppose that the profit located in C represents the result of profit shifting from the other countries. In that case, if P1 results in taxable profits being taxed in market countries rather than C, then it may be argued that the system is less prone to profit shifting.

The same would be true in the UN 12B proposal to the extent that the MNE moved profit from C to, say, B in order to take advantage of the tax credit in B, as discussed above.

4.2.3. Incentive compatibility

The main benefits of these proposals accrue to market countries and are considered in Section 3. The main costs accrue to countries whose taxing rights are displaced by these proposals. In a bilateral setting, such as that contemplated in the Article 12 B proposal, a country is more likely to identify as either primarily a market or a residence country (i.e. the country in which the recipient of the income subject to withholding is resident). If the latter, it is less likely to agree to amend its treaty to allow for Article 12 B. A previous draft of the UN proposal alluded to this when stating that it was possibly unpalatable to some residence countries.

On a multilateral basis, countries are more likely to be both market and residence countries, making the classification as one or the other less obvious and increasing the likelihood of agreement. Of course, if the portion of the residual profit is systematically shifted away from tax havens, it is more likely than non-haven countries will agree.

4.2.4. Ease of Administration

In principle the credit or exemption mechanism inherent in Article 12 B is relatively simple to administer and is based on tried and tested rules and mechanisms. That is a clear advantage of the approach of using a withholding tax mechanism that fits within existing treaty provisions.

By contrast, P1 proposes a materially greater complexity including a complex process to determine the relevant "paying entities" and a significant and novel multilateral administrative infrastructure (including the review panels required for the "certainty" process).[48] That approach is dependent upon a radical transformation of existing arrangements and practices relating to both tax administration and for the prevention and resolution of disputes.

In particular, this includes the centralised "tax certainty" process which necessitates two different levels of tax panels (comprising tax officials from selected states) as the primary mechanism to prevent disputes relating to the new rules and which would therefore require an agreement amongst participating states to delegate tax administrative powers under the panel mechanism. There is also the proposed standardized and centralized administration infrastructure through which, it is proposed, tax returns and tax payments relating to the new rules will be processed.[49] These measures are important for the P1 design, in order to avoid the possibility of its operation being derailed by disputes involving any one or more of up to 150 or so individual tax administrations.

However, as noted above, the radical shift that is required from existing administration and dispute practices operated by states to deliver these arrangements present difficult challenges given the scale of the tax sovereignty that must be ceded.[50] The nature of these requirements and their novelty may make it difficult to deliver the new approach in the first place or alternatively may unduly constrain the application of the new tax.

All of these factors have an impact on the potential scope of the P1 proposal. Due to its complexity and administrative cost, P1 can reasonably only be extended to a relatively select number of businesses, implying the need to restrict its scope by sector and/or business size.

A clear trade-off therefore arises here. P1, unlike Article 12 B, in principle provides a comprehensive approach to dealing with double taxation, but this comes at the expense of considerable added complexity and administrative cost. Article 12 B can – in principle - be applied more widely.

By its nature, the RPAI does not give rise to double taxation. However, the RPAI involves a much more ambitious programme of reform.

[48] See Chapters 9 and 10 of the Blueprint document.
[49] See generally Chapters 9 and 10 of the October 2020 P1 Blueprint.
[50] See for example the discussion of the various legal challenges from the Pillar 1 proposal in Jinyan Li, The Legal Challenges of Creating a Global tax regime with the OECD Pillar One Blueprint, forthcoming in *Bulletin for Int'l Taxation*, February 2021. Li argues that the legal obstacles (including the required ceding of sovereignty) to constructing the regime outlined in the Blueprint are significant and may be insurmountable.

5. Combining approaches

The discussion above considers certain key features of the proposals on a comparative basis. This makes it easier to identify the effect and implications of the individual design choices made in each of those proposals. In turn, this facilitates the possibility of considering how different features of the proposals might be combined to offer a greater range of possible options, or to improve upon features of a particular proposal.

