Recognising the Sales Component of Profit: Allocating Market Jurisdictions a Share of Taxing Rights on the Profits of Multinational Enterprises

Fei Gao

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STATEMENT OF ORIGINALITY

This is to certify that, to the best of my knowledge, the content of this thesis is my own work. This thesis has not been submitted for any degree or other purposes.

I certify that the intellectual content of this thesis is the product of my own work and that all the assistance received in preparing this thesis and sources have been acknowledged.

Fei Gao

3 May 2024

AUTHORSHIP ATTRIBUTION STATEMENT

Chapter 7 of this thesis is based on the book chapter published as Fei Gao and Antony Ting, 'Is Arm's Length Profit Split Methodology Morphing into a Formulary Apportionment Hybrid: The Chinese Example' in Richard Krever and François Vaillancourt (eds.), *The Allocation of Multinational Business Income: Reassessing the Formulary Apportionment Option* (The Netherlands: Kluwer Law International, 1st ed, 2020) pp. 239-255.

I designed the study, analysed the data and wrote the drafts of the book chapter.

In addition to the statements above, in cases where I am not the corresponding author of a published item, permission to include the published material has been granted by the corresponding author.

Fei Gao

3 May 2024

As supervisor for the candidature upon which this thesis is based, I can confirm that the authorship attribution statements above are correct.

David Chaikin

3 May 2024

ABSTRACT

Traditional international taxation generally allocates taxing rights to the residence country and supply-side source countries that make labour or capital contributions. However, sales factor, which represents the demand side, does not share any profits under this system. This is problematic because online sales may separate sales and supply-side activities, meaning the market jurisdictions may not receive any taxing rights over Multinational Enterprises (hereinafter MNE) profits at all. To address this issue, the Organisation for Economic Co-operation and Development (hereinafter OECD) proposed a new approach named "Amount A" in the inclusive framework of the Two-Pillar Approach in 2019. It uses revenue as the nexus and shifts some taxing rights from the more effective or intangible-rich jurisdictions directly to market jurisdictions that host little or no supply-side value-added activities to compensate the taxing rights they have lost in the changed business mode.

While this thesis agrees that the market jurisdictions should have some taxing rights merely for hosting sales, it argues that the Amount A's formulary apportionment approach is not a viable solution for political reasons. Instead, the thesis suggests that transfer pricing methodologies could be used to allocate an appropriate portion of taxing rights to market jurisdictions without a paradigm shift. Specifically, a creative interpretation of the arm's length principle that uses marketing intangibles and the profit split method could be well effective.

This thesis takes a market jurisdiction's perspective. It outlines the obstacles they face in taxing residual profits, including physical presence, the ownership of marketing intangibles, enhancing the value of the existing intangibles, and transfer pricing methods

that could be advantageous. The thesis uses the Chinese model as an example of how a market jurisdiction could interpret the traditional OECD model and proposes a “market-source-residence” paradigm as an alternative to the current income allocation approach.

Overall, this thesis provides valuable guidance to policymakers on a viable and achievable solution to the problem of recognising sales as a source of profit that can be taxed by the country providing this crucial source element.

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ABBREVIATIONS

GENERAL

AJRDP	Adjusted Jurisdictional Return on Depreciation and Payroll
ALP	Arm's Length Principle
APA	Advance Pricing Agreement
APMA	Advance Pricing and Mutual Agreement
BEFIT	Business in Europe: Framework for Income Taxation
BEPS	Base Erosion and Profit Shifting
BMT	Book Minimum Tax
BU	Business Unit
CBC	Country by Country
CCA	Cost Contribution Agreements
CCCTB	Common Consolidated Corporate Tax Base
CE	Constituent Entity
CFC	Controlled Foreign Corporate
CPI	Consumer Price Index
CPM	Comparable Profits Method
CUP	Comparable Uncontrolled Price
CUT	Comparable Uncontrolled Transaction
DEMPE	Development, Enhancement, Maintenance, Protection and Exploitation
DEMPEP	Development, Enhancement, Maintenance, Protection, Exploitation and Promotion

DST	Digital Service Taxes
ETRDP	Elimination Threshold Return on Depreciation and Payroll
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
FA	Formulary Apportionment
GILTI	Global Intangible Low-Taxed Income
GloBE	Global Anti-Base Erosion
IIR	Income Inclusion Rule
IRS	Internal Revenue Service
JRDP	Jurisdictional Return on Depreciation and Payroll
LSA	Location-specific Advantage
MDSH	Marketing and Distribution Profits Safe Harbour Adjustment
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
OG	Operating Group
PE	Permanent Establishment
PSM	Profit Split Method
QDMTT	Qualified Domestic Minimum Top-Up Tax
RDP	Return on Depreciation and Payroll
ROA	Return on Operating Assets
STA	State Taxation Administration
TCJA	Tax Cuts and Jobs Act
TNMM	Transactional Net Margin Method

UDITPA	Uniform Division of Income for Tax Purposes Act
UN	United Nations
UPE	Ultimate Parent Entity
US	United States
UTPR	Under Tax Payment Rule

REGULATIONS

OECD Guidelines	OECD Transfer Pricing Guidelines from 1979 to 2022
1979 Report	OECD Transfer Pricing and Multinational Enterprises 1979
1995 Report	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995
2010 Report	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010
2017 Report	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017
2022 Report	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022
1992 Regulations	US Income Tax Regulations § 1.482 1992 Amendment INTL-0372-88, INTL-0401-88, 57 FR 3571
1993 Regulations	US Income Tax Regulations § 1.482 1993 Amendment T.D. 8470; INTL 401-88, 58 FR 5263
1994 Regulations	US Income Tax Regulations §1.482 1994 Amendment T.D. 8552 1994-2 C.B. 93

Circular 2	China Implementation Measures for Special Tax Adjustment (trial) 2009
2015 Draft Circular	China Consultation Draft Circular: Implementation Measures for Special Tax Adjustments 2015
Bulletin 6	China Administrative Measures of Special Tax Investigation and Adjustment and Mutual Agreement Procedure 2017

GLOSSY OF TERMS

Adjusted Covered Tax

A Constituent Entity's (CE) current tax expense accrued in profit before tax (with adjustments) in a low-tax jurisdiction.[1]

Advance pricing agreement (APA)

According to the OECD definition, APA is "[a] arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations."[2]

Advance pricing and mutual agreement (AMPA)

In 2012, the Advance Pricing Agreement (APA) Program in the US merged with that portion of the Office of the US Competent Authority (USCA) that resolves transfer pricing

[1] OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (2021), Article 4.1. It can be less than zero. See Article 4.1.5.
[2] OECD, Glossary of Tax Terms, <https://www.oecd.org/ctp/glossaryoftaxterms.htm#c> accessed 10 May 2023.

cases under the mutual agreement procedures of the United States' bilateral income tax conventions to form the AMPA Program.[3]

Allocation keys or splitting factors

They are used interchangeably in the OECD documents. Both of them are used to divide the combined profits under a profit split method (contributory or residual approach) among related parties.[4]

Amount A

A formula-based system that reallocates some of the existing taxing rights over the residual profits of the biggest and most profitable MNEs from intangible-rich countries to market jurisdictions that perform limited supply-side value-added activities (see Section 3.4).

Amount B

A few sets of artificial comparable transactions made by OECD describing "baseline marketing and distribution activities" in each region.[5] It was designed to simplify the

[3] Internal Revenue Service, Advance Pricing and Mutual Agreement Program, <https://www.irs.gov/businesses/corporations/apma> accessed 13 June 2023.
[4] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), at Chapter II, C.5.1.
[5] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint* (2020), para 650 and 694.

transfer pricing and expected to reduce compliance costs and enhance tax certainty.[6] Once the activities are in the scope of Amount B, the tax authority will lose the position to challenge it as being "non-routine".[7]

Arm's length principle (ALP) or Arm's length approach/system/methodology

The arm's length methodology treated each part of an MNE as a separate entity dealing with other parts of the same enterprise on an arm's length basis.[8] A country's right to tax a share of the profits of an MNE depended on the enterprise's physical presence in the jurisdiction.[9] In effect, the arm's length system allocated profits using two of the three factors used in the FA system, labour and capital inputs.

Brand value stripping

It happens to related or unrelated entities that the brand owner terminates licensing agreement with the distributor who has invested a tremendous amount of money and effort in exploiting the brand name or trademark. The brand owner may engage a new distributor with the exploited brand name, and the old distributor's money and effort, which should have given them long-term benefits, is stripped (see Sections 5.4.2 and 5.4.3).

Bright line test

[6] Ibid, para 651.
[7] Ibid, para 654.
[8] See Vann, Richard J., 'Reflections on Business Profits and the Arm's Length Principle' in Brian J Arnold, Jacques Sasseville and Eric M. Zolt (eds), *The Taxation of Business Profits Under Tax Treaties* (Canadian Tax Foundation, 2003) 133. Also see, Fiscal Committee of the League of Nations, *Report to the Council on the Fourth Session of the Committee*, League of Nations Doc. C.399.M.204.1933.II.A. (1933), at 2.
[9] See Chapter 4 of this thesis for details.

The "bright line" test developed in the trial judge of *DHL case*[10] mark the line of distributor creating marketing intangible of its own in the US. It noted that though every licensee or distributor is expected to expend a certain amount of cost to exploit the items of intangible property provided to it, the investment might be cross the "bright line" of routine expenditure into a realm of non-routine. This is when a marketing intangible is likely created.[11]

Business in Europe: Framework for Income Taxation (BEFIT)

On 18 May 2021, the EU Commission announced a proposal for a new framework for income taxation for businesses, namely "Business in Europe: Framework for Income Taxation (BEFIT)".[12] This initiative establishes unified regulations for calculating the taxable base of EU companies, allocating profits among EU member states based on a formula.

Carve-out

Carve-out usually include payroll carve-out and tangible asset carve-out. They are calculated based on the eligible payroll costs of employees[13] that perform activities for an MNE or carrying value of eligible tangible asset[14] located in a low-taxed jurisdiction.

[10] *DHL Corporation and Subsidiaries v. Commissioner* (1998) T.C. Memo. 1998-461.
[11] See Mark M. Levy, Lawrence W Shapiro, Robert J. Cunningham, et al., 'DHL: Ninth Circuit Sheds Very Little Light on Bright-Line Test' (2002) 13(10) Journal of International Taxation 10.
[12] European Commission, *Communication Business Taxation for the 21st Century,* COM (2021) 251 at < https://taxation-customs.ec.europa.eu/system/files/2021-05/communication_on_business_taxation_for_the_21st_century.pdf>, accessed 11 August 2023.
[13] OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (2021), Article 5.3.3.
[14] Ibid, Article 5.3.4.

Constituent Entity (CE)

The smallest unit relevant in Pillar Two is not "entity", but "Constituent Entity" (CE) which consists of a main entity and its PEs.[15]

Combined reporting or combined reports

An FA approach to aggregate income, where accounting figures of related entities are combined, and each geographic location takes a share based on their contributions in terms of capital, labour, and sales.

Comparable profits method (CPM)

The CPM is an US transfer pricing method subscribed in section 482 in 1992, which originated OECD transactional net margin method (TNMM). The CPM "evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances."[16]

Comparable uncontrolled price (CUP) method

According to the OECD, the CUP method is "[a] transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances."[17]

[15] Ibid, Article 1.3.
[16] 26 CFR § 1.482-5(a).
[17] OECD, Glossary of Tax Terms, <https://www.oecd.org/ctp/glossaryoftaxterms.htm#c> accessed 10 May 2023.

Comparable uncontrolled transaction (CUT) method

The CUT method is a US transfer pricing method that equivalent to comparable uncontrolled price (CUP) method, but only applies to transactions involves intangibles assets. It "evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction."[18]

Controlled transaction

Transactions between two enterprises that are associated enterprises with respect to each other.[19]

Cost plus method

According to the OECD, the cost plus method is "[a] transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction."[20]

Core business activities

In this thesis, they refer to the business activities that are not preparatory or auxiliary in nature (see Section 4.2.1).

[18] 26 CFR § 1.482-4(c)(1).
[19] OECD, Glossary of Tax Terms, <https://www.oecd.org/ctp/glossaryoftaxterms.htm#c> accessed 10 May 2023.
[20] Ibid.

Doctrine of economic allegiance

It roots in the "ability to pay principle", which says the government services (to person or property) rendered to an individual increase his economic faculty (or the ability to pay). Therefore, to these countries, the individual owes economic allegiance. Tax is the consideration he pays for the economic allegiance he owes.[21]

Entity approach

A form of FA approach that the total income ready for allocation only includes income from a legal entity and its branches.

Entity-level advantages

They usually refer to intangibles or development, enhancement, maintenance, protection, and exploitation (DEMPE) functions of intangibles that help the entity perform better than the comparable party in an uncontrolled transaction. The transfer pricing analysis discusses the “market advantages” or “competitive advantages” that an intangible asset is expected to bring to the entity.[22] This concept is contrary to the “jurisdictional level

[21] Gijsbert W.J. Bruins, Luigi Einaudi, Edwin R.A. Seligman, and Sir Josiah Stamp, *Report on Double Taxation Submitted to the Fiscal Committee of the League of Nations* (Economic and Financial Commission, League of Nations, Geneva, 5 April 1923), at 18-20.
[22] For example, paragraph 6.118 regarding the exclusivity of intangibles and paragraph 6.122 regarding the useful life of intangibles. The 2022 Report, above fn 1.

advantages", which refers to market features that belong to location-specific advantages (see Section 5.7).

Excessive Profit

The OECD introduced a concept named "Excessive Profit" of a jurisdiction to exempt a portion of return arising from payroll and tangible assets:[23]

$$Excessive\ Profit$$
$$= \Sigma Net\ GLoBE\ Income\ of\ the\ jurisdiction$$
$$- \Sigma Substance\ Based\ Income\ Exclusion\ for\ each\ CE\ in\ the\ jurisdiction$$

Formulary Apportionment (FA)

A system divides global profits based on each country's shares of the factors that give rise to profits – labour and capital inputs to create the company's goods or services and customers willing to pay more for the output than its cost, thus yielding a profit.[24]

Functional analysis

[23] OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (2021), Article 5.2.2.
[24] Apart from the classic three-factor formula, there are other forms of FA, such as the single-sales factor formula. See Section 3.2 of this thesis.

Functional analysis is a key component of the arm's length principle. The OECD believes that in a transaction between two independent enterprises, the compensation matches the functions each enterprise performs.[25] Hence, functional analysis involves the identification of the key contributions of an entity, including functions performed, assets used, and risks assumed. These contributions would then be compared to the comparable third-party transaction that can be used as a benchmark to establish arm's length prices.

GloBE Income or Loss

The financial profit and loss (with adjustments) for a CE is called the "GloBE Income or Loss" of a Constituent Entity (CE).[26]

Group synergies

Group synergies are the cost saving or additional profits MNEs obtain for being a group enterprise. These costs include research and development costs, transaction costs, information-obtaining costs, managerial costs, and finance costs.[27] The additional profits may arise from economics of scope and scale.

Jurisdictional level advantages or market level advantages

[25] For details of the functional analysis, see OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), at Chapter I, D.1.2.
[26] OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (2021), Article 3.1 and 3.2.
[27] See Reuven S. Avi-Yonah and Ilan Benshalom, 'Formulary Apportionment – Myths and Prospects' (2010) *Law and Economics Working Paper, Paper 28*, at 10.

They refer to some of the location-specific advantages (LSAs) that shared by all entities in a specific geographic area, such as market premium or strong purchasing power. Unlike intangibles, which are entity-level advantages, the jurisdictional level advantages will not bring much benefit to the jurisdiction unless a non-local comparable is adopted in transfer pricing analysis (see Section 5.7.1).

Jurisdictional Top-Up Tax

The Pillar Two calculations start from the Top-Up Tax calculations. The jurisdictional Top-Up Tax is basically a multiply of the Top-Up Tax Percentage and Excessive Profit, with adjustments.[28]

Jurisdictional Top-Up Tax Percentage

Refers to the difference between a minimum tax rate and effective tax rate in a jurisdiction.[29] For instance, if a jurisdiction has an effective tax rate of 10%, the Top-Up Tax Percentage will be 5%, comparing to a 15% minimum tax rate.

Jurisdictional Effective Tax Rate[30]

$$Effective\ Tax\ Rate\ of\ a\ Jurisdiction = \frac{\Sigma Adjusted\ Covered\ Taxes\ of\ each\ CE\ in\ the\ jurisdiction}{\Sigma Net\ GLoBE\ Income\ of\ the\ jurisdiction}$$

[28] OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (2021), Article 5.2.3.
[29] Ibid, Article 5.2.1.
[30] Ibid, Article 5.1.

Massachusetts formula

The first three-factor formula was adopted by Massachusetts in 1919.[31] It allocated the income of multistate corporations based on the proportion of the company's tangible property, labour costs and sales receipts within the state. The three factors were weighted equally so each factor apportioned 1/3 of the profits.[32]

Market jurisdictions/market countries

The location where the goods are delivered, and services are rendered by the MNEs to the third parties. See Section 2.3.

[31] Laws of Massachusetts (1919) Chapter 355, Section 6. Massachusetts introduced its income tax in 1916 but only applied to certain income. See Laws of Massachusetts (1916) Chapter 269. The income tax law was amended in 1919 to be more comprehensive, including the introduction of the three-factor formula to apportion interstate profits.

[32] Three-factor formula with equal weights looks like this:

$$Total\ business\ income\ of\ an\ entity \times \frac{\frac{Property\ located\ in\ the\ state}{Total\ property\ of\ the\ entity} + \frac{Labour\ costs\ inclurred\ in\ the\ state}{Total\ labour\ costs\ of\ the\ entity} + \frac{Sales\ made\ in\ the\ state}{Total\ sales\ of\ the\ entity}}{3} = Entity's\ income\ apportioned\ to\ the\ state$$

If the three factors are not arbitrarily made equal, the formula will look like this:

$$Total\ business\ income\ of\ an\ entity \times \frac{Property\ located\ in\ the\ state + labour\ costs\ incurred\ in\ the\ state + sales\ made\ in\ the\ state}{Total\ property\ of\ the\ entity + total\ labour\ cost\ of\ the\ entity + total\ sales\ of\ the\ entity} = Entity'sincome\ apportioned\ to\ the\ state$$

Marketing intangible

An intangible (within the meaning of paragraph 6.6) that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.[33]

One-sided transfer pricing methods

Out of the five transfer pricing methods prescribed by the OECD, namely the comparable uncontrolled price (CUP) method, the resale price method, the cost plus method, the profit split method (PSM) and the transactional net margin method (TNMM), three of them are the one-sided methods, which are the resale price method, cost plus method, and the TNMM.[34] Under the one-sided methods, the party that performs functions that are easier to be priced will be the tested party (usually the party without intangibles),[35] which leaves nearly all residual profits to the other party of the controlled transaction (see Section 5.2).

[33] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), at 23 Glossary.
[34] Ibid, para 3.20.
[35] Ibid, para 2.65 and 3.18.

Permanent establishment (PE)

According to OECD Model Tax Convention Article 5, an MNE maintains a PE if it has a fixed place of business,[36] or a dependent agent acts on behalf of it.[37] If the MNE is only carrying on business activities in a preparatory or auxiliary nature, the fixed place of business or dependent agent does not constitute a PE in that country[38] (see Section 4.2.1).

Profit split method (PSM)

According to the OECD, the PSM is a "[t]ransfer pricing method that allocates the combined operating income or loss from a transaction among the separate parties by determining the relative value of each party's contribution to such overall profits or loss."[39] It can be combined with the other transfer pricing methods by pricing out the routine functions first using other methods, and split the residual profits according the comparative contributions of each party. This analysis is called "residual analysis".[40]

Two-Pillar Approach

It consists of Pillar One (Amount A and Amount B) and Pillar Two. Pillar One aims to address broader challenges of the digital economy and focuses on allocating taxing rights,

[36] OECD, 'Article 5 Permanent establishment', in *Model Tax Convention on Income and on Capital 2017* (2019), Article 5(1).
[37] Ibid, Article 5(5).
[38] Ibid, Article 5(4).
[39] OECD, Glossary of Tax Terms, <https://www.oecd.org/ctp/glossaryoftaxterms.htm#c> accessed 10 May 2023.
[40] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), part C.3.1.2 Residual analysis.

while Pillar Two aims to put a floor to international taxation and make profit shifting less attractive.[41]

Separate accounting

A method for determining the geographic source of income through segregation of the accounting information, including revenue, costs, and profits attributable to each entity and branch from their accounting books and records. The separate accounting method assumes that the transactions between related entities are carried out as if they are unrelated and dealing with arm's length.[42]

Substance Based Income Exclusion

Substance Based Income Exclusion is basically a 5% carve-out on eligible payroll costs and a 5% carve-out on the carrying amount of eligible tangible assets.[43]

Resale price method

According to the OECD, resale price method is a "[m]ethod used in transfer pricing between affiliated companies, under which an arm's length price is ascertained by

[41] OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note* (2019), at 1.
[42] Massimo Agostini, 'U.S. Perspectives of Worldwide Unitary Taxation' (1989) 7(2) *Dickinson Journal of International Law* 213, at 215.
[43] OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (2021), Article 5.3. The carve-outs are a cost-plus "top-up" return on how much has been determined under the ALP.

deducting a normal profit margin from the resale price at which a buyer of inventory assets resells these assets to an unrelated party."[44]

Residence and source dichotomy

Modern international taxation is based on the residence and source dichotomy.[45] The source countries have the primary right to tax profits derived from active businesses, and the residence country will either exempt active business income or provide credits to the tax already paid in the source countries. On the other hand, the residence countries should tax the profits from passive investments with negotiated caps setting the maximum source country tax that could be levied on this income.[46] See Section 2.2.