This point is illustrated in this section by reference to the P1 proposal, with possible impacts from both the UN proposal and the RPAI. In particular, we consider here a possible revision to the P1 delivery mechanism, which also has implications for how double taxation is relieved. Before doing so, however, we summarise the conclusions of the previous discussion for ease of reference.

5.1. Summary of conclusions

Table 1 summarises the key features of the proposals. It also identifies which features are inherent to these proposals and thus cannot be changed without changing the very nature of the proposal.[51]

Table 2 sets out the strengths and weaknesses of the different options available for each key feature. It also highlights the difficult trade-offs that arise in choosing among these options. For example, narrowing the scope of the tax (to only include businesses in certain sectors and/or businesses of a certain size) and the definition of the market (to only include immediate purchasers) has a negative effect on economic efficiency, robustness to avoidance and incentive compatibility. But, overall, such a change would reduce administrative costs significantly. Another option to reduce the administrative costs under P1 is to reallocate the profit taxed in the market country from the recipient country rather than the countries where the residual profit is found. We discuss this option, and the trade-offs it gives rise to, next.

Table 1 Extent to which features are inherent in each proposal

Key:

- *Light grey shading: feature not inherent in proposal and, therefore, can be changed*
- *Dark gray shading: feature inherent in proposal and, therefore, cannot be changed*

	Scope	Definition of market	Base taxed in market	Collection mechanism	Adjusting country	Credit against
P1	ADS & CFB High revenue threshold	Direct or indirect purchasers, or users	Part of residual	Direct assessment	Broadly, where residual	Tax on the residual

[51] Of course, there can be different views on when the nature of a proposal is changed.

					currently located	
A 12B	ADS	Direct purchasers	Revenue or profit[52]	Withholding or direct assessment[53]	Residence country	Tax on the profit
RPAI	All businesses beyond de minimis threshold	Direct or indirect purchasers, or users	Residual	Direct assessment	No adjustment required[54]	No credit required[55]
UK DST	ADS High revenue threshold	Users	Revenue attributable to users	Direct assessment	No adjustment offered	No credit offered

Table 2 Evaluation of key features

Key:

- *Dark gray shading: weakness*
- *Light gray shading: strength*

	Efficiency	Ease of administration	Robust to avoidance	Incentive compatibility
Narrower scope (limited number of sectors, and/or only very large firms)	Limits benefits from allocating tax to the market Creates distortions between businesses of different size and in different sectors.	Reduces administrative costs (including those relating to revenue sourcing rules, collection, and for P1 the certainty process) Classification borders need policing	Creates opportunities to avoid by reclassifying	Leaves more profit being taxed in location of functions and activities, so greater incentive to compete for business
Narrower definition of market (direct purchaser) (including implications for collection mechanism)	Location more mobile, so greater incentive to change location of direct purchaser	No need for look-through rules for indirect purchaser or user; no need to identify non-resident to tax	Easier to create structure to relocate profit to a low tax country (e.g. independent distributor and	Greater incentive to compete for purchasers

[52] Article 12 B includes an alternative profit-based approach.
[53] The alternative profit-based approach is collected through direct assessment.
[54] No adjustment is made, but relative to the existing system the base allocated to the market is shifted from all countries which are currently allocated more than routine profit.
[55] No credit, but the system produces a result that is akin to credit being given against residual profit.

			centralised purchasing strategies)	
Narrower base (profit rather than revenue)	Less potential distortion to investment overall, depending on extent of credit elsewhere	Harder to identify profit	More opportunity for manipulating revenue sourcing rules	Incentive to shift purchasing operations creates incentive to compete
Adjusting country where residual profit is, rather than recipient country	Less potential distortion to investment through double taxation Less impact if residual profit not already taxed	Complexity of "certainty" process	If residual currently shifted to low tax country	Less reduction in tax in country of functions and activities so more incentive to compete
Credit against residual profit only	Less impact if residual profit not already taxed	Requires identification of residual profit	Limits extent to which residual profit can be shifted to low tax country May offer greater opportunity for manipulation of where residual profit is located	Less reduction in tax in country of functions and activities so more incentive to compete

5.2. Possible Revision to the P1 Delivery Mechanism

This section considers whether the P1 approach could be delivered through a bilateral delivery mechanism. The intention would be to minimise or remove the need for the ongoing multilateral infrastructure required under the P1 proposal, given that this infrastructure is complex and costly to administer, and may prove an obstacle to P1's implementation. But the intention would be to retain other elements of the P1 proposal – including scope, nexus, revenue sourcing and profit allocation.

The starting point is to identify the tax in the market country following the P1 approach, but to transform this into a tax on revenue to make it possible to apply the tax using existing bilateral mechanisms. For example, suppose that under the formulary apportionment approach of P1, country A is allocated 1,000 of the profit of company Y. Suppose also that the tax rate in country A is 20%. So A would seek to collect 200 in tax. If the revenue of company Y in country A is 10,000, this could be viewed as a tax on revenue at a rate of 2%. The tax rate applied to revenue is given by the formula:

*Tax rate applied to revenue = Local rate of tax * Profit allocated to country / Revenue in country*

This tax rate would be of course company- and year-specific, since the ratio of profit allocated to revenue will differ from company to company, and from year to year, just as in the basic operation of P1 as currently proposed.

Mechanically, the notional tax on revenue could be applied either in the style of a DST (where the MNE remits the tax at year end) or in the form of a withholding tax, or possibly both, in combination.[56] Note that the idea here is to keep the P1 revenue sourcing rules in terms of defining the market country, so a withholding tax will not always be possible.

This revised approach would simplify the process for the identification of the relevant "paying entity" for the purposes of making adjustments to avoid double taxation. Specifically, the method currently proposed under P1 for identifying the relevant paying entity would be replaced with a bright line test, turning on the identity of the legal entity receiving the relevant sales revenue. Relief for double taxation would be provided by the recipient jurisdiction in the same way as the UN Article 12B proposal, subject to that jurisdiction's own double tax relief system, replicating the existing treatment for other income subject to double tax, such as dividends, interest and royalties. The revised approach would also follow P1 in operating irrespective of the existence of an applicable bilateral tax treaty in any particular case.

These changes would enable the tax to be administered largely, if not exclusively, on a familiar bilateral basis using a separate entity approach.[57] The revised approach would still require an up-front multilateral agreement covering the details of the approach to be adopted in line with the P1 proposals (including scope, calculation mechanics, revenue sourcing, thresholds, etc). The intention would be that, thereafter, the system would run on a fundamentally bilateral basis. The up-front multilateral agreement would also, consistent with the current P1 proposal, enable the new approach to be operated irrespective of the existence of tax treaties (the up-front multilateral process would remove existing treaty obstacles, just as is contemplated under the current P1 proposal). Under this revised approach of delivering the P1 proposal through bilateral mechanisms, the "tax certainty" process would be removed altogether, or possibly operated on a materially scaled-back basis, for example as where the panel process is used simply to advise on or possibly determine the appropriate methodology to be used for matters such as revenue sourcing and the approach to segmentation.

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[56] The use of a withholding tax as a back-up collection mechanism to support a separate tax addressing the digitalisation of business is suggested in the BEPS Final Report – See OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris at para 301.

[57] For example, whilst questions relating to scope and the calculation methodology would be determined through the up-front multilateral process and agreement, questions such as whether the relevant nexus requirements were met in any particular case would be determined by the market state, which would also calculate and charge the tax. Returns would be filed in each market jurisdiction by the relevant recipient entity.

This revised methodology would therefore adopt a different stance in the trade-off inherent between the strengths and weaknesses of the P1 proposal relative to the Article 12 B proposal. It would lack the "tax certainty" feature of that Pillar 1 proposal according to which any and all disputes relating to the new Amount A rules are identified, addressed, and resolved through the tax panel process. However, as a result, it would have considerably lower administrative costs, as well as removing concerns about sovereignty which may in any case make consensus over the existing P1 proposal difficult.