Residual profits

It refers to the portion of total profits of an MNE or a transaction that exceeds routine profits.[47]

[44] OECD, Glossary of Tax Terms, <https://www.oecd.org/ctp/glossaryoftaxterms.htm#c> accessed 10 May 2023.
[45] For an overall discussion of the residence and source dichotomy, see Robert A. Green, 'Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993-1994) 79(1) Cornell Law Review 18. Also see Section 2.3 of this thesis.
[46] See Richard Krever and Peter Mellor, 'History and Theory of Formulary Apportionment' in Richard Krever and François Vaillancourt (eds.), *The Allocation of Multinational Business Income: Reassessing the Formulary Apportionment Option* (The Netherlands: Kluwer Law International, 1st ed, 2020) pp.9-40, at 23.
[47] Stephen E. Shay, 'The Deceptive Allure of Taxing 'Residual Profits'', (2021) 75(527) *Bulletin for International Taxation* 527, at 527.

Routine profits

It is a concept that is widely used by tax academics and practitioners. Routine profits may refer to "risk-free return", which is earned without bearing a noticeable level of risks by parties such as "risk-free distributors" or "limited-risk distributors" in market jurisdictions.[48] It may also be a benchmark used to calculate the residual value. Under a profit split methodology, routine profits may refer to the level of profits that a comparable third party without unique and valuable intangibles earns.[49]

Separate entity doctrine

The arm's length principle assumes that the entities within the same MNEs are separate entities.[50] These entities try to maximize their own profits rather than the overall group profits. For this reason, a group is nothing but an aggregation of individual members (see Section 6.2).

The most appropriate method rule

Prior to 2010, the OECD had a hierarchical structure of transfer pricing methods: the CUP method was the most preferred method for being direct and reliable;[51] followed by the

[48] For a discussion of risk-free return, see OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), Section D.1.2.2. Risk-free and risk-adjusted rates of return.
[49] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), at 477 example 11.
[50] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), para 1.6.
[51] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995), para 2.7.

other traditional transactional methods, namely the resale price method and the cost plus method;[52] the transactional profit methods, namely the PSM and the TNMM, are the last resort.[53] They might be used "when traditional transactional methods cannot be reliably applied alone or exceptionally cannot be applied at all".[54] The OECD removed this hierarchical structure in 2010 and substituted it with "the most appropriate method rule".[55] The selection of the method should take into account a variety of issues, such as the strengths and weakness of each method; the appropriateness of the method; the availability of the comparable transactions, and so forth.[56] The most appropriate method that could be applied in a reliable manner should be chosen.

Tested party

When applying a one-sided transfer pricing method (resale price method, cost plus method and transactional net margin method), it is necessary to choose the party to the transaction for which a financial indicator (gross margin, mark-up on costs, or net profit indicator) is tested. The tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found.[57] In a situation where one party of the controlled transaction makes all unique and valuable contributions, including intangible assets, and the other party does not make

[52] The OECD provided that "traditional transaction methods are preferable to other methods". See OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995), para 2.49.
[53] Ibid para 3.50.
[54] Ibid, para 3.1.
[55] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), para 1.6.
[56] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995), para 3.1.
[57] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010), Para 2.2.

any unique and valuable contributions, the tested party should be the less complicated one.[58]

Transactional new margin method (TNMM)

TNMM is an OECD version of US comparable profits method (CPM). According to the OECD, TNMM is "[a] transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that it is appropriate to aggregate under the principles of OECD TP guideline Chapter I)."[59]

Unitary approach

A form of FA approach that the total income ready for allocation includes income from several related entities, or global income of an entire MNE. See Section 3.2.1.2.

[58] Ibid, para 2.65.
[59] OECD, Glossary of Tax Terms, <https://www.oecd.org/ctp/glossaryoftaxterms.htm#c> accessed 10 May 2023.

PART ONE: SHOULD THE MARKET JURISDICTIONS BE REWARDED FOR BEING MARKETS?

Chapter 1

Introduction

1.1 Introduction

Soon after income taxation spread among developed nations in the second decade of the 20th century, countries had to decide how to allocate profits earned by multinational enterprises (hereinafter MNE)[1] operating across several nations. It was widely accepted that each country could tax the share of the global profits sourced in the country, but there was no immediate agreement on how the source of profits could be determined. Two models emerged: Formulary Apportionment (hereinafter FA) system[2] and the arm's length system.[3] FA system divided global profits based on each country's shares of the three factors that give rise to profits – labour and capital inputs to create the company's goods or services and customers willing to pay more for the output than its cost, thus

[1] The multinational enterprise (MNE) has been defined as an economic entity that controls operations dispersed across national borders. See Richard E. Caves, *Multinational Enterprises and Economic Analysis* (Cambridge University Press, 3rd ed, 2007), at 1.
[2] For a brief history and past proposals of the FA, see Section 3.2 of this thesis.
[3] For a brief historical development of the residence and source dichotomy and arm's length principle, see Section 2.2.1 of this thesis.

yielding a profit.[4] The arm's length methodology treated each part of an MNE as a separate entity dealing with other parts of the same enterprise on an arm's length basis.[5] A country's right to tax a share of the profits of an MNE depended on the enterprise's physical presence in the jurisdiction.[6] In effect, the arm's length system allocated profits using two of the three factors used in the FA system, labour and capital inputs. The arm's length system emerged as the system accepted by all developed economies and, through their influence on international bodies, by developing economies as well.[7]

The acceptance of the arm's length system had two unintended consequences for the global tax system. The first consequence was the development of profit shifting.[8] Under the arm's length system, the MNEs can shift profits to low-taxed jurisdictions by moving intangible assets to the jurisdictions and paying to use intellectual property developed using labour and capital located elsewhere.[9] For example, marketing intangibles developed where the location of sales was shifted to a tax haven. The market jurisdiction (see definition in Section 1.3) would not have taxing rights over profits attributable to the marketing intangibles developed by the local team.

[4] Apart from the classic three-factor formula, there are other forms of FA, such as the single-sales factor formula. See Section 3.2 of this thesis.
[5] See Vann, Richard J., 'Reflections on Business Profits and the Arm's Length Principle' in Brian J Arnold, Jacques Sasseville and Eric M. Zolt (eds), *The Taxation of Business Profits Under Tax Treaties* (Canadian Tax Foundation, 2003) 133. Also see, Fiscal Committee of the League of Nations, *Report to the Council on the Fourth Session of the Committee*, League of Nations Doc. C.399.M.204.1933.II.A. (1933), at 2.
[6] See Chapter 4 of this thesis for details.
[7] Both the FA and arm's length approach had reasonable prospects of adoption when the business community sought international consensus in the 1930s. The latter had a "decided victory" because it benefited the residence countries (developed economies) more than the former approach. See Section 2.2.1 of this paper.
[8] For a discussion of why transfer pricing is the dominant international issue and the problems of the transfer pricing rules, see Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World' (2010) 3(2) *World Tax Journal* 291.
[9] The FA system does not have this problem because intra-group transfers (transactions between group members) are ignored, and profits are allocated on the basis of the three factors that yield profits together under the FA system. See Sections 3.2 and 3.3 of this paper.

The second consequence of adopting an arm's length methodology to allocate profits was the inability of sales destination countries, or in the OECD's words "market jurisdictions", to collect a share of the profits from the third factor that helps create profits, namely sales. The logic of the third factor was clear to see – regardless of how much labour and capital an MNE might put in to produce the goods or services it supplies to the market, the sale will only generate a profit if the customer is willing to pay more than the cost of production.[10] The extent to which the customer is willing to pay more than the cost will determine the level of profit from the sale.

In the closing years of the 20th century and with a renewed vigour in the 21st, countries have adopted a host of unilateral measures to address the profit shifting of MNEs. These rules often followed suggestions of the OECD, which endorsed these measures and engaged in an active campaign to encourage greater adoption of rules to discourage the practice.[11] The issue of transfer pricing and new approaches to tackle the problem has been the subject of considerable study by academics, practitioners, government officials and international organisations. Hence, this issue will not be deeply scrutinised in this thesis.

The focus of the current study is the second issue raised by the arm's length methodology: the absence of any recognition of sales as a source of profits. Addressing the second problem – the inability of the market jurisdictions to tax profits derived from sales in their

[10] For a discussion criticising the OECD version value creation principle does not consider the contribution of market jurisdictions, see Michael P. Devereux and John Vella, 'Taxing the Digitalised Economy: Targeted or System- Wide Reform?' (2018) 4 *British Tax Review* 387.

[11] For example, in 2013, the OECD initiated the Base Erosion and Profit Shifting Project in response to the international profit-shifting problem and released 15 distinct Action Plans addressing the 15 most discussed profit-shifting topics. For a discussion of a review of the 15 Actions and summaries of how jurisdictions responded to the obligations set out in the Actions, see Kerrie Sadiq and Richard Krever, 'Actions to Counter Base Erosion and Profit Shifting: A General Report' in Kerrie Sadiq, Adrian Sawyer and Bronwyn McCredie (ed) *Tax Design and Administration in a Post-BEPS Era: A Study of key Reform Measures in 18 Jurisdictions* (Birmingham: Fiscal Publications 2019), pp. 1-24.

countries – has proved equally, if not more challenging, than tackling the problem of transfer pricing. The simplest solution is explicitly recognising sales as one factor that gives rise to profits, as in FA regimes. This system is commonly used to allocate profits between states or provinces in a country, such as the US and Canada,[12] where subordinate jurisdictions levy income taxes and has been proposed for allocating taxing rights within the European Union (hereinafter EU).

Until now, no country has adopted the system unilaterally to tax multinational companies on the share of profits attributable to the country. Instead, many countries have looked for alternative surrogate methods to recognise the role of sales as a source of profits. The most commonly used tool is a "digital services tax" (hereinafter DST), which imposes customer-country income taxes on a share of the profits of offshore digital service providers with no or minimal physical presence in the market jurisdiction.

The spread of DSTs, particularly in Europe, in a short period prompted the OECD to propose a model of FA in 2019, labelled "Amount A",[13] in the OECD's mix of international tax proposals, with a limited scope to apply only to digital service companies.[14] Pressure from market jurisdictions led to an expansion of the OECD proposal to include a wider

[12] The United States uses the FA system to distribute profits domestically within states but uses the arm's length system for international taxation. It allows them to use a more economically sound allocation method within the country and benefit as an intangible-rich country in international profit allocation. The US has led international taxation for years by actively creating the arm's length principle and FA system. However, having different tax policies for domestic and international transactions may be considered a misuse of global economic power for self-interest. For the game theory among countries when formulating the arm's length principle, see Bret Wells & Cym H. Lowell, 'Income Tax Treaty Policy in the 21st Century: Residence vs. Source' (2014) 5(1) *Columbia Journal of Tax Law* 1.

[13] Academics proposed alternatives to Pillar one. See e.g., Pasquale Pistone, João Félix Pinto Nogueira, Betty Andrade and Alessandro Turina, 'The OECD Public Consultation Document "Secretariat Proposal for a 'unified Approach' under Pillar One": An Assessment' (2019) 74(1) *Bulletin for International Taxation.*

[14] Amount A is a formula-based system that reallocates some of the existing taxing rights over the residual profits of the biggest and most profitable MNEs from intangible-rich countries to market jurisdictions that perform limited supply-side value-added activities. Agreeing to implement Amount A by a jurisdiction means giving up unilateral DST. See OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 October 2021), at 6 Annex. Detailed Implementation Plan. Also, see Section 3.4 of this thesis.

range of suppliers of services and goods. However, the prospect of widespread adoption of Amount A is limited given the complete rejection of the proposal by the world's largest and arguably most powerful economy, such as the United States of America (hereinafter US), and tepid support at best by many other major economies, United Kingdom (hereinafter UK) and Canada.[15]

1.2 Research question, assumption and aims

Theoretically, the optimal international taxation model would be FA or some variation thereof because FA recognises the contribution made by all three factors that give rise to profits – labour, capital and customer. However, due to political considerations, FA is unlikely to materialise in the near future.

A feasible alternative to FA lies in exploring opportunities within existing accepted arm's length principle (hereinafter ALP) methodologies to accommodate a sales factor. The "profit split method" (hereinafter PSM), aided by marketing intangibles, represents a simpler and more readily achievable solution for recognising the sales factor on potentially equal ground with the labour and capital factors. Moreover, the PSM comes closest to the FA model but operates within the existing ALP framework, thereby eliminating the need for additional international multilateral agreements.[16] Therefore, as a surrogate to FA, the PSM represents a second-best international taxation model and is preferred over other ALP methodologies that overlook sales or customers.

[15] See Section 3.4.4 of this thesis.
[16] See Chapters 4-6.

In arriving at this conclusion, this thesis asserts that market jurisdictions[17] should share a portion of profits because they are the sales destinations. Traditional international taxation disregards sales as a determinant of profit allocation with the OECD narrowly interpreting the value creation rule,[18] focusing solely on supply-side value-added activities, such as manufacturing, marketing, and distribution.[19] Consequently, market jurisdictions that lack these activities are excluded from profit sharing. However, market jurisdictions play a distinct role in value creation compared to supply-side source countries,[20] and should not be subjected to the same classification or profit-sharing logic.

This issue was less salient in a traditional brick-and-mortar economy[21] because the MNEs typically maintained dependent local teams in market jurisdictions to better service their customers, thus attributing value-added activities and designating them as source countries. However, technological advancements have reshaped this structure, enabling MNEs to engage with customers remotely and conduct online sales, diminishing the necessity for supply-side value-added activities in market jurisdictions and potentially excluding them from profit sharing.

Consequently, this thesis addresses the following research questions:

(1) Why is FA considered the optimal model? In other words, why should market jurisdictions share a portion of taxing rights over global profits?

[17] Defined in Section 1.3 of this thesis.
[18] See Section 2.5 of this thesis.
[19] See Section 2.2 of this thesis.
[20] See Section 2.4 of this thesis.
[21] 'Brick-and-mortar economy' is a common term often used as opposed to 'digital economy'. For a discussion of the difference between these two types of economies, see Andrew Gillespie, Simon Marvin and Nick Green, 'Bricks Versus Clicks: Planning for The Digital Economy' in James Wilsdon (ed), *Digital Future: Living in a Networked World* (London: Routledge, 2001) 200.

(2) Why is FA, including Amount A, not a feasible option in the near future?

(3) As the closest surrogate methodology, how can the PSM be interpreted to ensure that market jurisdictions obtain an appropriate[22] share of taxing rights?

To address these research questions, the thesis will explore a "market-source-residence" paradigm, where source and market jurisdictions share primary taxing rights over business profits, with residence jurisdictions retaining the remaining taxing rights.[23] In this context, the term "market jurisdiction" refers to the geographic location where MNEs sell their goods or services to third parties (see Section 1.3). For example, where products are marketed, sold, and distributed in a country, it serves as a source country for marketing and distribution functions but as a market jurisdiction for sales. The market jurisdiction does not need to host significant functions on the supply side but contributes to value creation from the demand side.

This thesis aims to address this issue from a market jurisdiction's perspective. It assesses and provides suggestions on three aspects to assist the market jurisdictions in insightfully interpreting the OECD model: physical presence (Chapter 4), creating marketing intangibles or enhancing the value of existing intangibles (Chapter 5), and the profit split method (Chapter 6). Furthermore, it includes China's approach as a case study (Chapter 7), showcasing a creative interpretation of the OECD model that benefits the market jurisdictions.[24] Additionally, it proposes a "market-source-residence" paradigm

[22] The words "appropriate," "equitable," and "fair" do not have a fixed meaning in any literature and are used by jurisdictions in accordance with their national perspectives.
[23] See Chapter 9 of this thesis.
[24] India also creatively interprets the OECD transfer pricing rules using concepts such as location-specific advantages, see Eduardo Baistrocchi, 'The International Tax Regime and Global Power Shifts' (2021) 40(2) *Virginia Tax Review* 219; UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries*, Part D.3 India Country Practice (2021).

(Chapter 9) based on the recommendations and China's approach as an alternative pathway to support market jurisdictions.

This thesis analyses the Coca-Cola case (Chapter 8), demonstrating the challenges faced by market jurisdictions in asserting an appropriate share of taxing rights over MNEs' profits generated within their borders. It applies the "market-source-residence" paradigm to the Coca-Cola case to illustrate how the proposed paradigm could facilitate equitable profit allocation among jurisdictions.

1.3 Define "market jurisdiction"

"Market jurisdiction" or "market country" emerged with the development of the Two-Pillars Approach by the OECD in 2019. Initially, within the framework of the Two-Pillars, "market jurisdiction" referred to specific jurisdictions where an MNE group engage in the sales of its products or services, particularly focusing on providing digital services and consumer-facing businesses:

> *"…jurisdictions where an MNE group sells its products or services or, in the case of highly digitalised businesses, provides services to users or solicits and collects data or content contributions from them."*[25]

However, as the OECD expanded the scope of Amount A to encompass various business types, the definition of "market jurisdiction" became more generalised. Nevertheless, there remains inconsistency among various public consultation papers regarding the

[25] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint* (2020), at 11.

interpretation of this term. For example, the 2022 consultation paper on the Amount A nexus and revenue sourcing rule described market jurisdictions as

> *"…jurisdictions in which goods or services are supplied or consumers are located".*[26]

This definition presents a potential contradiction, as "*jurisdiction in which goods are supplied*" appears to refer to the seller's geographic location, while "*jurisdiction…in which customers are located*" may pertain to the buyer's geographic location. Furthermore, an MNE may engage in intra-group transactions across different locations before selling goods or services to third parties, leading to complexities in determining the relevant market jurisdictions.

To mitigate misunderstandings, the OECD clarified in the 2021 public consultation paper on the Two-Pillars Approach that the market jurisdictions are the "*end market jurisdictions where goods or services are used or consumed*."[27] This clarification aims to emphasise that the concept of "market jurisdiction" pertains to the location where goods or services are sold to third parties, rather than taxing consumption directly.[28] However, it is worth noting that third-party buyers may not necessarily be the final consumers of the goods, as they may further distribute them to other geographic locations for profits.

[26] OECD, *Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing* (2022), at 2.
[27] OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 October 2021), at 2.
[28] Richard Colier, Michael P. Devereux and John Vella, 'Comparing Proposals to Tax Some Profit in the Market Country' (2021) 13(3) *World Tax Journal* 405, at 411.

This thesis considers the experiences of both the US (see Section 3.2.1.4) and Canada (see Section 3.2.2), as well as the OECD's intentions presented in the above rules. It defines "market jurisdiction" as:

> *The location where the goods are delivered, and services are rendered by the MNEs to the third parties.*

Under the existing arm's length system, the market jurisdiction is typically only entitled to share profits as a source country. For instance, if an MNE headquartered in Jurisdiction A establishes a permanent establishment (hereinafter PE) in Jurisdiction B[29] and sells goods to consumers there. Taxing rights over profits attributable to marketing and distribution activities will be allocated to the PE of Jurisdiction B. However, this allocation is not a direct recognition of the sales destination or an allocation of taxing rights to a "market jurisdiction". Rather, it rewards the labour involved in conducting marketing and distribution activities as a source jurisdiction.

In contrast, under an allocation of taxing rights to market jurisdictions, Jurisdiction B should be allocated taxing rights due to the "mere presence of purchasers" in Jurisdiction B, regardless of the presence of a PE. While both scenarios involve Jurisdiction B as a market jurisdiction because sales occur here, there exists a fundamental conceptual distinction between the two regarding the allocation of taxing rights.[30]

[29] See Chapter 4 of this thesis for discussions of the PE.
[30] For a discussion regarding the conceptual difference between market and source jurisdiction. See Richard Colier, Michael P. Devereux and John Vella, above fn 28, at 411 and 412; Michael P. Devereux et al., *Taxing Profit in a Global Economy*, (Oxford University Press, 1st edition, 2021) at 168-173.

1.4 Significance of the research

This thesis introduces a new paradigm named "market-source-residence". The longstanding residence and source dichotomy, along with the ALP have been taken for granted for over a century, which labels market jurisdiction as source county. However, market jurisdiction differs significantly from the supply-side source country, necessitating distinct rules and principles tailored to their unique characteristics. By delineating the differences between market jurisdictions and supply-side source countries, this thesis analyses relevant transfer pricing concepts, such as the nexus rules and value creation principle, specifically from the market jurisdiction's perspective. It advocates for the recognition and reward of market jurisdictions for hosting sales.

Furthermore, this thesis expands upon the value creation principle by identifying three key contributors: residence countries providing initial capital to MNEs, source countries contributing resources on the supply side, and market jurisdictions driving sales on the demand side. This novel perspective on international taxation offers fresh insights that may shape future tax reforms. It fills a notable gap in the literature by outlining potential rules to enable market jurisdictions to claim a more equitable share of taxing rights over MNEs' global profits.[31] Additionally, this thesis pioneers research into treating location-specific market features akin to marketing intangibles for the purpose of sharing residual profits.

[31] The taxing right of market jurisdiction has become a popular topic since the OECD initiated Amount A. However, the existing academic literature predominantly focuses on assessing the benefits and drawbacks of the Amount A. See e.g., Suranjali Tandon and Chetan Rao, *Evaluating the Impact of Pillars One and Two* (2022) South Centre Research Paper 165; Lorraine Eden, 'Winners and Losers: U.S. Country and Industry Estimates of Pillar One Amount A' (2021) 50(5) *Tax Management International Journal* 222; Mona Barake and Elvin Le Pouhaër 'Tax Revenue from Pillar One Amount A: Country-by-Country Estimates' (2023) *Paris School of Economics Working Paper 12*.

Lastly, by offering policymakers valuable guidance on a feasible and pragmatic solution for market jurisdictions to obtain a fair share of taxing rights over MNE profits, this thesis contributes to the ongoing discourse on international tax reform.

1.5 Methodology

This thesis employs a combination of comparative legal research methodology and doctrinal legal research methodology.

Comparative legal research methodology can be used to analyse historical developments and different bodies of law in addressing common issues.[32] This methodology has four main approaches: functionalism, comparative legal history, the study of legal transplants, and the comparative study of legal cultures. [33] Among various approaches, the comparative legal historical approach is a mandatory part of any comparative research studies.[34] It delves into historical antecedents to shed light on the contemporary legal landscape.[35] Unlike other approaches, historical research often yields readily available information and sources, making it a preferred method in many legal studies.[36]

On the other hand, doctrinal legal research methodology "lies at the basis of the common law and is the core legal research method." [37] Grounded in primary sources of legal

[32] See, e.g., Geoffrey Samuel, 'Does One Need an Understanding of Methodology in Law before One Can Understand Methodology in Comparative Law?' in Mark Van Hoecke (ed), *Methodologies of Legal Research Which Kind of Method for What Kind of Discipline?* (Hart Publishing, 2011) 177.
[33] Ralf Michaels, 'The Functional Method of Comparative Law' in Mathias Reimann and Reinhard Zimmermann (ed), *The Oxford Handbook of Comparative Law* (Oxford University Press, 2019) 345, at 345.
[34] Mark Van Hoeche, Methodology of Comparative Legal Research (2015) *Law and Method* <10.5553/REM/.000010> accessed on 28 December, at 18.
[35] Ibid, at 18.
[36] Ibid, at 19.
[37] Terry Hutchinson and Nigel Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17(1) *Deakin Law Review* 83, at 85.

materials,[38] doctrinal legal research go beyond mere literature review or descriptive analysis It aims to construct legal systems[39] by extracting general principles from seemingly unrelated strands of law,[40] critiquing legal sources, and identifying ambiguities and criticisms, and offering solutions.[41] This methodology focuses on the letter of the law rather than the law in action. Hence, it is also called "black letter work".[42] The doctrinal legal research methodology is a two-part process. It usually includes (1) locating the sources of the law to determine the "objective reality" and (2) interpreting and analysing the text.[43] It is commonly categorised as a qualitative methodology, but Hutchinson and Duncan have argued that it could also be quantitative, as it was underpinned by positivism, and the law was objective, neutral and fixed, infused with quantitative characteristics.[44]

While both methodologies share certain alignments, Hutchinson and Duncan observed that they diverge in their primary objects of examination:

> *"As an example, in doctrinal research, these voices or versions of the truth are those of the judges in case law and the parliament in legislation… The doctrinal researcher is examining the finding of legal principle. The legal researcher examines primary sources in order to draw logical conclusions about what the*

[38] See, e.g., Council of Australian Law Deans, *The CALD Standards for Australian Law Schools* < https://cald.asn.au/wp-content/uploads/2017/11/CALD-Standards-final-adopted-17-November-20091.pdf> accessed on 28 December 2022, p4; Terry Hutchinson and Nigel Duncan, above fn 39, at 106.
[39] Mark Van Hoeche, above fn 34, at 10.
[40] Council of Australian Law Deans, *CALD Statement on the Nature of Legal Research* <https://cald.asn.au/wp-content/uploads/2017/11/cald-statement-on-the-nature-of-legal-research-20051.pdf> access 28 December 2022, at 3.
[41] Martha Minow, 'Archetypal Legal Scholarship - A Field Guide', in *AALS Workshop for New Law Teachers* (2006), < https://jle.aals.org/cgi/viewcontent.cgi?article=1093&context=home> accessed on 28 December 2022, at 66.
[42] Michael Doherty and Patricia Leighton, 'Research in Law: Who Funds It and What Is Funded? A Preliminary Investigation' (2004) 38(2) *Law Teacher* 182, at 183.
[43] Terry Hutchinson and Nigel Duncan, above fn 37, at 110.
[44] Ibid, at 116.

> *law is in those instances where it is not immediately self-evident from those sources. By contrast, the historical researcher examines primary sources as evidence of fact."*[45]

By combining these two methodologies, this thesis seeks to mitigate the limitations inherent in either approach. Specifically, it aims to overcome the perceived formalism of doctrinal research and the challenges associated with accessing materials in comparative legal research.[46]

This thesis adopts a doctrinal legal research methodology, prioritising theoretical analysis over practical implementation of the law. It relies on primary source materials, including the OECD transfer pricing guidelines, Two-Pillar Approach consultation documents, and domestic tax laws and cases from jurisdictions such as the US, China, and Canada. These materials serve as fundamental "data" for the thesis.

Drawing on this data, this thesis addresses the research question of how market jurisdictions can obtain an appropriate share of taxing rights over MNEs' profits through a creative interpretation of the ALP. It argues for the inclusion of market jurisdictions in profit allocation, explores the feasibility of the FA model, and proposes reinterpretations under the ALP framework. Each chapter provides suggestions for reinterpreting the OECD model from the perspective of market jurisdictions.

Chapters 4 to 7adopt a comparative legal research methodology, employing a comparative legal historical approach to trace the evolution of relevant issues in OECD

[45] Ibid, at 117.
[46] Mark Van Hoeche, above fn 35, at 1.

Guidelines.[47] Additionally, a Chinese approach and a US approach (specifically on the development of various transfer pricing methods) are introduced for comparison with OECD positions, offering insights into potential tensions between intangible-rich countries and market jurisdictions.

This study reflects the legal landscape and publications as of 31 July 2023.

1.6 Structure

This thesis has three parts.

Part One establishes the fundamental theoretical contexts for the thesis and denies the OECD Amount A as a practical solution. Chapter 2 outlines the rationale for market jurisdictions to share profits as sales destinations. Since "sales" is not currently considered a factor in profit allocation under the ALP, the question arises of how to allocate taxing rights over MNEs' profits to market jurisdictions. While the FA model could achieve this by incorporating "sales" into its predetermined formula, Chapter 3 argues that the implementation of the OECD version FA model, namely Amount A, is unlikely in the near future, rendering FA impractical as a solution. Consequently, the ALP remains the only feasible option for addressing this issue at present.

[47] It includes, most importantly, the OECD Transfer Pricing Guidelines of different times. They are OECD, *Transfer Pricing and Multinational Enterprises* (1979); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022). The later chapters refer to “OECD Guidelines” for all OECD Transfer Pricing Guidelines.

Part Two explores an alternative approach to resolving the problem within the arm's length system. Chapters 4 to 6 advocate, from the perspective of market jurisdictions, that existing concepts and the transfer pricing toolbox can effectively allocate more taxing rights to market jurisdictions. Chapter 4 elucidates the rules governing physical presence, while Chapter 5 discusses how market jurisdictions can claim a share of residual profits by owning marketing intangibles or enhancing existing intangibles. Chapter 6 looks into the PSM, which is deemed advantageous for market jurisdictions. Additionally, Chapter 7 presents a case study of the Chinese interpretation of the OECD model, showcasing how emerging markets can creatively interpret OECD approaches to safeguard their tax bases.

Part Three applies the suggestions and paradigm introduced in Part Two. Chapter 8 offers a case study of Coca-Cola, highlighting practices that divert profits away from market jurisdictions. Chapter 9 proposes a novel paradigm, the "market-source-residence" paradigm, as a policy option that deviates slightly from the ALP and approaches FA without a complete paradigm shift. It consolidates the recommendations from Chapters 4 to 6 and incorporates insights from the Chinese approach discussed in Chapter 7. Chapter 9 further applies the newly proposed paradigm to the Coca-Cola case study discussed in Chapter 8, demonstrating its potential to protect the interests of market jurisdictions.

Chapter 2

Theories

2.1 Introduction

The allocation of taxing rights among jurisdictions concerning multinational enterprises (hereinafter MNEs) has sparked debate for over a century. While the arm's length principle (hereinafter ALP) has traditionally served as the dominant method for distributing MNEs' global profits to the geographic locations hosting labour and capital, it is criticised for being "biased". These critiques include allegations of favouring wealthier countries over poorer ones[1] or prioritising residence countries over source countries. [2] In contrast, policymakers have increasingly shown interest in Formulary Apportionment (hereinafter FA),[3] which allocates MNE's global profits to jurisdictions based on factors such as labour, capital and sales.[4] FA is often considered an alternative approach to profit allocation compared to the ALP.

However, scholars like Avi-Yonah suggested that the ALP and FA are the two ends of a continuum of policy options.[5] Based on this view, Brauner proposes that the ALP and FA

[1] See Allison Christians and Laurens van Apeldoorn, 'Taxing Income Where Value Is Created' (2018) 1(22) Florida Tax Review 1, at 2.
[2] See Jinyan Li, Nathan Jin Bao, Huaning (Christina) Li, 'Value Creation: A Constant Principle in a Changing World of International Taxation' (2019) 4(67) *Canadian Tax Journal* 1107, at 1122.
[3] See, for example, the OECD proposed Amount A under the Two-Pillar Approach, and the European Union (hereinafter EU) has debated the implementation of the Common Consolidated Corporate Tax Base (hereinafter CCCTB) for many years.
[4] See Chapter 3 of this thesis for a throughout analysis of the historical development of the formulary apportionment, different approaches, and current practices.
[5] Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation' (2007) *Law and Economics Working Paper*, at 2.

essentially employ similar profit indicators,[6] namely sales and capital, with the primary distinction lying in the treatment of sales as a separate factor.[7] Consequently, it is plausible to allocate taxing rights to the sales factor or market jurisdiction under the ALP framework without necessitating a complete shift to the FA model. It is simply a policy option that moves away from the ALP towards FA along the continuum spectrum. This chapter explores whether the sales factor should indeed share a portion of MNEs' global profits, thereby considering whether market jurisdictions should possess taxing rights merely for hosting sales.

The primary aim of this chapter is to establish the economic rationale for a market jurisdiction to levy income tax. Section 2.2 discusses how the ALP primarily focuses on the supply side of transactions, lacking an explanation of how value is truly realised. It examines the historical evolution of the ALP and separate accounting, delving into theories such as "economic allegiance" and the "benefit principle." These theories serve as the basis for the OECD's version of the value creation principle, indicating that its current interpretation was narrowly tailored to suit the needs of the Base Erosion and Profit Shifting Project (hereinafter BEPS Project) introduced in 2013. A broader interpretation of the value creation principle would encompass the demand side of the equation, allowing for genuine value realisation. Section 2.3 provides a precise definition of "market jurisdiction" for international taxation purposes to mitigate potential misunderstandings among non-tax experts. Section 2.4 analyses the fundamental economic theory of supply and demand to elucidate the economic rationale behind granting taxing rights to market jurisdictions. Finally, Section 2.5 outlines the inherent

[6] See Glossy of terms for details.
[7] Yariv Brauner, 'Between Arm's Length and Formulary Apportionment' in Richard Krever and François Vaillancourt (eds.), *The Allocation of Multinational Business Income: Reassessing the Formulary Apportionment Option* (The Netherlands: Kluwer Law International, 1st ed, 2020) pp. 209 to 238, at 224.

flaws of the traditional international taxation regime and the OECD's interpretation of the value creation principle.

2.2 The supply side of the story

One of the building blocks of the traditional international taxation regime is the residence and source rules.[8] This dichotomy allocates the primary taxation right over profits derived from active businesses to the source countries, and the residence countries typically either exempt active business income or provide tax credits for taxes already paid in the source countries.[9] Moreover, residence countries are tasked with taxing profits from passive investments, often subject to negotiated caps to limit the maximum tax that source countries can impose on such income.[10]

Within this dichotomy, source countries are generally those that host supply-side economic activities, such as providing labour or capital to produce goods. For instance, consider a Chinese resident company engaged in manufacturing and selling shoes, with subsidiaries in Italy for design, Vietnam for manufacturing, and Australia for promotion and sales. In this scenario, each country hosting a subsidiary is considered a source country, contributing design, manufacturing, and promotional functions, respectively.

[8] For an overall discussion of the residence and source dichotomy, see Robert A. Green, 'Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993-1994) 79(1) Cornell Law Review 18. Also see Section 2.3 of this thesis.
[9] Ibid, at 23-24. Many countries use a comprehensive exemption system for corporations so that business profits, dividends from foreign subsidiaries and capital gains on shares in foreign subsidiaries are exempt from tax in the country of the parent. See Richard J. Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World' (2010) 3(2) *World Tax Journal* 291, at 308.
[10] See Richard Krever and Peter Mellor, 'History and Theory of Formulary Apportionment' in Richard Krever and François Vaillancourt (eds.), *The Allocation of Multinational Business Income: Reassessing the Formulary Apportionment Option* (The Netherlands: Kluwer Law International, 1st ed, 2020) pp.9-40, at 23.

Additionally, Australia is also a market jurisdiction because it hosts the sales (for the definition of "market jurisdiction", see Section 1.3). However, if the company sells shoes directly to Australian customers online from Vietnam without a subsidiary in Australia, Australia remains a market jurisdiction but may face challenges in collecting taxes due to the lack of physical presence and "meaningful" supply-side value-added activities by the MNE.

The criteria for determining corporate residency differ between individuals and companies. For individuals, tests typically include factors such as domicile and length of physical presence. Conversely, for companies, residency is determined by factors like the location of "real" management and control (or headquarters in some civil law countries)[11] and the place of incorporation, which are jointly used to ascertain corporate residency.[12]

This section explores the historical origins of the residence and source dichotomy, the rise of the ALP and separate accounting, and the relevant economic theories underpinning these concepts.

2.2.1 The emergence of the arm's length principle and separate accounting

[11] Richard J. Vann, above fn 9, at 307.

[12] In the past, some commonwealth countries, such as the United Kingdom (hereinafter UK), Canada, and Australia, traditionally focused on the place of central management and control to determine corporate residency. It may give rise to a "stateless company" if the company is incorporated in, for example, Ireland (for a very long time only recognised the place of management and control) and has its management and control in the US (the best-known contrary example of a country using only a place-of-incorporation test for corporate residence). Now the commonwealth countries combine the place of management and control with the place of incorporation. See Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation: A Structural Analysis* (Wolters Kluwer Legal Reg, 4th ed, 2019), at 565. For an example of the "stateless company", see Antony Ting, 'iTax—Apple's International Tax Structure and the Double Non-Taxation Issue', (2014) (1) *British Tax Review* 40.

During the late 1800s, the concept of income tax began to take shape and gained traction worldwide.[13] Following the First World War, many countries adopted the practice of taxing income on both a residence and source basis. However, the lack of a mechanism to alleviate double taxation soon emerged as a significant international concern.[14]

In response to this issue, the League of Nations addressed it by convening the Fiscal Committee, which tasked two groups of experts with studying double taxation. One group, comprising four economists,[15] produced a report in 1923 (hereinafter 1923 Report). Concurrently, the League commissioned another group of technical experts to develop Model Tax Conventions, which were released in various editions between 1927 and 1933.[16]

2.2.1.1 The 1923 Report

[13] Richard Krever and Peter Mellor, above fn 10, at 11. Krever and Mellor also suggested that the creation of modern limited liability companies in the mid-nineteenth century, the growth of international commerce in the later part of that century and decolonization in the twentieth century laid the foundation for the modern MNE, ibid at 11.
[14] Richard Krever and Peter Mellor, above fn 10, at 20.
[15] The four economists are Professor Bruins from Netherland, Professor Einaudi from Italy, Professor Seligman from the United States and Sir Josiah Stamp from the United Kingdom.
[16] Bret Wells & Cym H. Lowell, 'Income Tax Treaty Policy in the 21st Century: Residence vs. Source' (2014) 5(1) *Columbia Journal of Tax Law* 1, at 25. For the 1927 draft model tax convention, see League of Nations, *Report Presented by the Comm. Of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.216M.85.II.A (1927). For the 1928 draft model tax convention, see League of Nations, *Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.562M.178 1928 II (1928). For the 1933 draft model tax convention, see Fiscal Committee of the League of Nations, *Report to the Council on the Fourth Session of the Committee*, League of Nations Doc. C.399.M.204.1933.II.A. (1933).

In the League of Nation's 1923 Report, the economists proposed "the doctrine of economic allegiance" (see Section 2.2.2) and proposed four alternatives to the League of Nations for solving the double taxation problem:[17]

- Method One: residence countries would give up all taxing rights to the source countries (source-only method).
- Method Two: source countries would give up all taxing rights to the residence countries (residence-only method).
- Method Three: split the taxing rights between residence and source countries (profit split method or FA).
- Method Four: assign primary taxing rights to residence and source countries depending on the type of income (the classic residence and source method).

The economists considered Method Two the most preferable, suggesting that source countries exempt all non-residents from income derived within their borders to attract investment.[18] However, they acknowledged that achieving consensus on this method among all countries was unlikely. Therefore, they viewed Method Four as the second-best option:

> *"By convention it might be determined to attach origin taxation specifically and wholly to particular classes of investments or embodiments of wealth, such as rents of land and of houses and mortgages on real property, but to exempt the*

[17] Gijsbert W.J. Bruins, Luigi Einaudi, Edwin R.A. Seligman, and Sir Josiah Stamp, *Report on Double Taxation Submitted to the Fiscal Committee of the League of Nations* (Economic and Financial Commission, League of Nations, Geneva, 5 April 1923), at 41-42. Hereinafter "The 1923 Report".
[18] Ironically, the countries that apply low- or zero-income tax rates are so-called "tax havens" today, which are evil tax shelters for MNEs. For a discussion of the growth of tax havens, see Vanessa Ogle, 'Archipelago Capitalism: Tax Havens, Offshore Money, and the State, 1950s-1970s' (2017) 122(5) *The American Historical Review* 1431.

> *non-resident in respect of income derived from business securities. The country of residence would allow the whole of the foreign tax as a deduction from its income tax on the resident in respect of such sources of income, but would charge other sources in full. The country of origin would retain its specific origin taxes in full. It would be necessary to give the country of residence complete power of charging all sources except for certain specified exemptions…"*[19]

Although Method Four differed somewhat from modern international taxation systems, it shared the principle of granting source countries primary taxing rights over active business income, while residence countries would either exempt or tax the same income with foreign tax credits. Additionally, residence countries would obtain taxing rights for passive investment income. Economists held a pessimistic view towards Method Four, expressing no hope that it would prove to be a smooth and practical arrangement. They deemed it as "only approximate and not an instrument of that degree of sensitiveness and accuracy which developed communities expect".[20] Their foresight and concerns largely manifested into reality.

The International Chamber of Commerce, an influential business organisation actively drafting international taxation rules, supported either Method Two or Method Three. In its Second Congress in 1923, the Chamber of Commerce reached the conclusion that the residence countries should have full taxing rights over their corporate taxpayers. or if consensus was not reached, the combined profits could be allocated based on

[19] The 1923 Report, above fn 17, at 42.
[20] The 1923 Report, above fn 17, at 51.

proportional sales.[21] However, this sales-only FA approach did not gain significant traction.[22]

The rejection of Method Three (the FA method) by the League of Nations was controversial because the profit split or FA methodologies were already prevalent in tax treaties at that time. For instance, Carroll indicated that fractional apportionment was the primary method of resolving double taxation between Spain and Switzerland and was also used by France. Carroll also studied how Austria, Czechoslovakia, Hungary, and Poland formulated significant profit split methodologies.[23] Despite this, the 1923 Report rejected the FA method, citing its lack of a fundamental economic basis and challenging application.[24] However, the chosen Method Four was not substantially more straightforward than the FA method, leading some to speculate that the economists who drafted the 1923 Report favoured a method beneficial to their own countries which were

[21] International Chamber of Commerce, *ICC Second Congress Rome, Brochure 23* (March 18-25, 1923), at 34-35. Also see, Bret Wells & Cym H. Lowell, above fn 16, at 15-16.
[22] Today, the demand side is taxed by VAT/GST. For the rise of VAT, see Kathryn James, 'Exploring the Origins and Global Rise of VAT' (2011) *The VAT Reader (Tax Analysts)* 15. One may argue that Market jurisdictions have levied VAT on demands. Will this free the market jurisdictions from collecting income tax from the demand side? The simple answer is "no". firstly, not all countries levy VAT/GST. The US, for example, does not have a GST so far. Secondly, the VAT/GST taxes consumption instead of income, which has a different meaning to the countries. Thirdly, the VAT/GST has residence and source sides (destination and origin) like the income tax. The final markets do not collect 100% of the tax. For the above three reasons, having VAT/GST is not a reason to exclude the demand side from income tax. See for example, Rebecca Millar, 'Echoes of Source and Residence in VAT Jurisdictional Rules' (2009) Sydney Law School Legal Studies Research Paper No. 09/44.
[23] Mitchell B. Carroll, *A Brief Survey of Methods of Allocating Taxable Income Throughout the World, in Lectures on Taxation* (Roswell Magill ed., Commerce Clearing House 1932), at 131, 151-153 and 168-170. Also cited by Bret Wells & Cym H. Lowell, above fn 16, at 22. Germany-Holland treaty apportioned income for the railroad between the two countries. See John G. Herndon, *Relief from International Income Taxation: The Development of International Reciprocity for the Prevention of Double Income Taxation* (Chicago: Callaghan and Company, 1932), at 15.
[24] The 1923 Report, above fn 17, at 46.

net capital exporters.[25] Some of these countries applied or still apply the FA approach at the subnational level.[26]

2.2.1.2 The Model Tax Conventions

The League of Nations appointed a committee of technical experts to draft Model Tax Conventions, which included representatives from seven European governments.[27] The committee's first report, published in 1925, favoured source countries more than the 1923 Report. Representatives from the United States, T.S. Adams[28] and Mitchell B. Carroll[29], later joined the committee. Over the course of meetings in 1927, 1928, and 1933, the committee drafted three Model Tax Conventions, with the 1928 model becoming the standard for treaty negotiations in Europe and early US tax treaties.[30] This transition

[25] Seligman pointed out that Method Four was biased, and particularly helpful to creditor countries like England. See Edwin R. A. Seligman, *Double Taxation and International Fiscal Cooperation* (The Macmillan Co, 1928), at 138. The US was in the same posture. The US capital exported was four times as much as the capital imported. See H. David Rosenbloom and Stanley L. Langbein, 'United States Tax Treaty Policy: An Overview' (1981) 19(3) *The Columbia Journal of Transnational Law* 359, at 366. The US position was slightly different from Great Britain. For a throughout discussion of the different positions of Great Britain and the US, see Michael J. Greatz and Michael M. O'Hear, 'The "Original Intent" of U.S. International Taxation' (1997) 46(5) Duke Law Journal 1021, at 1072.