One particular feature of this revised proposal warrants further consideration. This concerns the status of the tax credit (reflecting the tax charged in the market state) in the hands of the entity currently receiving in-scope revenues. As noted in the earlier discussion, the UN proposal has relatively little to say on this matter, though it does note some of the barriers to the crediting mechanism that might arise in practice. It seems necessary to address the tax credit position in more definite terms.

Assuming that a tax credit is to be made available, there are two choices that might in principle be considered with respect to the issues raised in Section 4.

Whether credit is given against all profit or only residual profit

Leaving aside the possibility discussed above of dispensing with the credit mechanism completely, the first choice is whether the tax credit is fully available in the residence state (that is, the state in which the relevant payments are received) with no limitation, or whether it is limited by reference to a threshold based on a required level of profitability, specifically residual profits.

Having no limitation would be the simplest option and the option that would be applied on a straightforward application of the tax credit mechanism in Article 23 of the OECD Model. Priority taxing rights would be given to the market state, potentially constraining the ability of the residence state to levy and collect further tax on the receipt collected by an entity that is resident there. As noted above, this approach is likely to have the effect of displacing residence state taxing rights completely where the receipt is collected in that state by a limited risk distributor or an entity with a slim profit margin relative to the remainder of the multinational group. Note that any particular country may not lose overall, by virtue of being a residence state, at least to the extent to which it is also a market country.

Restricting the tax credit to residual profit would prevent the residence state's taxing rights on routine profits being automatically displaced by the tax levied on the relevant payments by the market state. We have already discussed this in Section 4 as a matter of principle. Apart from these issues of principle, two important questions arise.

First, this approach would put the onus on the taxpayer group either to ensure residual profits were booked in the residence state or to suffer the consequences of potential double taxation if they are not. However, there are likely to be situations where it is simply not possible to book residual profits in the residence state – for example, in situations where there is a long supply chain with profit spread across the entities in the chain consistent with the demands of the ALP.

Second, measuring residual profit at the level of an individual entity is far from straightforward. For example, it would not be possible simply to consider the ratio of profit to revenue, as would be done at the aggregate level in determining Amount A. This is because the scale of the revenue increases though the supply chain. For example, suppose 3 entities in the supply chain all have the same costs and all make profit of 100. A sells an intermediate good to B for 500; B develops this into a more complete good and sells the resulting product to C for 1,000. And finally C develops the product still further and sells the final good for 2,000. Then the rates of profit are 20% for A, 10% for B and only 5% for C.

However, this is the issue addressed by the RPAI proposal, which instead uses established transfer pricing techniques, such as a cost mark-up, to identify routine profit in each entity. Note that in this case, costs arising from purchases of intermediate products from other entities in the supply chain would need to be excluded from the base. A possibly simpler version of the RPAI proposal would be to use a common rate of return – say, 10% - on all other costs to generate a measure of the routine profit of the entity in the residence country and deduct this from total profit to identify residual profit. In this way, the P1 proposal would also draw on the RPAI proposal. However, such a standardised approach across industry sectors may not be appropriate given the wide variations in cost base and profitability across industries. But a more tailored approach by industry sector or based on the circumstances of the entity or group concerned is likely to prove complex.

Which country gives credit?

The second choice to be made is whether the tax credit is limited only to the residence country in which the payment is received, or whether it might be possible to recognise a "transfer" of the tax credit in limited circumstances. The idea would be that in designated circumstances (which might include there being insufficient profits to provide the capacity to absorb the tax credit in the residence state – a possibility that is, of course, more likely if the credit is limited to residual profit), a related entity in a third country could choose to fund the payment of some or all of the tax charged by the market state and thereby assume the tax credit for the purposes of the tax credit laws in its own state.

> Permitting such an approach would clearly go beyond the current operation of tax credits and would require adoption pursuant to an up-front multilateral agreement.