[26] Great Britain applied the FA method with respect to its colonies. See Edwin R. A. Seligman, above fn 25, at 138. The US applied FA at the state level for corporate income, see Section 3.2.1 of this thesis.

[27] The seven countries were Belgium, Czechoslovakia, France, Great Britain, Italy, Netherlands, and Switzerland. See Herndon, John G., *Relief from International Income Taxation: The Development of International Reciprocity for the Prevention of Double Income Taxation* (Chicago: Callaghan and Company, 1932), at 57 and 58.

[28] T.S. Adams was an economics professor at the University of Wisconsin and Yale University and the principal international tax advisor to the US Treasury in the 1910s and 1920s. He was an advocator of the FA. See Roy G. Blakey, 'The Revenue Act of 1921' (1922) 12(1) The American Economic Review 75, at 90. Also see, Chapter 3 of this thesis for his contributions of shaping the US FA system.

[29] Mitchell B. Carroll was an international tax lawyer and founder of the International Fiscal Association (IFA). It was believed that Carroll joined the League's committee as Adams' assistant, see, e.g., Greatz, Michael J. and Michael M. O'Hear, above fn 25, at 1088. For a contrary view that Carroll was an important collaborator with Adams, see Reuven S. Avi-Yonah, 'All of a Piece Throughout: The Four Ages of U.S. International Taxation' (2005) 25(2) *Virginia Tax Review* 313, at 323.

[30] H. David Rosenbloom and Stanley L. Langbein, above fn 25, at 365.

marked a shift from the FA approach to the ALP approach in international treaty negotiations.[31]

The draft Model Tax Conventions reflected a perspective similar to the fourth method proposed in the 1923 Report, but the former addressed the issues that the 1923 Report was ambiguous on, notably the attribution of business income to each source country. In the draft Model Tax Conventions, separate accounting was generally adopted to determine the geographic source of income,[32] assuming that different operations (subsidiaries or branches) of the same group were separate entities and maintained segregated accounting information, including revenue, costs, and profits attributable to each entity and branch. When an overseas subsidiary had its accounting information separately kept from the headquarters, the recorded profits would generally be respected as the tax base because the separate accounting method assumes that the transactions between related entities are carried out as if they are unrelated and dealing at arm's length.[33]

The separate accounting approach, while beneficial in many respects, encountered challenges when it came to determining the source of income for businesses operating across multiple jurisdictions, particularly in case where certain operations lacked

[31] For the view that the current international taxation was shaped by the draft tax treaties more than the 1923 Report, see Reuven S. Avi-Yonah, above fn 29, at 322.
[32] Fiscal Committee of the League of Nations, *Report to the Council on the Fourth Session of the Committee*, League of Nations Doc. C.399.M.204.1933.II.A. (1933), at 6. Also see, Mitchell B. Carroll, *Taxation of Foreign and National Enterprises* (League of Nations, Geneva, 1933), at 45. Prior to the 1933 League of Nations meeting, Adams, an advocator of the FA, passed away unexpectedly. The US had to appoint Carroll to replace him as the principal US representative. Carroll studied the FA approaches used by many countries, but he is a supporter of the ALP. For Carroll's position, see, e.g., Mitchell B. Carroll, 'Allocation of Business Income: The Draft Convention of the League of Nations' (1934) 34(3) Columbia Law Review 473; Mitchell B. Carroll, above fn 23.
[33] Massimo Agostini, 'U.S. Perspectives of Worldwide Unitary Taxation' (1989) 7(2) *Dickinson Journal of International Law* 213, at 215. Transfer pricing was not a primary concern at that time, so it was mentioned in passing in the 1923 Report. See, the 1923 Report, above fn 17, at 49.

separate accounting records. To address this issue, tax treaties often resorted to "arbitrary rules",[34] with the concept of "permanent establishment" (hereinafter PE) emerging as a key mechanism for allocating taxing rights to source countries[35] (further discussed in Chapter 4). Initially applied to branches without separate accounts, the concept of PE has since become essential in determining whether an MNE is liable to pay taxes in a particular jurisdiction where it conducts business.

The 1923 Report and the draft Model Tax Conventions played a significant role in establishing the residence and source rule as the prevailing approach. They laid the groundwork for the modern residence and source dichotomy, advocating for tax collection "where the wealth is really produced."[36] This principle was inherited by the OECD in its Transfer Pricing Guidelines and Model Tax Conventions. Though the final choice of the residence and source approach involved considerations balancing the interests of capital-exporting countries and the likelihood of international consensus, the economic theories discussed in the 1923 Report remain influential.

2.2.2 The doctrine of economic allegiance

The 1923 report introduced a novel concept known as "the doctrine of economic allegiance", which aimed to delineate the taxing rights of both source and residence countries. This doctrine originated from the ideas put forth by Edwin R.A. Seligman, a US economist, in his letter to Sir Josiah Stamp of Great Britain, both of whom were involved

[34] Reuven s. Avi-Yonah*, International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge University Press, 1st ed, 2007), at 27.
[35] *Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, Report Document C. 216. M. 85 (London, April 12th, 1927), at 15.
[36] The 1923 Report, above fn 17, at 23.

in drafting the 1923 Report). The doctrine of economic allegiance was proposed as an income allocation mechanism but evolved into a cornerstone of the 1923 Report.[37]

At its core, the doctrine of economic allegiance was grounded in the "ability to pay principle," which posited that government services provided to an individual or their property enhanced their “economic faculty”, or ability to pay. Consequently, the individual was deemed to owe economic allegiance to the countries providing such services, with taxation serving as the consideration for this allegiance.[38] When an individual and their property were situated in different states, determining the appropriate taxation jurisdiction required an analysis of the constituent elements of this economic allegiance.[39] These elements included:

- The acquisition of wealth

It was also referred to as the "origin of the wealth," denoting the location where wealth was generated.[40] This encompassed "all the stages which are involved up to the point when the physical production has reached a complete economic destination and can be acquired as wealth."[41] The 1923 Report put up with an example:

> *"The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they*

[37] See E.R.A. Seligman, *Note on Sir Josiah Stamp's Note Transmitted on June 1 1922* (June 22, 1922) (E.R.A. Seligman Papers, Columbia University, Box 44 League of Nations folder), at 6-8. Also see, Greatz, Michael J. and Michael M. O’Hear, above fn 25, at 1074 fn 215.
[38] The 1923 Report, above fn 17, at 18-20.
[39] Ibid, at 20.
[40] Ibid, at 23.
[41] Ibid, at 23.

> *are put where the consumer can use them. These stages, up to the point where wealth reaches fruition, may be shared in by different territorial authorities."*[42]

It included all the input activities that made the products available for sale, such as manufacturing, designing, and marketing. It explained the taxing rights allocated to the source countries where these activities were undertaken.

The question was whether sales activities were included in this stage, meaning whether the source countries in this context would include market jurisdictions. The simple answer was "yes". The example above used the phase of "until they are put where consumer can use them", which obviously included the sales activity. A customer may only use the goods when he owns them. The 1923 Report confirmed this position that "the origin of the wealth therefore may have to be considered … its direction and its sale."[43]

A market was an integral part of the acquisition of wealth. Without a market, the products and services were not sold, so the wealth was not "reaching fruition".[44] Thomas Adams articulated the importance of a market:

> *"[B]usiness ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market… a market is a valuable asset to the social group which maintains it and communities ought to charge for the use of community asse."*[45]

[42] Ibid, at 23.
[43] Ibid, at 24.
[44] Ibid, at 23.
[45] Thomas S. Adams, 'The Taxation of Business' (1917) (11) *Proceedings of the National Tax Association* 186, at 187.

It was irrelevant whether the business had a physical presence. The market's pivotal role in the economic allegiance theory was to "buy" the products to make the wealth ready for reaping. Also, it was worth noting that the market in this context means the "final market" where the consumers were located, as the products had to reach the location where "consumer can use them".[46] Any resale activities in between would also be included in this stage.

- The location of wealth & The enforceability of the rights to the wealth

These two elements were also called “possession of wealth”, which were the functions relating to establishing the title to the wealth and preserving it between the “actual fruition of production into wealth” (first element) and the “disposing of it in consumption” (fourth element).[47] For example, a group of people in Country A set up Entity A in their home country. Entity A established a wholly owned subsidiary Entity B in Country B. Entity B generated income locally in Country B (acquisition of wealth). Entity B remitted profits to Entity A for it to distribute dividends to its shareholders.[48] The remittance and distribution were included in the “possession of wealth”. Both the residence and source countries might provide the legal framework to ensure the smoothness of this process so that the taxpayer might owe economic allegiances to either or both countries.

- The consumption of wealth

[46] The 1923 Report, above fn 17, at 23.
[47] Ibid, at 23.
[48] The 1923 Report included a similar example. See the example of “Java” in Ibid, at 23.

The last element was relevant to the domicile or the residence country of the natural person shareholders. *"...when the wealth has reached its final owner, who is entitled to use it in whatever way he chooses. He can consume it or waste it or reinvest it; but the exercise of his will to do any of these things resides with him and there his ability to pay taxes is apparent.*"[49] Using the example set in the last paragraph, the shareholders of Entity A would receive dividends. This was the wealth at their discretion. The places where the shareholders were physically located had taxing rights over the wealth. This element explains the taxing rights of the residence country of the individual income tax[50] and was likely to underpin the legal foundation for consumption tax like VAT or GST.[51]

The 1923 Report provided economic rationale for the respective taxing rights of residence and source countries. However, it was drafted a century ago, at a time when the world economy differed significantly from today's landscape. As a result, the report was based on certain assumptions that may not be applicable to contemporary circumstances. One such assumption was that source countries were generally less developed than residence countries and were often considered "debtors" or "borrowing countries". This terminology implied that investments attracted from residence countries were akin to debt for the development of source countries. Accordingly, the taxes levied by source countries were seen as burdens or barriers to foreign capital, potentially diminishing the return on investment.[52] Therefore, the report suggested that source

[49] Ibid, at 23.
[50] The 1923 Report also spared a section discussing the determination of the individual's residence country. Ibid, at 19.
[51] VAT is short for value-added tax, and GST is short for goods and services tax. They are broadly-based consumption taxes assessed on the value added to goods and services.
[52] The report used a lengthy example of "Morania" to illustrate this position's economic effect and result. Ibid, at 7-10.

countries should exempt all non-residents from taxation in order to attract foreign investments.[53] In the economists' view, "the country wanting the money cannot successfully 'tax the foreigner'; it can only shut him out."[54] This perspective underscored the belief that source countries could only encourage foreign investment by refraining from imposing taxes on non-residents.[55] Thomas Adam criticised the doctrine of economic allegiance for being biased toward the residence countries:

> *"…I find this theory [of economic allegiance] I regret to say, little more than a generalized label covering a number of separate judgments… conclusions based upon diverse considerations which unfortunately vary with the business habits and stage of development of the various countries of the world… their judgements are practical not 'scientific', and 'economic allegiance' is distinctly different in different states. The theory leads many of its advocates to endorse exaggerated claims concerning the rights of the jurisdiction of domicile. These exaggerated claims rest partly on the fact that their advocates are citizens of creditor states."*[56]

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[53] See ibid, at 51. A pure destination-based framework (Method One in the 1923 Report), and a pure resident-based framework (Method Two) still have followers today. See Robert A. Green, above fn 8 Michael Devereux and Rita de la Feria, 'Designing and Implementing a Destination-based Corporate Tax' (2014) *Oxford University Centre for Business Taxation, Working Paper No. 14/17*; Michael P. Devereux and John Vella, 'Are We Heading towards a Corporate Tax System Fit for the 21st Century?' (2014) *Oxford University Centre for Business Taxation, Working Paper No. 14/25*; Wei Cui, 'A Critical Review of Proposals for Destination-Based Cash-Flow Corporate Taxation as an International Tax Reform Option' (2015) *Oxford University Centre for Business Taxation, Working Paper No. 15/21*.
Those alternatives avoid applying ALP greatly by discarding the entire residence and source framework, so there is no need to determine an arm's length price for intra-group transactions. It undoubtedly prevents BEPS. Nonetheless, these alternatives have their own limitations that are very difficult to overcome. See Reuven S. Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification' [1301] (1996) 74 *Texas Law Review* 1313.
[54] The 1923 Report, above fn 17, at 42.
[55] Ibid, at 48.
[56] Thomas S. Adams, 'Interstate and International Double Taxation' in Roswell Magill (ed), *Lectures on Taxation* (Commerce Clearing House, 1932) 101, at 102.

While the idea that source countries should lower their tax rates to attract investments may seem reasonable[57], it may not be applicable to market jurisdictions. Examples of supply-side source countries attracting FDI through tax incentives[58] and tax competition suggests a "race to the bottom" phenomenon.[59] However, market jurisdictions operate differently in today's highly competitive commercial landscape. Characterised by a wide array of product choices available to consumers, MNEs often rely heavily on market access. For instance, if a company like P&G exits a market, competitors like Unilever quickly seize the opportunity and gain market share. Thus, market jurisdictions should not be perceived solely as "debtors" seeking foreign investments but rather as countries leveraging their demand to ensure fair treatment alongside residence countries. Consequently, one may question the economic justification for the traditional international taxation system, which categorises market jurisdictions as "source countries" and applies rules such as physical presence to allocate profits accordingly.

Furthermore, the 1923 Report neglected to consider that residence countries might also need to compromise their taxing rights in certain situations. While source countries may

[57] Robert A. Green, above fn 8, at 30. Research found that there was a strong positive correlation between entering into double tax treaties and attracting more foreign direct investment for source countries. See Fabian Batthel, Matthias Busse, Richard Krever and Eric Neumayer, 'The Relationship Between Double Taxation Treaties and Foreign Direct Investment' in M. Lang, P. Pistone, J. Schuch, C. Staringer (ed) *Tax Treaties: Views from the Bridge — Building Bridges Between Law and Economics* (Amsterdam: IBFD, 2010) pp. 3-18. However, entering double tax treaties are costly to source countries. See Kim Brooks and Richard Krever, 'The Troubling Role of Tax Treaties' in Geerten M. M. Michielse and Victor Thuronyi (ed) *Tax Design Issues Wordwide* (Alphen aan den Rijn: Kluwe Law Internaitional, 2015) pp. 159 to 178.

[58] For example, between 1980 to 2008, China offered tax incentives to Chinese-foreign joint ventures and foreign-resident-funded companies, which significantly reduced their effective tax rates to 15% or lower (compared to 33% for the Chinese entities). To know more about the incentives, see, for example, Order of the President of the People's Republic of China No. 45, *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises* (1991), effective 30 June 1991 to 1 January 2008, Article 7; The State Council of the People's Republic of China No. 85, *Rules for The Implementation of The Income Tax Law of The People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises* (1991), effective 30 June 1991 to 1 January 2008, Article 71 and 73.

[59] "Race to the bottom" describes the tax competition in that governments reduce corporate tax rates to attract or retain foreign economic activities within their border. Pillar Two (global minimum tax rate of 15%) responds to this dangerous tax competition.

be concerned about losing FDI, residence countries may worry about MNEs failing to repatriate profits and instead making ongoing investments directly from subsidiaries in source countries. As a result, residence countries often opt to exempt foreign-sourced income, such as business profits and dividends from foreign subsidiaries, rather than providing foreign tax credits.[60]

Jurisdictions that traditionally provided foreign tax credits were stressed, and new tax regimes were implemented to encourage MNEs to repatriate profits. A recent example of this approach is evident in the response of the US Internal Revenue Service (hereinafter IRS) following the implementation of the Tax Cuts and Jobs Act (hereinafter TCJA) in 2017. Prior to the TCJA, the US generally taxed its residence MNEs on worldwide income. However, a US residence company could defer foreign income by retaining profits indefinitely through a foreign subsidiary. It would pay US tax on these profits only when they were repatriated, for example, in the form of dividends. Upon repatriation, the profits would be subject to US taxation at a rate up to 35%, with a credit for foreign taxes paid. Pursuant to the TCJA, the US now generally exempts the foreign income generated by active businesses, even if the earnings are repatriated.[61]

[60] The US is the only jurisdiction that adopts a foreign tax credit for foreign-sourced income among major developed economies. See Richard J. Vann, above fn 9, at 308. In January 2022, the US Treasury Department and the IRS published final foreign tax credit regulations (T.D. 9959) that dramatically narrowed the circumstances in which a US tax credit will be available for income taxes paid to a foreign jurisdiction. See Michael Smith, 'Petitions for Review of FTC Regs Raise Substantive Issues' (2022) 4(107) *Tax Notes International* 500.

[61] For a comparison of the pre-TCJA and post-TCJA tax effects, see IRS, <https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-a-comparison-for-large-businesses-and-international-taxpayers>. As a transition to the TCJA and to prevent certain MNEs from enjoying a windfall gain, the accumulated unrepatriated earnings abroad would be subject to taxation as if they were repatriated, albeit at preferred lower rates. This measure aimed to ensure that all profits generated by US resident MNEs prior to the implementation of the TCJA would be taxed, irrespective of whether they were repatriated or not.

Considering the compromises made by the supply-side source countries and the residence countries, only the market jurisdictions lack incentives to compromise their taxing rights for other benefits. Therefore, it is necessary to explore the economic theory that enables the market jurisdictions to share a portion of taxing rights over the MNE's global profits.

2.2.3 The benefit theory

The doctrine of economic allegiance was an extension of the benefit theory.[62] Both rooted in the understanding that governments provide individuals and property benefits in exchange for tax. These benefits encompass public infrastructures, such as general public safety, national security, a fair legal system, a transparent and secure financial infrastructure, a healthy and educated workforce, transportation and communication infrastructure, legal protection of intellectual property and so on.[63] However, the authors of the 1923 Report argued that the economic allegiance doctrine surpassed the benefit theory by also considering the consumption aspect.[64]

[62] The economic allegiance derived from the faculty theory (or theory of ability to pay), a modern version of the exchange theory. Exchange theory has two forms: cost theory and benefit theory, and the economic allegiance is obviously argued from the benefit side. See the 1923 Report, above fn 17, at 18. The cost theory rests on the premise that government services performed to individuals are costly, and taxes were the consideration in exchange for the services. Similarly, benefit theory assumes that taxes are the consideration in exchange for an individual's benefits from government services. See Arvid Aage Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law and Taxation Publishers, 1991), at 22. Based on that, the ability to pay theory advocated that if an individual can pay for the tax, he should pay. See Graeme S. Cooper, 'The Benefit Theory of Taxation' (1994) 11(4) *Australian Tax Forum* 397, at 417. Compared to these theories, the economic allegiance added one more aspect: the "disposition of wealth" once the wealth is realized and back to the investor's hand in the country of domicile. See section 2.2.2 of this thesis.

[63] For a discussion of what public infrastructures are relevant to benefit theories, see Stephen E. Shay, J. Clifton Fleming Jr. and Robert J. Peroni, 'The David R. Tillinghast Lecture - What's Source Got to Do with It - Source Rules and US International Taxation' (2002) 56(1) *Tax Law Review* 81, at 90.

[64] The 1923 Report, above fn 17 at 18.

Thomas Adams observed that *"[a] large part of the cost of government is traceable to the necessity of maintaining a suitable business environment."*[65] Individuals or companies, whether in source countries or residence countries, all reap the benefits of a civilised society and thus are subject to the cost for these benefits. However, such benefits tend to be more substantial for companies in source countries.[66] Therefore, the benefit theory offers a superior explanation for the taxing rights of the source country in corporate taxation.

However, does it elucidate the taxing rights of market jurisdictions, particularly when sellers conduct sales offshore? Viewing benefits in a broader context, a market is a product of a multitude of government services and programs.[67] When MNEs attempt to sell in a market, they employ their resources, such as marketing, sales channels, distribution channels, to exploit the market to their best advantage within legal confines. All foreign residents intending to sell in a market become beneficiaries of the opportunities afforded by the market's physical, legal, and economic infrastructure, irrespective of their profit margins or profit earnings.[68] A market, therefore, is a de facto resource when regarded as a confluence of public infrastructures. Just as it is legitimate to levy taxes on non-residents for exploiting a state's natural resources, it is equally justified to tax non-residents for accessing and exploiting the market.[69] Thus, the taxing

[65] Thomas S. Adams, above fn 45, at 187.
[66] Charles E. McLure Jr., Source-Based Taxation and Alternatives to the Concept of Permanent Establishment in 2000 World Tax Conference Report, <https://www.cesifo.org/DocDL/Forum300-focus2.pdf>, at 11; Richard L. Doernberg and Luc Hinnekens, *Electronic Commerce and International Commerce* (The Hague: Kluwer Law International for the International Fiscal Association, 1999), at 12.
[67] Stephen E. Shay, J. Clifton Fleming Jr. and Robert J. Peroni, above fn 63, at 91.
[68] Stephen E. Shay, J. Clifton Fleming Jr. and Robert J. Peroni, above fn 63, at 98. Some academics argued that only the developed markets with affluent customers that provide "location-specific rent" should levy a tax. In these markets, the MNEs have a higher before-tax yield than in other markets. Robert A. Green, above fn 8, at 30.
[69] Stephen E. Shay, J. Clifton Fleming Jr. and Robert J. Peroni, above fn 63, at 91.

rights allocated to the market jurisdictions are, in fact, market entry fees for accessing the selling opportunities provided by the markets.[70]

From this perspective, the market access rationale predominantly accounts for the taxing rights a market jurisdiction holds over profits derived within its borders. It matters little whether sales are conducted remotely or whether an MNE maintains a physical presence. The policies of a market jurisdiction across all spheres foster the creation and sustenance of a robust and prosperous market, enticing MNEs to explore its offerings.

2.3 The Demand side of the story

In 2013, the OECD initiated the BEPS Project in response to growing concerns regarding transfer pricing practices wherein MNEs employ aggressive tax planning strategies to shift profits to low-tax jurisdictions. A pivotal principle introduced in the BEPS Project emphasised that profits should be allocated to locations where supply-side activities are performed and where value is created rather than being based solely on legal ownership or contractual arrangements.[71] Some academics contend that the value creation principle is an elaboration of the doctrine of economic allegiance, which underpins the traditional international tax regime. [72] Conversely, others posit that the value creation principle

[70] The previous discussions regarding this issue did not distinguish the market jurisdiction from the source countries, which means the argument didn't directly point to the benefits exclusively provided by the markets. Yet, if market jurisdictions are distinguished from the source countries for being pure markets that make purchases, the market access rationale is still valid in the rationale discussed above.
[71] OECD, *Explanatory Statement: 2015 Final Reports* (2015), para 1.
[72] See e.g., Jinyan Li, above fn 2, at 1111; Stanley I. Langbein and Max R. Fuss, "The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard" (2018) 2(51) International Lawyer 259, at 262.

emanates from the benefit principle, which links the allocation of taxing rights between countries to the benefits they provide taxpayers in generating income.[73]

However, the value creation principle does not specify how “value” was quantified. Economic value of the goods or services is determined where the supply and demand meet.[74] Supply alone does not dictate price without a corresponding market. Traditional notions of "value creation" typically concentrate on supply side, encompassing activities such as design, manufacturing, marketing and distribution, where value is deemed to be created.[75] Therefore, taxing rights are allocated to geographic locations where these activities transpire. Yet, income generation needs a customer willing to pay. Without final consumption, goods and services arguably do not create value.

This perspective aligns with discussions on economic allegiance and the market access rationale, illustrating that market jurisdictions, representing the demand side, wield equivalent taxing rights to source countries, representing the supply side. Michael P. Devereux and John Vella challenge the prevalent interpretation of the value creation principle as economically flawed for neglecting the demand side. They argue that "the allocation of income among countries owes as much to the market as it does to various parts of a supply chain."[76] They critique the international taxation regime for deviating from this "simple and uncontroversial economic understanding of value creation."[77] Unlike the benefit principle, which underscores governments' provision of public

[73] See e.g., Stephen E. Shay, J. Clifton Fleming Jr. and Robert J. Peroni, above fn 63, at 90; Reuven S. Avi-Yonah, 'Commentary' (2000) 53(2) *Tax Law Review* 167, at 169.
[74] In 1890, Alfred Marshall developed the supply-and-demand curve, which is still used today to demonstrate the point at which the market is in equilibrium. See Alfred Marshall, *Principles of Economics* (Palgrave Macmillan UK, 1st ed, 2013).
[75] See e.g., Jinyan Li, above fn 2, at 1124; Michael P. Devereux and John Vella, ‘Taxing the Digitalised Economy: Targeted or System- Wide Reform?’ (2018) 4 *British Tax Review* 387, at 394.
[76] Michael P. Devereux and John Vella, ibid, at 394.
[77] Michael P. Devereux and John Vella, ibid, at 394.

infrastructure to cultivate and sustain a vibrant market, Devereux and Vella underscore the significance of customers. They presented an example to prove that customers make contributions to produce income:

> *"…due to higher demand in Japan for high quality tuna, businesses can sell such tuna at a higher price in Japan than anywhere else. This higher consumer demand clearly is a factor that generates value for the supplier, but this notion is absent from the usual understanding of the principle of value creation."*[78]

This example underscores how consumer preference impacts transaction profitability and highlights a shortcoming of the OECD model, which assumes markets are isolated. The ALP typically necessitate a third-party transaction comparable to the controlled transaction to determine an arm's length price. The OECD exhibits a clear preference for domestic transactions over foreign ones. In the aforementioned case, the preference for high-quality tuna is a feature the Japanese have in common. Any comparable domestic transactions will tell the same story: the premium price charged in Japan is fair. Thus, the premium due to customer preference is not considered value created in Japan. The tradename owner will likely tax the additional profits (see Chapter 5). However, this example does not elucidate why a market, regardless of its quality, possesses the right to tax or is more qualified to collect tax.

From a market access rationale, the markets that buy high-quality tuna at a lower price provide similar types of public infrastructures to the MNEs as markets. While demand in these markets may be lower than in premium tuna loving markets, such as Japan, so it meets the supply at a lower point. Various factors influence MNEs' choice of target

[78] Michael P. Devereux and John Vella, ibid, at 394.

markets, including market size, growth rates, competitive forces, customer fit, profitability and more.[79] Nevertheless, once MNEs enter a market and engage in sales, all markets enjoy equal taxing rights over profits derived within their borders.

2.4 Dismiss the market jurisdiction: a narrow OECD interpretation of the value creation principle

Professor Richard Vann, in an article outlining the fundamental flaws of the traditional international taxation regime, remarked that "…the importance of the market is constantly emphasised by administrators, but then often subverted by various devices in an apparently haphazard fashion."[80]

As previously discussed, the value creation principle is intricately linked with the doctrine of economic allegiance and the benefit principle. Upon closer examination, it becomes evident that both theories support the taxing rights long owed to the market jurisdictions. However, the OECD's interpretation of the value creation principle is overly narrow, diverging from the original economic theories in several key respects:

Firstly, the principle exclusively focuses on the supply side, neglecting the significance of the demand side—the role of the market. Consequently, it primarily benefits source countries where supply-side activities occur within their borders. Market jurisdictions, which primarily engage in purchasing, are not entitled to any share of the profits.

[79] Lyndon Simkin and Sally Dibb, 'Prioritising Target Markets' (1998) 7(16) *Marketing Intelligence & Planning* 407.
[80] Richard J. Vann, above fn 9, at 313.

Secondly, the value creation principle needs to acknowledge the distinct roles of market jurisdictions compared to supply-side source countries. While source countries may seek FDI and offer incentives such as cheap labour and tax benefits,[81] market jurisdictions primarily serve as consumption markets for MNEs. Attracting FDI is not their main job as markets. The benefits of accessing markets, such as making sales, do not necessarily require physical presence due to the internet's ubiquity. Thus, attempting to apply rules tailored for source countries to market jurisdictions overlooks their fundamentally different roles.

Source countries and market countries are indeed distinct entities, yet they are not mutually exclusive. A thriving market can often incentivise MNEs to undertake various activities within its borders. For instance, beverage companies like Coca-Cola may establish bottling plants in key markets worldwide to cater to local demand and neighbouring regions. It is important to recognise that a market with robust demand can also function as a source country, thus necessitating different regulatory frameworks to account for its varied roles in value creation.

Lastly, the value creation principle relies on MNEs' physical presence in a geographic location as a nexus between income and jurisdictions (also see Chapter 4). This approach, particularly when combined with separate accounting, can facilitate harmful profit

[81] Research shows that tax rates and FDI are generally negatively related. See e.g., Ruud A De Mooij and Sjef Ederveen, "Explaining the Variation in Empirical Estimates of Tax Elasticities of Foreign Direct Investment", Tinbergen Institute Discussion Paper No. 108/3 (December 2005). For discussions of how the FDI stipulate economic growth, see Usha Nair-Reichert and Diana Weinhold, 'Causality Tests for Cross-country Panels: a new look at FDI and Economic Growth in Developing Countries' (2001) 2(63) *Oxford Bulletin of Economics and Statistics* 153; Henrik Hansen and John Rand, 'On the Causal Links Between FDI and Growth in Developing Countries' (2006) 1(29) *World Economy* 21.

shifting, especially in the digital economy, where significant activities can be conducted remotely.

These inherent flaws in the traditional international tax system have persisted unnoticed for too long. The BEPS Interim Report underscored the entrenched nature of these perceptions. Even countries open to modifying nexus and profit allocation rules resist structural changes to the existing regime:

> *"In particular, most of the countries in this group reject the idea that a country that provides the market where a foreign enterprise's goods and services are supplied on its own provides a sufficient link to create a nexus for tax purposes, regardless of the scale of these supplies. Instead, they consider that profits should continue to be taxed exclusively where the factors that produce the income are located, in accordance with long-standing principles of the existing tax system (e.g., aligning profit with value creation). "*[82]

The European Union (EU), which incorporates "sales" as a factor in its extensively discussed formulary apportionment system, the Common Consolidated Corporate Tax Base (hereinafter CCCTB), also strongly supports the commonly understood value creation principle.

> *"…this Commission has taken action to ensure the principle that all businesses operating in the EU should pay their taxes where profits and value are generated.*

[82] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (2018), para 390.

> *This principle is essential for a fair and effective taxation in the Single Market, and it can only be enforced through common and coordinated measures."*[83]

The United Kingdom (hereinafter UK) also takes a conservative stance on this matter. The HM Treasury maintains that users may create value, but customers do not,[84] suggesting that Amount A of Pillar One should ring-fence the digital giants. Market jurisdictions do not possess broad taxing rights solely by virtue of being markets. The HM Treasury provided:

> *"…for some types of digital businesses, users can be seen participating in a non-traditional value chain and performing supply-side functions that would historically have been undertaken by the business itself. While digitalisation might allow traditional businesses to build stronger and more interactive relationships with their customers, the government does not expect the role of customers within those businesses to change to an extent that leads to the same blurring of production and consumption boundaries."*[85]

There is a notable disparity between the OECD's interpretation of the value creation principle and the growing trend of allocating taxing rights to market jurisdictions. While the OECD seems to be considering a paradigm shift, evidenced by the minimal mentions of "value creation" in the Pillar One Blueprint (only three times in passing)[86] and its mere

[83] EU Commission, *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market* (2017) < https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A52017DC0547>.
[84] HM Treasury, *Corporate Tax and the Digital Economy: Position Paper Update* (2018), paras 2.26–2.32.
[85] HM Treasury, *ibid*, paras 2.30–2.31.
[86] The Pillar One Blueprint only mentioned the value creation principle three times, including one time in the foreword and two times in the footnotes. See OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint* (2020), at 3, 145 fn 113, 160 fn 124.

inclusion in the foreword of the Pillar Two Blueprint,[87] it is not imperative for the OECD to completely discard the value creation principle.

Indeed, the underlying economic theories support the notion of allocating taxing rights to market jurisdictions, and this perspective has found support from emerging markets, particularly China.[88] The China International Tax Centre has proposed a narrower interpretation of "value creation," distinguishing between the supply side and the demand side by introducing the concept of "value realisation" for the latter.[89]

This thesis proposes that transfer pricing mechanisms can be leveraged to achieve a similar outcome without necessitating a complete paradigm shift. By employing transfer pricing mechanisms effectively, market jurisdictions can be empowered to claim an appropriate share of taxing rights, thereby aligning with the evolving dynamics of global taxation. (See Chapters 4-7 for further discussion on this topic).

Additionally, this thesis underscores the importance of viewing market jurisdictions and source countries distinctly and advocates for allocating taxing rights under separate regulatory frameworks. While a market's attractiveness may lead to MNEs establishing a physical presence and conducting operations within its borders, it is essential to recognise the unique roles played by both types of jurisdictions. Market jurisdictions

[87] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint* (2020), at 3.
[88] Johanna Hey, '"Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative' (2018) 72(4/5) *Bulletin for International Taxation* < https://maxlewis.com.sg/wp-content/uploads/2020/04/1-Taxation-where-value-created-Hey.pdf> at 2.
[89] China International Tax Center/International Fiscal Association (IFA) China Branch, *Comments Received on Public Discussion Draft - BEPS Action 10: Use of Profit Splits in the Context of Global Value Chains* (2015), at 101. This is a semi-official organisation, so it represents the Chinese government's position to some extent.

primarily serve as consumption markets for goods and services, while source countries facilitate supply-side activities such as production and distribution.

By delineating between market jurisdictions and source countries, tax authorities can tailor regulations to suit the specific characteristics and functions of each jurisdiction. This approach ensures that taxing rights are allocated appropriately, reflecting the distinct contributions and economic activities undertaken within each jurisdiction.

Chapter 3

Formulary Apportionment

3.1 Introduction

Apart from arm's length principle (hereinafter ALP) discussed in Chapter 2, there is another way for the MNE to allocate income among different geographic locations, known as Formulary Apportionment (hereinafter FA). Unlike the ALP, which is applied on a transaction-by-transaction basis, the FA approach distributes a pool of total income based on a formula that takes into account various factors, such as property, payroll and sales. The total income pool may only include income from a legal entity and its branches, income from several related entities, or global income of an entire MNE. The first option is referred to in this thesis as the "entity approach", while the second and third option are commonly referred to as the "unitary approach".

There are different ways to calculate the pool of total income under the unitary approach. A preferred method is a consolidation that removes internal controlled transactions. However, most jurisdictions apply a simpler method called "combined reporting", where accounting figures of related entities are combined, and each jurisdiction takes a share based on their contributions in terms of capital, labour, and sales. Ideally, all participating jurisdictions should adopt the same formula, such as the proposed Amount A in the Two-Pillar Approach (see Section 3.4), the CCCTB (see Section 3.3.2), which has been under

discussion in the EU for many years,[1] and the newly proposed comprehensive solution for business taxation in EU, namely Business in Europe: Framework for Income Taxation (hereinafter BEFIT). However, it is not a prerequisite that all jurisdictions use the same formula. In the US, for example, different states use different formulas to calculate the share of the profits of enterprises with a presence in or sales to multiple states attributable to their states.

FA is considered to have many advantages over the ALP, such as reducing tax competition,[2] minimise profit shifting,[3] and avoiding the hassle of pricing the controlled transactions.[4] In particular, most FA formulas allocate a portion of corporate profits to the market jurisdictions, which better reflect the economic reality than the ALP (see Chapter 2). Despite the benefits of FA, there has been no living FA model applied at the jurisdictional level.

The chapter examines past, present, and future FA proposals at both the state and jurisdictional levels. Section 3.2 discusses the US and Canada's FA models, which operate

[1] For a discussion of the CCCTB rules, see, e.g., Joann Martens Weiner, 'The Dream Is Alive: EU Tax Policy with a Common Consolidated Corporate Tax Base and Formulary Apportionment' in Richard Krever and François Vaillancourt (eds.), *The Allocation of Multinational Business Income: Reassessing the Formulary Apportionment Option* (The Netherlands: Kluwer Law International, 1st ed, 2020) pp. 101 to 136.
[2] See, e.g., Rüdiger Pethig and Andreas Wagener, 'Profit Tax Competition and Formula Apportionment' (2007) 14 *International Tax and Public Finance* 631. A similar argument was put up in the EU's context, see, Thomas Eichner and Marco Runkel, 'Why the European Union Should Adopt Formula Apportionment with a Sales Factor' (2008) 110(3) *The Scandinavian Journal of Economics* 567.
[3] Sales were comparatively immovable, so a single sales factor formula would better prevent profit shifting than a formula that combined the three factors. See e.g., Reuven S. Avi-Yonah and Kimberly A. Clausing, 'Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment' in Jason Furman and Jason Bordoff (eds), Path to Prosperity Hamilton Project Ideas on Income Security, Education, and Taxes (Washington, D.C.: Brookings Institution Press, 1st ed, 2008) pp.319 to 344; Kenneth J Klassen and Douglas A Shackelford, 'State and Provincial Corporate Tax Planning: Income Shifting and Sales Apportionment Factor Management' (1998) 25(3) *Journal of Accounting and Economics* 385.
[4] See e.g., Louis M. Kauder, 'Intercompany Pricing and Section 482: A Proposal to Shift from Uncontrolled Comparables to Formulary Apportionment Now' (1993) 60 *Tax Notes* 485.

at the state level, while Section 3.3 explores the short-lived California model and the under-long-debate EU CCCTB and BEFIT, both of which are jurisdictional FA models.

Section 3.4 analyses the recently proposed Amount A under Pillar One by the OECD, which is the first FA model that apportions profits among jurisdictions and allocates a portion of MNEs' global profits to market jurisdictions.

Despite the advantages, there are political obstacles to the implementation of FA. Section 3.5 concludes that FA may not be a feasible solution for allocating an appropriate share of taxing rights over MNEs' global profits to market jurisdictions. Overall, the chapter provides a comprehensive overview of FA proposals, their historical developments, and ongoing challenges.

3.2 The historical and current proposals: formulary apportionment at the state level

FA is implemented at the state or provincial level in both the US and Canada. At the federal level, both countries use the ALP. Each state or province has the flexibility to tailor the FA formula to better reflect the economic activities within its borders. For instance, some US states double the weight of the sales factor, while others use a single sales factor formula to allocate profits for state tax purposes. This section examines the historical developments of FA in the US and Canada.

3.2.1 The US leads the development of formulary apportionment

3.2.1.1 Early experience: formulary apportionment introduced with the state corporate income tax

The FA was first introduced in the US in the early 20th century to allocate state income. In 1911, Wisconsin became the first state to tax corporate income, adopting a formula based on the proportion of "business transacted and property located within the state."[5] The formula was originally developed for the purpose of determining the proportion of capital stock employed within the state.[6] Here, the "business" factor acted as a proxy for sales and manufacturing costs,[7] while "property" referred to capital assets located in the state. The method was illustrated with an example in the Explanatory Note of Laws of Wisconsin (1911) Chapter 658, which computed the tax payable by a company that did business both within and outside the state:

> *"Taking the case of a concern which does business both within and without the state, let it be supposed that the net profit or income is $12,000; the gross business done within the state is $50,000; the property located within the state is worth $20,000; the total business done within and without the state is $150,000 and the total property within and without the state is $60,000. Taking the second and third items for the numerator and the last two for the denominator we have the formula*

[5] Laws of Wisconsin (1911) Chapter 658, section 1087m 2.3. For an assessment of the Wisconsin 1911 Income Tax Law, see Kossuth Kent Kennan, 'The Wisconsin Income Tax' (1911) 26(1) *The Quarterly Journal of Economics* 169; T. S. Adams, 'The Significance of the Wisconsin Income Tax' (1913) 28(4) *Political Science Quarterly* 569.
[6] Code of Wisconsin, section 1770b, subsection. 7(e).
[7] Carl S. Lamb, et al., *Report of the Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business*, (1922) 15 Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association 198, at 206.

$$\frac{50{,}000 + 20{,}000}{150{,}000 + 60{,}000} = \frac{70{,}000}{210{,}000} = \frac{1}{3} of\ 12{,}000 = 4{,}000$$

Thus, the concern would have to pay income tax on $4,000."[8]

In this example, the property and business might not each explain 50% of the profit allocation. For instance, if the property factor was generally ten times the business factor, it could allocate 10/11 of the profits and dominate the allocation.

After Wisconsin, other states introduced corporate income tax, and most adopted formula-based approaches to determine the source of income for corporations operating in multiple states. For instance, Oklahoma, Connecticut, and West Virginia passed income tax law in 1915, with Oklahoma leaving the rule of apportionment to the state auditors,[9] Connecticut providing an apportionment rule solely based on sales,[10] and West Virginia apportioning corporate income of businesses in more than one state by the proportion of valuation of assets and property.[11] In 1917, New York,[12] Montana[13] and Missouri[14] passed corporate income tax laws, and all of them applied formula-based approaches in different forms to apportion corporate income to the state.[15]

[8] Wisconsin Income Tax Law of 1911: With Explanatory Notes, Governor's Special Message, etc. (1911), at 12.
[9] Laws of Oklahoma (1915) Chapter 164.
[10] Laws of Connecticut (1915) Chapter 292. Connecticut law provided for an apportionment on the basis of gross receipts if the income derived principally from the holding or sales of intangibles. The apportionment will be based on the relative fair cash value if the profits are derived principally from the holding or selling of real or tangible personal property. For comments on the US income law from 1911 to 1920, see Harley L. Lutz, 'The Progress of State Income Taxation Since 1911' (1920) 10(1) *The American Economic Review* 66.
[11] Laws of West Virginia, Second Extraordinary Session (1915) Chapter 3.
[12] Laws of New York (1917) Chapter 726.
[13] Laws of Montana (1917) Chapter 79.
[14] Laws of Missouri (1917) p. 524.
[15] Delaware also passed income tax in 1917 but only applied to the income of resident individuals. See Laws of Delaware (1917) Chapter 26. For a discussion of the income tax of New York, Montana, Missouri, and Delaware, see Harley L. Lutz, 'The Progress of State Income Taxation Since 1911' (1920) 10(1) *The American Economic Review* 66, pp. 69 to 71.