> Not permitting such a transfer would allow bilateral implementation of the new allocation to market states and avoid further complexity.

On the other hand, permitting a transfer would mitigate the incentive for some multinational groups to shift profits into residence countries to maximise the use of the tax credit. That is because the profit currently declared in other countries would also be available for credit. Such an entitlement might be allowed where the company in the third country meets specified criteria that are similar to those targeted under the current P1 proposal to identify "paying entities" for the purposes of the elimination of double tax proposals.[58] In that case, the obvious target would be states in which there are entities with residual profits. It would be necessary to avoid the need for the maintenance, on an ongoing basis, of a multilateral infrastructure to deal with the operation of such a system as otherwise potentially difficult sovereignty and infrastructure issues may be raised (similar to those difficulties discussed above in connection with the tax certainty infrastructure of P1). It would therefore be necessary to restrict any multilateral agreement to the up-front agreement of the principles of the system of "transfers" of tax credits, leaving any disputes about the operation of the system to be resolved through the courts in the relevant jurisdictions, rather than by the panel system proposed under the proposed full certainty process.

6. Conclusions

This paper has set out to compare and evaluate three current proposals for reform of the international tax system for multinational profit: the Unified Approach (Pillar 1) of the OECD, Article 12B of the United Nations and the RPAI proposed by Devereux et al (2021). Each of these proposals shifts an element of the taxation of such profit to the "market" country. They differ in a number of ways, not least in the definition of what is considered to be a market country, and whether the reform is intended to address the digitalization of the economy, or to be applied more widely.

A key contribution of the paper is to show that these proposals can be characterised as representing something more than just stand-alone alternatives. Rather, they may also be thought of as alternative attempts to address a number of issues that must be considered in any such proposal. Specifically, these factors include: the scoping of any proposed tax (that is, which businesses (or which part of businesses) would be liable to the tax; the mechanism by which the tax base is identified and allocated to a market state; the nature of the tax base (for example, whether it is based on gross revenue or net profit); the method by which tax is collected; the country, if any, in which adjustments are made to alleviate perceived double

[58] The detailed rules governing the operation of such a rule, and any limitations on its application, would need to be developed.

taxation; and whether that country offers credit against all taxes on profit, or only taxes on residual profit.

This perspective is helpful in clarifying the comparative merits of the each of the proposals. It also illustrates that the differences between the proposals rests on the different ways in which they address these issues. It also helps to identify which aspects of each proposal are inherent in the design, and which aspects could be amended, without fundamentally changing the design. This insight promotes the possibility that elements from the different proposals could also be combined in a new way, as we illustrate in section 5 above. In that section, we demonstrate how possible problems in the design of one proposal might be addressed by drawing on the design features of another.

The discussion in this paper is largely limited to the three proposals under consideration here. However, the perspective suggested here is equally relevant to other approaches proposing reform to international taxes.

The detailed discussion of the three proposals on a comparative basis also highlights two specific issues. The first is a comparison between unilateral, bilateral and multilateral approaches, which to some extent reflect a trade-off between ease of implementation and the extent of ambition possible within each proposal. We conclude that material change to the existing system is likely to require a multilateral approach if the obstacles to change (chiefly, from the network of existing double tax treaties) are to be overcome in sufficient scale.

A second issue is a comparison between proposals where the allocation of taxing rights to market countries is part of a new system that is simply layered on top of the existing ALP-based income allocation system (as in the P1 and Article 12 B proposals), as compared to one which sets out a more coherent package (the RPAI proposal). In order to alleviate double taxation, the former approach requires an allocation of taxing rights under the existing system, and then a subsequent adjustment to those taxing rights. The inherent difficulties arising from the layering approach (including, in particular, the difficulties relating to the operation of the tax credit mechanism) underscore the desirability of a more coherent and integrated system such as the RPAI, rather than the piecemeal or “dual” approach which is necessarily adopted by the P1 and UN proposals.