The first three-factor formula was adopted by Massachusetts in 1919.[16] It allocated the income of multistate corporations based on the proportion of the company's tangible property, labour costs and sales receipts within the state. The three factors were weighted equally so each factor apportioned 1/3 of the profits.[17] This formula was considered the most suggestive formula in the beginning of the 1920s, appreciated by academics for "[giving] weight to the more important factors involved in the origin of interstate income"[18]

The various factors of the formula were also discussed by academics. Thomas Adams, the University of Wisconsin-Madison economics professor who played an important role in drafting the Wisconsin tax, recommended a formula based on the proportion of property and payroll within the state. The payroll factor substituted the ambiguous "business" in Wisconsin corporate tax law. In Adams's view, a range of business activities such as

[16] Laws of Massachusetts (1919) Chapter 355, Section 6. Massachusetts introduced its income tax in 1916 but only applied to certain income. See Laws of Massachusetts (1916) Chapter 269. The income tax law was amended in 1919 to be more comprehensive, including the introduction of the three-factor formula to apportion interstate profits.

[17] Three-factor formula with equal weights looks like this:

$$Total\ business\ income\ of\ an\ entity$$

$$\times \frac{\frac{Property\ located\ in\ the\ state}{Total\ property\ of\ the\ entity} + \frac{Labour\ costs\ inclurred\ in\ the\ state}{Total\ labour\ costs\ of\ the\ entity} + \frac{Sales\ made\ in\ the\ state}{Total\ sales\ of\ the\ entity}}{3}$$

$$= Entity's\ income\ apportioned\ to\ the\ state$$

If the three factors are not arbitrarily made equal, the formula will look like this:

$$Total\ business\ income\ of\ an\ entity$$

$$\times \frac{Property\ located\ in\ the\ state + labour\ costs\ incurred\ in\ the\ state + sales\ made\ in\ the\ state}{Total\ property\ of\ the\ entity + total\ labour\ cost\ of\ the\ entity + total\ sales\ of\ the\ entity}$$

$$= Entity'sincome\ apportioned\ to\ the\ state$$

[18] Harley L. Lutz, 'The Progress of State Income Taxation Since 1911' (1920) 10(1) *The American Economic Review* 66, at 89.

production, marketing, purchasing, and sales were "fairly recognised by an apportionment in accordance with the expenditures for salaries and wages".[19] However, Adams also clarified that the rule was less important, and the most important issue was to have a uniform rule laid down by the federal government that could be generally adopted by every state.[20]

The tax administrators foresaw the problem and chaos that uncoordinated taxes could bring. In 1915, the National Tax Association began designing a common corporate tax model for multistate business income to avoid the possible double taxation that could arise from the application of different allocation rules.[21] In 1920, the National Tax Association appointed a committee to explore the options for the allocation of multistate business income, and in 1922, the committee concluded that an FA approach dominated any other approach.[22] The committee recommended a formula with equal weighting of property and business. In which property included only tangible assets and business measured both income and expenses, including labour, material sales and incidental receipts.[23] The committee made the suggestion for a fair basis of compromise between Wisconsin, New York and Massachusetts. The considerations it had in determining the business factor reinforced that the business activities producing the net income include both the input (labour and other costs), and the output (sales). This formula was

[19] T.S. Adams, 'The Taxation of Business' (1917) 11 *Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association* 185, at 193.
[20] Ibid, at 194.
[21] Joann M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level' (1999) *OTA Paper 83*, U.S. Department of the Treasury, at 9.
[22] The other approaches include separate accounting and what they called a "specific allocation", which was the allocation method recommended by the National Tax Association conference, which was a "uniform mathematical formula over water's edge separate accounting". See Richard Krever and Peter Mellor, 'History and Theory of Formulary Apportionment' in Richard Krever and François Vaillancourt (eds.), *The Allocation of Multinational Business Income: Reassessing the Formulary Apportionment Option* (The Netherlands: Kluwer Law International, 1st ed, 2020) pp.9-40, at 14.
[23] Carl S. Lamb, et al., above fn 7.

supported by Thomas Adams at the time, though he put forward concerns about the equal weighting of the property and business factors.[24]

The National Tax Association continued to search for a better method of allocating interstate business income. In 1931, it explored the benefits of separate accounting.[25] In 1933, the National Tax Association once again endorsed a formula-based approach to allocating interstate business income, but this time, it recommended adopting the Massachusetts formula, which gives equal weights to three factors: tangible property, labour costs and sales receipts.[26] Following this recommendation, the Massachusetts formula gradually became the "standard" method.[27]

The reason the National Tax Association chose the FA approach over any other approach was not because it convinced by the economic framework behind it. On the contrary, the National Tax Association agreed that separate accounting would produce the most accurate measurement, but conducting a transaction-based analysis was too costly. A formula could approximate the outcome of separate accounting to a large extent with lower cost.[28]

3.2.1.2 The unitary approach

[24] T. S. Adams, *Discussion- Apportionment of Taxes between States* (1922) 15 Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association 215, at 221.
[25] Charles W. Gerstenberg, *Allocation of Business Income*, in Seth T. Cole, et al., *Report of the Committee of the National Tax Association on Uniformity and Reciprocity in State Taxing Legislation* (1931) 24 Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association 294, at 308.
[26] Franklin S. Edmonds, et al., *Report of Committee on Uniformity and Reciprocity in State Taxing Legislation* (1933) 26 Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association 259, pp. 261 to 263.
[27] Joann M. Weiner, above fn 21, at 10.
[28] Franklin S. Edmonds, et al., above fn 26. Also see Richard Krever and Peter Mellor, above fn 22, at 14.

The FA is sometimes called unitary taxation, or unified approach in the OECD's terms,[29] but they are not the same. Unitary taxation involves calculating the pool of income to be apportioned. This is done by combining reporting of a corporate group or related entities as a consolidated single enterprise, including income. Intra-group transactions do not affect the size of the income pool and eventually end up in the same pool for apportionment, reducing the risk of profit shifting. Under the unitary approach, the formula is only applied once to the pool of income to determine the portion of profits each geographic location will share.

On the other hand, the FA is a type of source rule used to allocate total corporate income to geographic locations. It is "a method of estimating something that is hard to geographically locate".[30] The FA can be applied at the group or sub-group level using unitary taxation to calculate income on combined reporting. Alternatively, it can be applied to each entity and its branches using separate reporting. In the latter case, intra-group transactions are not offset, which increases the risk of transfer pricing compared to the unitary approach.

In the early 1920s, US interstate corporate groups learned to use the limited coverage of the state corporate income tax and transfer profits to states that did not tax them. For example, Studebaker Corporation was a New Jersey corporation manufacturing and selling motor vehicles. The parent company established subsidiaries specialised in sales in many states, including Studebaker Corporation of America, a New Jersey corporation

[29] See OECD, *Secretariat Proposal for a "Unified Approach" under Pillar One* (2019).
[30] Shirley Sicilian and Joe Huddleston, 'The US States' Experience with Formulary Apportionment' in Richard Krever and François Vaillancourt (eds.), *The Allocation of Multinational Business Income: Reassessing the Formulary Apportionment Option* (The Netherlands: Kluwer Law International, 1st ed, 2020) pp. 41 to 74, at 42.

responsible for sales in New York and elsewhere (hereinafter NY Sales).[31] These sales subsidiaries were so-called "skeleton sales companies" at that time (or shell companies today) transacting all the business outside the home state and making small profits to avoid tax.[32] The sales subsidiaries continuously made losses while the parent company made huge profits. For example, in 1920, all the selling subsidiaries made losses, except for the Ohio subsidiary, while the parent made a net profit of $11,434, 954.41.[33] Back then, the corporate tax had not been introduced in New Jersey, so the profits were tax-free in New Jersey. The sales subsidiaries took the sales outside New Jersey away from the parents, so under an entity approach, the parent was not taxed in any other state, including New York.

New York applied a unitary approach in calculating the total profits of the group and levied a tax on NY Sales for a portion of the parent's profits based on a proportion of the "determinative assets" located in New York.[34] The Appellate Division sided with the State Tax Commission,[35] but the Court of Appeals reversed.[36] Judge Cardozo hoped that the New York Tax Commission could ask to pierce the corporate veil, but the Commission did not ask. Judge Cardozo seemed to view this FA case using a separate accounting mindset. He could not agree with the State of New York taxing all the income attributable to it rather than further apportionment between the sales subsidiary and parent.[37]

[31] *People ex rel. Studebaker Corp. v. Gilchrist*, 155 N.E. 68 (N.Y. 1926), at 69. For a detailed analysis of the Studebaker case, see Joel S. Newman, 'Two New York Tax Cases' (2018) 34(1) Touro Law Review 301.
[32] Richard Ford, 'Legal Problems in National Merchandising' (1934) 32(4) Michigan Law Review 433, at 434.
[33] *People ex rel. Studebaker Corp. v. Gilchrist*, above fn 31 (N.Y. 1926), at 69.
[34] *People ex rel. Studebaker Corp. v. Gilchrist*, 216 N.Y.S. 208 (App. Div. 1926) (Kellogg, J., dissenting), at 214.
[35] *Ibid,* at 210.
[36] *People ex rel. Studebaker Corp. v. Gilchrist*, above fn 31, at 68.
[37] *People ex rel. Studebaker Corp. v. Gilchrist*, above fn 31, at 70-71.

In some other cases, the tax commissioners successfully applied the unitary approach to corporate groups with or without "skeleton sales companies". For example, in *Underwood Typewriter Co. v. Chamberlain*,[38] the tax commissioner of Connecticut found that the Underwood Typewriter Company derived profits mainly from tangible property, 47% of which was located in Connecticut. Though Connecticut had a single sales factor formula to apportion the state corporate income,[39] which allocated only $42, 942.18 to Connecticut, the commissioner still placed a tax over $629,669.5, which was 47% of the company's total profits. The US Supreme Court upheld the tax commissioner that the corporate had not shown that the apportionment was unfair.[40]

Another case in which the commissioner successfully applied the unitary approach was *Palmolive Co. v. Conway*.[41] In this case, the Wisconsin manufacturer sold sops to a "skeleton sales company" in Delaware at a very low margin to avoid paying taxes to Wisconsin on the profits arising from sales.[42] The Wisconsin tax commissioner applied a unitary approach, which treats the corporate group as a single enterprise instead of separate entities, to apportion the total income of the corporate group.[43] The Court upheld the Wisconsin tax commissioner that the skeleton sales companies were created solely to remove income from the state.[44]

Inspired by these cases, the former Treasury official and Columbia law professor Roswell Magill published his famous paper *Allocation of Income by Corporate Contract,* supporting

[38] 254 U. S. 113 (1920) and 94 Conn. 47 (I919).
[39] Laws of Connecticut (1915) Chapter 292.
[40] *Underwood Typewriter Co. v. Chamberlain*, 254 U. S. 113 (1920), aff'g 94 Conn. 47 (I919).
[41] 43 F.(2d) 226 (W.D. Wis 1930).
[42] Wisconsin placed a state corporate income formula on capital assets and "business", which referred to sales less manufacturing costs. See Laws of Wisconsin (1911) Chapter 658, section 1087m 2.3.
[43] Roswell Magill, 'Allocation of Income by Corporate Contract' (1931) 44(6) Harvard Law Review 935, at 935.
[44] *Palmolive Co. v. Conway* 43 F.(2d) 226 (W.D. Wis 1930). For a discussion of the other reasons for forming the skeleton sales companies, see, e.g., Arthur Stone Dewing, *The Financial Policy of Corporations*, (The Ronald Press Company 5th ed, 1926); William O. Douglas and Carrol M. Shanks, 'Insulation from Liability Through Subsidiary Corporation'' (1929) 39(2) *The Yale Law Journal* 193.

the unitary approach of combined reporting of the corporate group as a single enterprise on a theoretical basis.[45] By the 1930s, more corporations were incorporating separate entities rather than establishing divisions of a single corporation and carrying out business in the form of corporate groups. Tax policymakers faced the problem of whether to respect separate legal entities and tax the corporations one by one or apply a unitary approach of combined reporting.

The theory was put into practice in 1936 by California to tax the movie industry.[46] During the 1930s, movies were produced in California and then distributed by related entities in other states. California was allocated very little profits if Hollywood was targeted as the taxpayer. California tax administrators argued that income attributable to the state should not vary upon corporate structure. Therefore, California calculated the profits of the entire corporate group based on a combined report and apportioned profits to California according to the proportion of the group's profit factors attributable to the state. The California Supreme Court supported this position in 1947 in *Edison California Stores v. McColgan*, upholding a combined reporting of related separate entities based on the unitary approach.

Sixteen years later, the same Court held in *Honolulu Oil Corp. v. Franchise Tax Bd* that separate incorporation did not make a business division distinct and separate from the group:

> *"Extensive intracompany assets and efforts were devoted to each producing well, wherever it may be located, and the mere fact that production and sale therefrom are a local operation does not transform that operation to something*

[45] Roswell Magill, above fn 43.
[46] For a discussion of the unitary approach of California, see, Joe Huddleston and Shirley Sicilian, above fn 30, at 7-8.

> *distinct and apart. To the contrary it becomes an integral part of the unitary business, and thereafter contributes its share to future exploration and development efforts in other areas."*[47]

At that time, the Unitary approach was tentatively built with statutory authority.

3.2.1.3 Efforts to achieve uniformity

Efforts to establish a uniform system for FA in state corporate income tax have been ongoing for over a century. In the 1910s, Thomas Adams called for a uniform rule to be established by the federal government that would be adopted by every state.[48] Roswell Magill also proposed a uniform accounting practice allocating profits and expenses in 1931.[49]

The implementation of different tax rules among the states caused chaos and prompted attempts to uniform state corporate taxes at the federal level in 1945 and 1947, but these efforts did not result in federal legislation.[50] In 1957, the National Conference of Commissioners on Uniform State Laws (consisted of a group of state legislators) proposed the Uniform Division of Income for Tax Purposes Act (hereinafter UDITPA), which called for all states to adopt the Massachusetts three-factor apportionment

[47] Honolulu Oil Corp. v. Franchise Tax Bd., 60 Cal.2d 417 (1963), at 424.
[48] T.S. Adams, above fn 19, at 194.
[49] Roswell Magill, above fn 43, at 952.
[50] Initially discussed in William E. Tuttle, 'The proposed Uniform State Taxation Statute' (1966) 16 *Proceedings of the Annual Tulane Tax Institute* 796, at 798 to 799. Quoted by Richard Krever and Peter Mellor, above fn 26, at 16.

formula based on property, payroll and sales on a separate-entity basis,[51] but also allowed for separate accounting if it fair reflected business activities.[52]

However, the states did not adopt these rules quickly enough. Two years after the UDITPA was proposed, in response to the business pressure, Congress initiated a committee process to study state corporate income tax and promote more harmonised state tax practices. The federal intervention prompted the wider and faster adoption of the UDITPA.[53] Many states adopted UDITPA directly into their statutes in the mid-1960s to forestall the Congressional action.[54] Some states adopted it by enacting the Multistate Tax Compact,[55] while some others have enacted both UDITPA and the Multistate Tax Compact.[56]

As of March 2023, the Compact has sixteen full member states, including District of Columbia, ten sovereignty member state, and twenty-four associate member states, meaning that all fifty states except for Nevada are members of the Compact in some capacity.[57]

The Multistate Tax Compact was intended to bring harmony to the state corporate tax system, but it did not achieve the goal. Without Congressional action, a Court decision

[51] The UDITPA was criticised substantially, see, e.g., Arthur D. Lynn, Jr., 'The Uniform Division of Income for Tax Purposes Act Re-Examined' (1960) 46(6) *Virginia Law Review* 1257; Vernon B. Savoie and Michael L. Burr, 'The Throwback Rule: Concepts, Components and Planning Opportunities' (1983) 2(1) *Journal of State Taxation* 19.
[52] Richard Krever and Peter Mellor, above fn 22, at 17.
[53] The federal intervention greatly worried the state legislators, see, e.g., Charles E. McLure, Jr., 'Understanding Uniformity and Diversity in State Corporate Income Taxes' (2008) 61(1) *National Tax Journal* 141.
[54] H.R. Rep. No. 89-952, pt. VI, at 1139 (1965).
[55] See *United States Steel Corp. v. Multistate Tax Commission*, 434 U.S. 452 (1978).
[56] See Joe Huddleston and Shirley Sicilian, 'History and Considerations for Combined Reporting: Will States Adopt a Model Combined Reporting Statute?' (2008) *The State and Local Tax Lawyer: Symposium Edition* 3, at 8.
[57] See Multistate Tax Commission official website at <https://www.mtc.gov/the-commission/member-states/> accessed 21 March 2023.

would also give a FA approach statutory basis. The UDITPA adopted a three-factor formula that distributed profits equally to the factors of tangible property, labour costs, and sales receipts. This approach favoured states with all three profit factors but generated less revenue for states that only hosted customers. The US Supreme Court held that a fair formula must be internally and externally consistent.[58] An internally consistent formula could use one or more of the three factors regardless of the weightings, including a single sales factor formula.[59] However, external consistency required that the factors reflect a reasonable sense of how income is generated.[60] The states that could not obtain much tax revenue from the standard three-factor formula gradually shifted to a single sales factor formula[61] or other variations with the Supreme Court's statutory support.[62]

In 2015, the Multistate Tax Compact was revised due to growing fragmentation of the state practices.[63] The new recommended formula retained the old three factors but doubled the weighting of the sales factor. It was not a mandatory practice, so states had the ultimate decision on the factors to use and their weighting. By 2019, only nine states still required an equal-weighted three-factor formula,[64] while the other states were moving towards heavily weighting the sales factor. Thirty-seven states at least double

[58] *Container Corp. of Am. V. Franchise Tax Bd*, 463 US 159 (1983), at 169.
[59] *Ibid*, at 183 to 184.
[60] *Ibid,* at 169.
[61] The single sales formula was upheld by the Supreme Court in 1978. See *Moorman Mfg. Co. v. Bair*, 437 US 267 (1978). The Supreme Court recognised that some formulas were problematic because they focused on only a small spectrum of activities by which value is generated, including the single sales formula. Even so, they still provided a reasonable rough approximation of the income attributable to the state. See *Container Corp. of Am. V. Franchise Tax Bd*, above fn 58, at 182.
[62] If an in-state taxpayer's out-of-state activity has some "concrete connection" with its in-state activity, the in- and out-of-state business activities are part of a "single economic enterprise" where a unitary approach can be applied to a combined report. See *Mobil Oil Corp. v. Commissioner of Taxes of Vermont* 445 US 425 (1980), at 436-437. This case also developed a test of the "Mobil three factors" test to determine whether income was attributable to a unitary business. See Shirley Sicilian and Joe Huddleston, above fn 34, at 43 and 44.
[63] On July 2015, the Multistate Tax Commission adopted the Revised Model Compact Article IV, and passed Resolutions adopting conforming amendments to Article IV and amendments to Section 18. See, <https://www.mtc.gov/uniformity/article-iv/> accessed on 21 March 2023.
[64] CCH Smart Charts, State Tax Smart Charts, ¶11-520, General Apportionment Formula, 2019 Tax Year.

weighted the sales factor, and twenty-four of them used a single sales factor formula.[65] The main driver for the states to place more weight on the sales factor was economic development.[66] Exempting property and payroll provided a quasi-tax incentive that would encourage corporates to choose the state that used single sales factor FA as the destination for its investment. This approach is consistent with the 1923 Report drafted by economists for the League of Nations, which recommended that source countries should give up their taxing rights to attract FDI (see Section 2.3).

3.2.1.4 The amount and location of sales

The trend of giving more weight to the sales factor raised two issues: what should be considered as sales and how to determine where the sales occurred. The definition of "sales" was provided in both the UDITPA and Multilateral Tax Compact models. The UDITPA included sales receipts arising from:

1) Transactions and activity in the regular course of the taxpayer's trade or business, e.g., sale of goods.
2) Tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations, e.g., sales of equipment for manufacturing use.[67]

[65] Shirley Sicilian and Joe Huddleston, above fn 30, at 52.
[66] See, e.g., *Report of the Maryland Economic Development and Business Climate Commission, Phase II: Taxes* (2016) at 37-38; Shirley Sicilian, Exhibit 2: Multistate Tax Compact Article IV Recommended Amendments, Memorandum to Cory Fong (Chair) (2012) *Multistate Tax Commission*, at 22.
[67] See, e.g., *Jim Beam Brands Co. v. Franchise Tax Bd*., 133 Cal.App.4th 514 (2005), at 523.

On the other hand, the Multilateral Tax Compact models only included the first type of sales receipts with the same wording.[68]

Sicilian and Huddleston argued that the sales factor should reflect the taxpayer's "market activity", rather than "production activity".[69] In this case, the Multilateral Tax Compact model's definition of sales was more accurate because "sales" should be limited to those that reflect the contribution of the taxpayer's market to their income, rather than "to include transactions involving the taxpayer's production property."[70] This was especially true in a three-factor formula, where property and payroll represented the production side of the business. However, in a sales-only formula, it was more reasonable to use the more inclusive UDITPA definition of "sales" to reflect the contribution of the production side of the business, though to a very limited extent.

Regarding the location of sales, both the UDITPA and the Multilateral Tax Compact models traditionally attributed sales of tangible property to the state where the property was "delivered or shipped to a purchaser".[71] If the property was delivered to a state where the seller had no nexus or law to tax, some states implemented a "throwback" rule that threw the sales back to the departure state from which the company shipped the goods.[72] This rule prevented corporations from manipulating sales factor using skeleton sales companies.

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[68] Multistate Tax Commission, *Model General Allocation and Apportionment Regulations* § 2(a)(6) (2018) <https://www.mtc.gov/wp-content/uploads/MTCImages&Files/MTC/media/AUR/FINAL-APPROVED-2018-Proposed-Amendments-042020.pdf> accessed on 23 March 2023. The Multistate Tax Commission uses the term" receipts factor" rather than "sales factor".

[69] Shirley Sicilian and Joe Huddleston, above fn 30, at 53.

[70] Ibid, at 53.

[71] Uniform Law Commission, *UDITPA*, §16(a) (updated 2021) <https://www.uniformlaws.org/viewdocument/final-act-54?CommunityKey=f2ef73d2-2e5b-488e-a525-51be29fbee47&tab=librarydocuments> accessed on 23 March 2023; Multistate Tax Commission, *Multistate Tax Compact, Article IV,* § 16(a) (2017) <https://www.mtc.gov/the-commission/multistate-tax-compact/> accessed on 23 March 2023.

[72] Uniform Law Commission, above fn 71, §16(b) (updated 2021)

The location of sale of intangible and service was attributed to the state that hosted a greater proportion of the income-producing activities judged by cost of performance.[73] However, the cost of performance rule was criticised for not accurately representing the sales factor, as these types of costs usually arose from property and payroll, rather than the market.[74] The cost of performance rule was a reasonable proxy for market location when the UDITPA was introduced in the 1950s, but it is now outdated.

Today, production activities can be completely separated from markets, and services can be provided to customers remotely. The cost of performance rule, which attributes sales to production states, no longer reasonably approximates the location of the market. It has become a replica of property and payroll factors, which could be counterproductive for states trying to increase the weight of the sales factor in their formula to attract investment. This situation is similar to what international taxation is facing, as the location of production activities cannot reasonably approximate the market location.

In response to this, the OECD's launched the Two-Pillar Approach, in which Amount A is a global FA that uses revenue as the nexus to apportion a share of MNE's global profits to where goods or services are supplied, or customers are located (see Section 1.3). Traditionally, the ALP does not allocate taxing rights to "sales", so the OECD introduced a new taxing right specifically for market jurisdictions.

On the other hand, the FA allocates method assigns some of the taxing rights over the pool of income to the sales factor. The US needed to adjust its nexus rules of physical presence to align with the new business models, but it was not an easy task because the US Supreme Court had ruled in 1967[75] and 1992[76] that a physical presence was necessary

[73] Uniform Law Commission, above fn 71, §17 (updated 2021)
[74] Shirley Sicilian and Joe Huddleston, above fn 30, at 54.
[75] *National Bellas Hess v. Department of Revenue*, 386 US 753 (1967).
[76] *Quill Corp. v. North Dakota*, 504 US 298 (1992). The Court held that the states could not tax a business that merely made remote online sales to the state unless the business had a physical presence in the state.

for a state to impose tax. This made it possible for businesses to avoid taxation by having minimal physical presence in a state that used single sales-factor formulas. In the late 1990s, some state court decisions allowed the imposition of state corporate income tax without physical presence,[77] but the US Supreme Court did not reach a similar conclusion until 2018.[78]

The new nexus rule focuses on economic connections between sales and the state, whether virtual or physical, but it could still be challenging to determine the market for sales. As states moved away from the cost of performance rule used in the UDITPA, the Multilateral Tax Commission developed a "market-based sourcing model" in 2014 to replace it. Under this rule, the sales of services are attributed to where the service is "delivered," and sales of intangibles are attributed to where they are used.[79]

The Multilateral Tax Commission aimed to make the sales location of services consistent with the sourcing rules for the sales location of the tangible property because it was increasingly difficult to determine whether a product was a good or service, such as electric utilities, research reporting services, or digital products.[80] However, the states could modify this rule to suit their needs.[81]

The states adopted market-based sourcing rules for the sales or licensing of intangibles consistently, as recommended by the Multilateral Tax Commission. The rules attribute

[77] See, e.g., *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (1993), cert. denied, 114 S. Ct. 550 (1993); *KFC v. Iowa Department of Revenue*, 792 N.W.2d 308 (Iowa 2010), cert. denied, 132 S. Ct. 97 (2011).
[78] *South Dakota v. Wayfair, Inc*., 138 S. Ct. 2080 (2018).
[79] Multistate Tax Commission, above fn 71.
[80] Shirley Sicilian, above fn 56, at 22.
[81] Other examples of the altered market-based sourcing rules included locations where the taxpayer's customer received a benefit, where the service was delivered (same as sales of tangible assets), where the customer was located, or where the service was received. The most popular version for the location of sales of service was where the customer received the benefit of the services. See, e.g., California Revenue & Taxation Code §25136(a)(1).

the proceeds for using a marketing intangible to the market location, regardless of where the licensor is located:

> *"Where a license is granted for the right to use … a marketing intangible … the royalties or other licensing fees … assigned to [state] to the extent that those fees are attributable to the sale … [to] customers in [state]."*[82]

This is significantly different from the OECD rules, where the royalty is allocated to the legal or economic owner of the intangible (see Section 5.3) In some cases, the parties that provide DEMPE function will share a portion of the royalty, but the royalty will never be allocated to market jurisdiction merely for hosting customers or sales. If the US approach of allocating the royalties to market jurisdictions is applied to international taxation, the market jurisdictions will certainly share an appropriate amount of taxing rights over MNE's global profits (see Chapter 5).

3.2.2 The harmonised formulary apportionment practice in Canada

The Canadian provinces introduced corporate income tax between the late nineteenth century and 1939,[83] but during World War II, the provinces agreed to "rent out" the income taxation rights temporarily to the federal government as a temporary wartime measure. When peace came, the provinces gradually regained their taxing rights and

[82] Multistate Tax Commission, *Model General Allocation and Apportionment Regulations*, IV. 17(e)(2) (2018) <https://www.mtc.gov/wp-content/uploads/MTCImages&Files/MTC/media/AUR/FINAL-APPROVED-2018-Proposed-Amendments-042020.pdf> accessed on 23 March 2023. The Compact defined "marketing intangible" is wider than the OECD. It included, "without limitation, the license of a service mark, trademark, or trade name; certain copyrights; the license of a film, television or multimedia production or event for commercial distribution; and a franchise agreement." See ibid IV. 17(e)(2).
[83] A. Milton Moore, J. Harvey Perry & Donald I. Beach, *The Financing of the Canadian Federation: The First Hundred Years* (Canadian Tax Foundation 1966), at 114, Table 26.

shared income tax rights with the federal government.[84] In 1956, the Federal-Provincial Tax-Sharing Agreement Act[85] resolved the battle over income taxing rights between the federal and provincial governments. The federal government imposed a national-level corporate income tax, while the provinces imposed their own provincial corporate income tax separately.

Though Canada has a decentralised income tax system, the provincial corporate income tax is substantially coordinated among most provinces and territories. They have entered into Tax Collection Agreements[86] with the federal government for the federal Canada Revenue Agency, the Canadian tax authority, to collect provincial income tax for them. The allocation of multi-provincial corporate income is based on the presence of a permanent establishment (hereinafter PE).[87]

The PE in this context was substantially similar to the concept of PE under the OECD Model Tax Convention, but it has a wider scope that built nexus not only on fixed place of business and agents but also on tangible property. PE for Canadian provincial corporate income tax purposes referred to a "fixed place of business of operations, including an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop or a warehouse"[88] or "…owns land in a province…"[89] If a corporation carries on business through an employee or agent, it is deemed to have a PE in that place if the employee or

[84] Michael Smart and François Vaillancourt, 'Formulary Apportionment in Canada and Taxation of Corporate Income in 2019: Current Practice, Origins and Evaluation' in Richard Krever and François Vaillancourt (eds.), *The Allocation of Multinational Business Income: Reassessing the Formulary Apportionment Option* (The Netherlands: Kluwer Law International, 1st ed, 2020) pp.75 to 100, at 86.
[85] *Federal-Provincial Tax-Sharing Agreement Act 1956* (Can.). Also see D.B. Perry, *Financial the Canadian Federation, 1867 to 1995: Setting the Stage for Change* (Canadian Tax Foundation, 1997), at 54 to 61.
[86] Eight of the ten provinces (all but Alberta and Quebec) and three territories have entered into the agreements. For a summary of the Tax Collection Agreements, see Government of Canada, '*Summary of Reciprocal Taxation Agreements with Provinces and Territories*' (as of April 2010), at <https://www.tbs-sct.canada.ca/pol/doc-eng.aspx?id=19028> accessed on 24 March 2023.
[87] Income Tax Regulations (Canada), s. 400(2).
[88] Ibid, s. 400(2).
[89] Ibid, s. 400(2)(d).

agent has "general authority to contract for his employer or principal …"[90] Canadian provincial income tax also uses tangible property as a nexus, meaning a province may have a PE "where a corporation uses substantial machinery or equipment" in the province.[91] When a business does not have a PE anywhere in Canada, it is taxed where it is incorporated or where the head office is located.[92]

Among all the provinces with PEs, A two-factor formula weighting gross revenue (sales) and payroll equally apportions the total income to provinces according to the proportion of gross revenue and payroll the corporate had in the province. To determine where the gross revenue was earned or the market of the sales, Canada uses the "destination of a shipment" approach for sales of goods[93] and "where service was rendered" for sales of services.[94] The Income Tax Regulations do not specify how to locate the market for sales of intangibles. Canadian provinces have thought about adopting a three-factor Massachusetts formula based on property, payroll, and sales. [95] Though the Massachusetts formula was rejected, the three factors eventually appeared in Canadian provincial corporate tax indifferent ways: property helped to build the nexus for PE, while payroll and sales are the profit factors that apportioned the corporate's total income to the provinces.

Combing the PE rules and the sourcing rules, if a taxpayer does not have a PE in the provinces other than a factory and it sells goods throughout Canada using a third-party commission-based agent. The sales will be assigned back to the location of the factory. If

[90] Ibid, s. 400(2)(b).
[91] Ibid, s. 400(2)(e.1).
[92] Ibid, s. 400(2)(e).
[93] Ibid, s. 402(4)(a).
[94] Ibid, s. 400(4)(g).
[95] Ernest H. Smith, 'Allocating to Provinces the Taxable Income of Corporations: How the Federal-Provincial Allocation Rules Evolved' (1976) 24(5) *Canadian Tax Journal* 545, at 549.

the taxpayer has more than one production location in different provinces, the sales will be apportioned based on payroll.[96]

Canadian provinces have never adopted combined reporting, so the FA applied at the entity level.[97]

3.3 The historical and current proposals: formulary apportionment at the jurisdictional level

3.3.1 California extended the boundary of formulary apportionment

As discussed in Section 3.2.1.2 that the state of California led the first tide of combined reporting in the 1930s, which was later upheld by the California Supreme Court and served as the basis for other states to adopt the combined reporting as well. After that, other states followed the lead. For example, Courts in Idaho,[98] Illinois,[99] Kansas,[100] Montana,[101] Nebraska,[102] and Oregon[103] found that the combined reporting was coherent with the UDITPA. The tide peaked in the *Container* case in 1983 when the US Supreme Court praised the three-factor formula in the *Container* case and stated that it had become

[96] Joann Martens Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU* (The National Tax Association, 2006), at 54.
[97] Michael Smart and François Vaillancourt, above fn 84, at 85.
[98] *Am. Smelting & Refining Co. v. Idaho State Tax Commission*, 592 P. 2d 39 (Idaho 1979).
[99] *Caterpillar Tractor Co. v. Lenckos*, 417 N.E.2d 1343 (Ill. 1981).
[100] *Pioneer Container Corp. v. Beshears*, 684 P.2d 396 (Kan. 1984).
[101] *Mont. Dep't of Rev. v. Am. Smelting & Refining Co*., 567 P.2d 901 (Mont. 1977).
[102] *PMD Investment Co. v. State Dep't of Rev*., 345 N.W.2d 815 (Neb. 1984).
[103] *Coca Cola Co. v. Or. Dep't of Rev*., 533 P.2d 788 (Or. 1975).

the benchmark for apportionment formulas.[104] However, the trend was slowed down in the late 1980s when the state courts in Maine[105] and Massachusetts[106] found that there was no statutory basis for using the combined reporting. This trend resurfaced after more than twenty years (second tide). Before, 2004, only sixteen states used combined reporting. Almost every year since 2004, one or two states join the combined reporting family. Before 2004, only sixteen states used combined reporting. Almost every year since 2004, one or two states join the combined reporting family. Today, twenty-eight US states, as well as Washington DC, required or combined reporting for the state corporate income tax.[107]

In the *Container* case,[108] the US Supreme Court upheld the use of the unitary approach, which was applied to an MNE with subsidiaries incorporated overseas. This case addressed not only the validity of the unitary approach but also whether it was applicable to income generated by separated incorporated foreign companies. The Court upheld the position, which extended the unitary approach to the international level, citing the precedent set in the *Bass, Ratcliff & Gretton v. State Tax Commission* case.[109] Since the early 1940s, California had given the MNEs the option to calculate their California corporate tax liability based on worldwide unitary data if it produced a lower California state tax.[110] After the adoption of the UDITPA in 1966, California tried to stretch the unitary approach to include worldwide

[104] *Container Corp. of Am. V. Franchise Tax Bd*, above fn 63, at 170.
[105] *Sears, Roebuck & Co. v. State Tax Assessor*, 561 A.2d 172 (Me. 1989).
[106] *Polaroid Corp. v. Commission of Revenue*, 472 N.E.2d 259 (Mass. 1984).
[107] Center on Budget and Policy Priorities, *'28 States Plus D.C. Require Combined Reporting for the State Corporate Income Tax*', <https://www.cbpp.org/28-states-plus-dc-require-combined-reporting-for-the-state-corporate-income-tax> accessed on 22 March 2023.
[108] *Container Corp. of Am. V. Franchise Tax Bd*, above fn 58.
[109] The taxpayer was a business operating in both England and the US. The Court allowed the profits to be apportioned under FA. *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 US 271 (1924).
[110] Benjamin F. Miller, Worldwide Unitary Combination: The California Practice, in *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Hoover Institution Press, Charles E. McLure, Jr. ed., 1984) 132, at 138-139. Also quoted in Richard Krever and Peter Mellor, above fn 22, at 28.

income and put it into practice in the 1970s.[111] Following the *Container* case,[112] twelve US states used worldwide income in their formulas.[113]

The extensive use of the worldwide unitary approach caused concern among the international business community and foreign governments. In response, the US Treasury formed a Working Group with stakeholders from states, federal, and business communities. The Working Group were interested in the unitary approach, but they were also worried that the unitary approach might harm US firms and lace them at a competitive disadvantage relative to their foreign competitors.[114] Hence, the Working Group recommended adopting a water's edge (an earlier name for ALP) unitary combination for both US and foreign-based companies, limiting the unitary approach to a specifically defined water's edge group. This approach included all US corporations and certain corporations, such as the ones in tax havens and those foreign corporations with at least a threshold level of business activities in the US.[115] However, the option was left open for the states.

Although the *Container* case[116] was reaffirmed at the Supreme Court in 1994,[117] the worldwide unitary approach was extremely unpopular among the major business partners of the US. As a result, the states eventually stepped away from mandatory

[111] Ibid, at 28.
[112] *Container Corp. of Am. V. Franchise Tax Bd*, above fn 58.
[113] Franklin C. Latcham, 'Worldwide Combination and the Container Case: A perspective on Unitary Taxation' (1984) 2(1) *International Tax & Business Lawyer* 29, at 29-30.
[114] US Department of the Treasury, Office of the Secretary, *The Final Report of the Worldwide Unitary Taxation Working Group Chairman's Report and Supplemental Views* (August 1984), at 10.
[115] The Working Groups (state, business and federal representatives) generally agreed on three principles including 1) Water's edge unitary combination for both U.S. and foreign-based companies; 2) Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability; and 3) Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses. Based on these principles, the task force developed 6 options to apply the "water's edge unitary combination, and in the final report, option 2 was picked as the recommendation. See, US Department of the Treasury, Office of the Secretary, *The Final Report of the Worldwide Unitary Taxation Working Group Chairman's Report and Supplemental Views* (August 1984), at 9,10, 30 and 52.
[116] *Container Corp. of Am. V. Franchise Tax Bd*, above fn 58.
[117] *Barclays Bank plc v. Franchise Tax Board of California*, 512 US 198 (1994).

worldwide combined reporting.[118] The short-lived California worldwide combined reporting extended the boundary of FA and helped prompt new interest and discussion of the merits of extending FA from subnational taxes to national income taxes, as Krever observed.[119]

3.3.2 The development of the CCCTB and BEFIT in EU

The MNEs operating in the EU have faced high legal costs due to complying with the 15 different tax systems and reconciling their existence with the internal market,[120] despite the EU becoming a single economic and monetary union in 1993. In 2001, the European Parliament called for a unitary single set of rules, including a consolidated tax base and a mechanism for distributing revenue among member states.[121] In the same year, the European Commission took a step towards FA by releasing a study called *Company Taxation in the Internal Market*.[122] The study identified obstacles that hindered the free

[118] See Robert D. Wallingford, 'British Retaliation Against the California Unitary Tax: The Needed Impetus for a Federal Solution' (1986) 8(3) *Journal of Comparative Business and Capital Market Law* 345.
[119] Richard Krever and Peter Mellor, above fn 22, at 29.
[120] See speech of Benedetto Della Vedova in the European Company Tax Conference, Brussels 29-20 April 2002, *Towards an Internal Market without Tax Obstacles —A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide activities* (2002), at <https://taxation-customs.ec.europa.eu/system/files/2016-09/speech-della-04.2004.pdf> accessed on 26 March 2023, at 3. Benedetto Della Vedova was the MEP, Rapporteur of the Economic and Monetary Affairs Committee for the Commission Communication on Company Taxation (European Parliament). This speech reflected the position of the Commission Services' same-name internal paper released in 2001. See, European Commission, '*Towards an Internal Market without Tax Obstacles —A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide activities'* COM (2001) 582, at <https://www.eumonitor.eu/9353000/1/j9vvik7m1c3gyxp/vikqhjla9xy5>, accessed 26 March 2023. Associate with the internal report, the staff working paper is available to the general public: European Commission, *Staff Working Paper Company Taxation in the Internal Market*, COM (2001) 582, at <https://taxation-customs.ec.europa.eu/system/files/2016-09/company_tax_study_en.pdf> accessed on 26 March 2023.
[121] See EU, '*Towards an Internal Market without Tax Obstacles,* above fn 125., Also, the speech of Benedetto Della Vedova above fn 120, at 3 and 4.
[122] European Commission, *Staff Working Paper Company Taxation in the Internal Market*, above fn 120.

flow of income between related entities.[123], such as the failure to provide cross-border loss-compensation [124] and inconsistency among double taxation conventions, [125] The study explored options available to remedy these obstacles and recommended a group consolidation at EU-wide,[126] which led to the introduction of the CCCTB in 2004.[127]

From 2004 to 2011, the CCCTB gradually evolved into a comprehensive system that harmonised tax laws among member states. In 2011, the European Commission recommended the implementation of the CCCTB, along with an optional FA system to distribute the tax based calculated by CCCTB among member states.[128] The proposed FA used an equal-weighted three-factor formula with labour based on wages and number of employees.[129] A year later, the European Parliament amended the proposal by reducing the weighting of sales to 10%, with the rest of 90% shared by payroll and assets of 45% each.[130]

The main argument centred on the inclusion of the sales factor. The EU Commission favoured a three-factor formula because it avoided placing too much weight on a single factor, which was likely to better explain the source of profits of the MNEs.[131] Nonetheless,

[123] Ibid, at 9.
[124] Ibid, at 10.
[125] Ibid, at 11.
[126] Ibid, at 15.
[127] European Commission, Commission Non-Paper to Informal Ecofin Council, 10 and 11 September 2004, A *Common Consolidated EU Corporate Tax Base* (2014).
[128] European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM (2011) 121.
[129] The formula was specified in one of the two 2007 working papers. See European Commission, *Common Consolidated Corporate Tax Base Working Group (CCCTB WG), CCCTB: Possible Elements of the sharing Mechanism,* CCCTB/WP060\doc\en (13 November 2007), at <https://taxation-customs.ec.europa.eu/system/files/2016-09/ccctbwp060_en.pdf> accessed on 26 March 2023, at 8. For the other 2007 working paper, see European Commission, *Common Consolidated Corporate Tax Base Working Group (CCCTB WG), CCCTB: Possible Elements of a Technical Outline*, CCCTB/WP057\doc\en (26 July 2007), at <https://taxation-customs.ec.europa.eu/system/files/2016-09/ccctbwp057_en.pdf> accessed on 26 March 2023.
[130] European Parliament legislative resolution of 19 April 2012 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB) COM (2011) 0121 – C7-0092/2011 – 2011/0058(CNS)), at Amendment 16. Like the US and Canada, the EU version of "assets" only includes tangible assets. Intangibles and financial assets are excluded, see, ibid, Amendment 16.
[131] Joann Martens Weiner, above fn 1, at 121. However, the opponents of the FA pointed out that the magnitude of property, employment and sales explains less than 22% of the variation in profits between

the issue of sales was problematic, with some tax experts, especially the US ones, favouring the inclusion of sales factor measured by the destination (the common US approach), which they believed was "fair" since it represented the demand side while the assets and payroll represented the supply side. They also believed that it was difficult to manipulate the market location because corporations valued their customers, so tax avoidance alone should not be a sufficient reason for them to shift sales to third parties.[132] By contrast, the business experts were sceptical about including sales factor measured at the destination, as it was not consistent with the EU tax treaties.[133] Like most other treaties, the treaties between EU member states were infused with the concept of the ALP, which only allocated profits to locations of properties and payroll. The business experts were also worried that including a sales factor would allow the MNEs to artificially allocate profits to a state where they had no physical presence.[134]

Political resistance stalled the CCCTB proposal,[135] and alternative solutions appeared,[136] diminishing its prospects. Eventually, member states' attention was diverted to the OECD's BEPS action plans in 2013.[137] The interest in CCCTB revived in 2016 when the

firms. See James R. Hines Jr., 'Income Misattribution under Formula Apportionment' (2010) 54(1) *European Economic Review* 108.

[132] Joann Martens Weiner, above fn 1, at 121 and 122. The statement was true in the EU's context because CCCTB was an EU-wide consolidation regime (EU-wide unitary approach). It might not be accurate in the US context because half of the states still use an entity-level FA.

[133] Ibid, at 122.

[134] Ibid, at 122. In the year of 2012, the member states were not ready to abandon the traditional PE rules, which were reserved by both the treaty networks and the OECD Model Tax Convention. The traditional concept of PE was challenged in the BEPS Project, but it is still alive (see Chapter 4).

[135] For a few years, some member states were worried that low-tax member states would take the chance to abuse the system. See Johannes Becker and Clemens Fuest, 'Tax Enforcement and Tax Havens under Formula Apportionment' (2007) *FiFo-CPE Discussion Paper, No. 07-8*.

[136] See e.g., Erik Röder, 'Proposal for an Enhanced CCTB as Alternative to a CCCTB with Formulary Apportionment' (2012) 4(2) *World Tax Journal* 125.

[137] See European Council, *Note from Presidency to Permanent Representatives Committee/Council, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) —State of Play* (1 December 2015)

BEPS Project entered the implementation stage,[138] and the European Commission renewed the CCCTB proposal.[139] Changes included the mandatory use of the FA system by large MNEs, which attracted considerable opposition from tax advisors and academics who were worried about its impact on the fiscal relationship between the EU and the US, given the latter's "zealous commitment" to the ALP.[140] The EU would have to defend its position of adopting the CCCTB rather than stick to the ALP. The interest in CCCTB among the EU was still high. The latest amended CCCTB proposal in 2018 aimed to address the concerns of smaller states, such as Denmark, Ireland, Luxembourg, and Malta.[141]

On May 18, 2021, the EU Commission shifted its stance and unveiled a new proposal named "Business in Europe: Framework for Income Taxation (BEFIT)"[142] to replace the CCCTB. Similar to the CCCTB, BEFIT aims to establish unified regulations for calculating the taxable base of EU companies, allocating profits among EU member states based on a formula.

The BEFIT proposal is designed to align with and build upon the OECD's Two-Pillars Approach. In the public consultation initiated on October 13, 2022, the EU Commission presented stakeholders with various options and solicited feedback.[143] These options

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[138] See Jan van de Streek, 'Some Introductory Remarks on the Relaunched CCTB/CCCTB Proposals from a Policy Perspective' in Dennis Weber and Jan van de Streek (eds.), *The EU Common Consolidated Corporate Tax Base: Critical Analysis* (Kluwer Law International, 2018).

[139] European Commission, *Proposal for a Council Directive on a Common Corporate Tax Base*, COM (2016) 685 final 2016/0337(CNS), at <https://eur-lex.europa.eu/resource.html?uri=cellar:50e07d41-9b7f-11e6-868c-01aa75ed71a1.0002.02/DOC_1&format=PDF> accessed on 26 March 2023. The reserved opinion continued, see, e.g., Sijbren Cnossen, 'Corporate Taxes in the European Union: Slowly Moving Toward Comprehensive Business Income Taxation?' (2018) 25(3) *International Tax and Public Finance* 808.

[140] Pasquale Pistone and Yariv Brauner, 'The European Union and the United States: The Good Old Tax "Frenemies" in the Shadows of Reforms' (2017) 71 (6a) *Bulletin for International Taxation* 61, at 71.

[141] European Parliament, *Report on the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, A8-0051/2018 (1 March 2018).

[142] European Commission, *Communication Business Taxation for the 21st Century,* COM (2021) 251 at < https://taxation-customs.ec.europa.eu/system/files/2021-05/communication_on_business_taxation_for_the_21st_century.pdf>, accessed 11 August 2023.

[143] European Commission, *Business in Europe: Framework for Income Taxation (BEFIT)* (2022), at < https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13463-Business-in-Europe-Framework-for-Income-Taxation-BEFIT-_en>

concerned key elements, such as scope, sectoral considerations, tax base calculation, and the formula for profit allocation.

The longevity and likelihood of BEFIT's implementation remain uncertain.

3.4 The OECD formulary apportionment proposal: the Amount A

The OECD has supported separate accounting and the ALP for a century and regards any form of FA as unacceptable in its Guidelines. FA was criticized for being arbitrary and not taking into account the specific conditions of transactions.[144] It took the OECD 16 years to recognize profit methods as eligible transfer pricing method[145] only because they aggregate profits and allocate them using a mechanism similar to FA.

In 2019, the OECD began to consider introducing a formula-based profit allocation mechanism, which was a significant change from its previous position. Prior to this, the BEPS projects focused on combating profit shifting and tax avoidance and have substantially reshaped the international transfer pricing regime. As more countries adopt these principles, they may continue to shape transfer pricing regulations.

Despite the progress made in combating profit shifting, the current transfer pricing rules still face challenges.[146] For instance, marketing intangibles fail to properly allocate a portion of taxing rights to market jurisdictions. In the past, MNEs had to stay close to their customers, so the worst case that could happen to the market jurisdictions was that the

[144] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), para 1.25.
[145] The first OECD Transfer Pricing Guideline was published in 1979, while the profit methods were introduced in 1995.
[146] OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note* (2019), at 1.

MNEs used local limited risk distributors to justify minimal tax in the market jurisdiction.[147] Today, highly digitalized companies can make sales remotely and may not need a physical presence to sell, meaning that market jurisdictions may not share taxing rights at all.

It is not a transfer pricing "problem" but an underlying defect of the ALP. The current transfer pricing regime uses physical presence as the nexus of profit allocation, and the OECD version of the value creation principle does not recognize demand-side contributions. Therefore, a market jurisdiction needs a physical presence, meaningful supply-side economic activities within its borders,

In response to this these issues, the BEPS Project was split into two parts in 2019. One continued to incorporate the BEPS changes into OECD Guidelines,[148] believing the current paradigm would work. While the other one focused on addressing the tax challenges of the digital economy by challenging the ALP and published the Two-Pillar Approach. The Two-Pillar Approach has three parts: Pillar One (Amount A and Amount B) aims to address broader challenges of the digital economy and focuses on allocating taxing rights,[149] while Pillar Two aims to put a floor to international taxation and make profit shifting less attractive. As of 4 November 2021, 137 member jurisdictions have

[147] OECD, *Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy* (2019), para 13.
[148] The later chapters refer to "OECD Guidelines" for all OECD Transfer Pricing Guidelines. They are OECD, *Transfer Pricing and Multinational Enterprises* (1979); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022).
[149] OECD, 2019 Policy note, above fn 146, at 1. At the beginning, Pillar One aimed to have a unified method to tax digital MNEs and eliminate the unilateral DTS that was proposed or enforced by several countries like Austria, France, and the United Kingdom to prevent double taxation and administration burdens. At a point, the tune changed. The OECD suggested not to ring-fence the digital businesses but to tax the most profitable MNEs in the world with a formula.

agreed to incorporate the Two-Pillar Approach into their domestic law and remove any forms of DST.[150]

Of the three parts of the Two-Pillar Approach, only Amount A is pertinent to this thesis. It is a formula-based system that grants new taxing rights to market jurisdictions that have not collected an appropriate amount of tax because of their limited supply-side value-added activities. As the first formulaic allocation system adopted by the OECD in a century, it warrants a thorough analysis. Appendix A will cover the discussion of Amount B, and Appendix B will cover Pillar Two. This thesis will analyse this approach based on the public consultation documents as of 30 November 2022.

3.4.1 The OECD's proposed form of FA: the Amount A

The concept behind Amount A is profits and taxing right reallocation. It collects a portion of the residual profits from the world's most profitable MNEs before applying the ALP and reallocates these profits to the sales destination. Also, the new taxing right uses sales as nexus,[151] meaning that the market jurisdiction does not require a PE to share Amount A. The in-scope MNE will need to pay Amount A to qualified market jurisdictions even if the products are locally produced and consumed.[152] Under the ALP, this part of "lost

[150] OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 October 2021), at 6 Annex. Detailed Implementation Plan.
[151] Then new nexus rule does not influence the nexus rule under the ALP. The OECD stated that "The new special purpose nexus rule … will not alter the nexus for any other tax or non-tax purpose. In other words, the nexus rule has been designed as a stand-alone provision to limit any unintended spill-over effects on other existing tax or non-tax rules." OECD, *Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing* (2022), at 2.
[152] There was a discussion urging the OECD to exempt the decentralized entities that mainly produce and sell locally in each jurisdiction. With the scope getting narrow and the number of influenced MNEs down to 100 under the current rules, such exemption is less critical.

profits" will be ceded by countries that host highly profitable entities but with a low level of tangible assets and payroll. All in-scope MNEs shall manage the process through a single entity (worldwide unitary approach), reinforcing the enterprise approach the Amount A takes.[153]

To summarize, three fundamental aspects need to be defined to apply the Amount A:

- the MNEs that are liable for Amount A (scope),
- the quantum of profits that will be re-allocated (quantum),
- the countries (nexus).

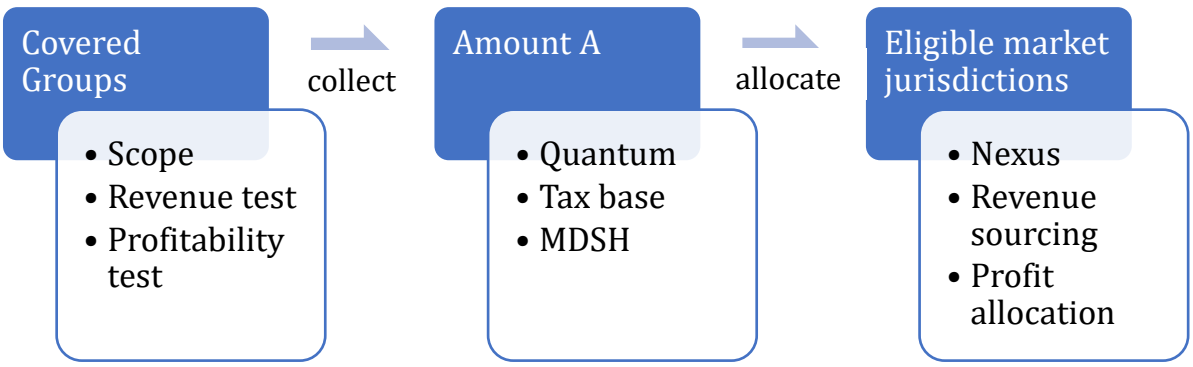

Figure 1

In addition to the aforementioned requirements, there is a separate process for identifying the jurisdictions that will cede profits under Amount A. This is necessary because there will be countries that benefit from the reallocation of profits and those that do not. Therefore, implementing Amount A will require significant changes to existing tax

[153] OECD, *October 2021 Statement,* above fn150, at 3.

treaties. The implementation of this approach will be done through a multilateral convention, which will take precedence over all existing and future tax treaties. If Amount A is successfully implemented, it is probable that there will be numerous treaty renegotiations that reflect and recognize the implementation of Amount A.

Amount A, although a form of FA, differs significantly from the common FA approach. While FA captures entities or MNEs in similar natures, Amount A discriminates against larger and more profitable MNEs. The common FA approach apportions the total income pool, whereas Amount A only apportions defined residual profits. In a single sales-factor FA formula, only the taxpayer's market activities, such as sales, are considered, while property and payroll only influence tax in terms of the nexus rule or physical presence. Conversely, Amount A allocated to a particular jurisdiction is negatively influenced by property and payroll factors to revert the excessive profit allocated to intangible-rich countries and exclude jurisdictions that share an appropriate amount of taxing rights under the ALP, using property and payroll.

3.4.1.1 Scope

Amount A aims to target the biggest and most profitable MNEs with global turnover above €20 billion (revenue test) and profitability above 10% (profitability test).[154] These MNEs are referred to as "Covered Groups" or "in-scope MNEs".[155]

This scope is extremely small. It is slightly different to what the OECD initially planned. The OECD had considered only targeting the digital giants that did not pay their fair share of tax in the market jurisdictions.[156] These MNEs are mostly American-headquartered, so the US has long insisted the reform should not ring-fence these MNEs because "the United States cannot accept any result that is discriminatory towards US firms".[157] Now, instead of ring-fence the digital giants, the OECD "aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the **largest MNEs** (emphasis added), which are the winners of globalisation" regardless of their industries.[158] This is such a narrow scope that according to the relevant research done by Oxford University, only 78 of the world's largest companies passed the €20 billion turnover test and 10% profitability test at the same time in 2020.[159] The aggregation size of Amount A is about $87 billion.[160] Of which 63.8% is contributed by US-headquartered companies, 9.5% paid

[154] The 10% profitability test is assessed by the Pre-Tax Profit Margin, which is the Financial Accounting Profit (or Loss) of the group for the period after making the adjustments set out in Article 5(2). The adjustments are outlined in OECD, *Progress Report on Amount A of Pillar One* (2022), p15. An MNE will only be in-scope if it meets the profitability test in the period and where the group was not in-scope in the two consecutive periods immediately preceding the period (a) in two or more of the four periods immediately preceding the period and on being in-scope on a four-year average. This prevents the MNEs from being in-scope if it is not particularly profitable on a continuous basis. See Article 1(2)(b).
[155] OECD, *October 2021 Statement,* above fn150, at 2.
[156] OECD, *2019 Public Consultation Document*, above fn 147, para 1.
[157] From a slide deck prepared by the US Treasury as part of Treasury's 8 April 2022 presentation to the steering group of the OECD inclusive framework on base erosion and profit shifting. See Stephanie Soong Johnston, 'US Offers Key to Unlock Scope Issue in Global Tax Reform Talks' (2022) 102 (2) *Tax Notes International* 147, at 148.
[158] OECD, *Addressing the tax challenges arising from the digitalisation of the economy* (July 2021), at 3. The change of tune caused many problems, e.g., whether the scheme should exclude revenue sourced in certain industries that may not be benefited from globalisation as much as others; whether the scheme should exclude MNEs that mainly source revenue domestically; should the scheme include any MNE that has a decentralised business structure with local entrepreneurs.
[159] 2 companies from the extractive industry and 56 from the financial sector are excluded. Michael Devereux and Martin Simmler, 'Who Will Pay Amount A' (2021) 36 (5) *EconPol Policy Briefs* 1, at 3.
[160] Ibid, at 3.

by Chinese companies, 3.8% paid by UK headquartered companies, and 1.6% paid by German companies.[161] This result did not take into consideration the revenue sourced domestically, which did not seem to be excluded by Amount A. Hence, the in-scope MNEs should be more than 78.

OECD needs to economically underpin the new taxing right allocated to the market jurisdictions. Although most of the big and profitable companies in this world are digital companies,[162] taxing them, for they all benefited from globalization, is not a good reason. The minute the OECD shifted its target from digital companies to the biggest and most profitable companies, it lost the initial internal logic of the Two-Pillar Approach.

3.4.1.2 Nexus

A nexus test enables a market jurisdiction to share Amount A when the Covered Groups derive a material amount of revenue within its border. The revenue needs to be at least €1 million, or for jurisdictions with a gross domestic product (hereinafter GDP) lower than €40 billion, €250,000.[163] The MNEs may or may not keep detailed records to trace where each transaction of profits is sourced, and sometimes, one transaction may source profits from multiple locations. Hence, the nexus rule is supported by revenue sourcing rules, which "provide a methodology for determining where the Revenues of a Group are generated, based on reliable indicators or allocation keys."[164]

[161] Ibid, at 5.
[162] Bob Michel and Tatiana Falcao, 'Pillar 1 as a Ticket to a Fairer Taxation For Low- and Middle-Income Countries' (2022) 106(5) *Tax Notes International* 655, at 656.
[163] OECD, 2022 *Progress Report,* above fn 154, at 13, Article 3(2).
[164] OECD, 2022 *Progress Report*, above fn 154, at 8.

The revenue sourcing rules include two steps. First, Revenues must be sourced using Reliable Indicators, which is information that identifies the source of Revenues.[165] Secondly, despite the best effort, the Covered Groups may not be able to identify the source for every transaction. In this case, allocation keys can be used to allocate the remaining revenue that cannot be sourced at a transaction level.[166] Combining these two methods, no revenue shall be unsourced.[167]

The OECD requires the MNEs to have internal control frameworks to apply revenue sourcing rules. In an earlier Public Consultation Document, the OECD asks for revenue to be sourced on a transaction-by-transaction basis. The Covered Groups need to identify the source for each item that generates revenue.[168] The revenue must be apportioned if the invoice or contract contains items sold in different jurisdictions.[169] It does not mean that the Covered Groups must keep records for each transaction. Records only need to be kept on a systemic level. The Covered Groups need to demonstrate robust internal control frameworks that use indicators that reliably identify the revenue source and explain the approach and indicators they use.[170] In the most recent Progress Report for Amount A, the OECD maintains the requirement for internal control frameworks.[171]

3.4.1.3 Quantum

[165] OECD, 2022 *Progress Report*, above fn 154, at 64, Section2(2). Unlike most FA regimes that clearly specified the rules to identify the sales location, The OECD is rather ambiguous. For identification of the sales location, see Section3.2.1.4.
[166] OECD, 2022 *Progress Report*, above fn 154, at 65, Section2(6). The allocation key for the source rules added another layer of complication to Amount A.
[167] OECD, 2022 *Progress Report*, above fn 154, at 14, Article 4(4).
[168] OECD, 2022 *Draft Model Rules*, above fn 151, at 5 Source rules.
[169] OECD, 2022 *Draft Model Rules*, above fn 151, at 5 fn 3.
[170] OECD, 2022 *Draft Model Rules*, above fn 151, at 3.
[171] OECD, 2022 *Progress Report*, above fn 154, at 65, Section 2(9).

With the Covered Groups on the one hand and the eligible market jurisdictions on the other, the next step is to collect ¼ of the residual profits from the MNEs and allocate them to eligible market jurisdictions:[172]

$$Q = (P - R \times 10\%) \times 25\% \times \frac{L}{R}$$

Where —

– Q is the amount of profit of the Covered Group allocated to a market for a Period.

– P is the Adjusted Profit Before Tax of the Covered Group for a Period pursuant to Article 5.

– R is the Revenues of the Covered Group for a Period.

– 10 per cent is the profitability threshold.

– 25 per cent is the reallocation percentage.

– L is the amount of Revenues of the Covered Group for a Period that arise in a market pursuant to Article 4 (revenue sourcing rules), in respect of which the nexus test is met for that Period pursuant to Article 3.

[172] OECD, 2022 *Progress Report*, above fn 154, at 17, Article 6(2).

It is worth noting that the "P"[173] and "R"[174] in the equation are determined mainly based on financial accounting information, with a small number of adjustments.

From the equation, one can tell that if $\Sigma\frac{L}{R}$ does not necessarily equation to 1. This is because the nexus test may rule out some small markets. Consequently, the maximum total Amount A a Covered Group may pay is $(P - R \times 10\%) \times 25\%$, which can be interpreted as 25% of the residual profits.[175] The OECD did not support the 10% and 25% thresholds with robust empirical evidence. Some MNEs, such as Coca-Cola, has questioned that a 10% return is too high for distributor.[176]

3.4.1.4 Marketing and Distribution Profits Safe Harbour

In some cases, Amount A may be reduced by the Marketing and Distribution Profits Safe Harbour Adjustment (hereinafter MDSH).[177] The idea is to reduce Amount A "for market jurisdictions that already have existing taxing rights over the Group's residual profits".[178] The MDSH calculated as:[179]

[173] The "Adjusted Profit Before Tax of a Group", or "P", is determined by Article 5. See 2022 *Progress Report,* above fn 154, at 15.
[174] "Revenues" of a Group refers to the revenues reported in the Consolidated Financial Statements of the group. See 2022 *Progress Report,* above fn 154, at 24.
[175] This concept is used in Chapter 9 to estimate the global Amount A that Coca-Cola would have paid.
[176] Robert J. Jordan and Mark Harris, 'Coca-Cola Notes Concerns with Marketing and Distribution Safe Harbor in Amount A Consultation' (29 August 2022) *Tax Notes Today International*. This argument does not help the MNEs to pay less Amount A. if 10% is reduced to a smaller number, the same equation yields a more significant Q, hence a bigger Amount A. Coca-Cola was using the traditional ALP perspective analysing the new paradigm, which was not suitable.
[177] OECD, 2022 *Progress Report*, above fn 154, at 16, Article 6(1). The equation has a built-in floor of zero to prevent the PER > EP, so the residual profits are negative. This is a case where the MNE has a high level of tangible assets and payroll but very little financial profit and loss.
[178] OECD, 2022 *Progress Report*, above fn 154, at 8.
[179] OECD, 2022 *Progress Report*, above fn 154, at 17, Article 6(5).

$M=MIN((EP-PEP)\times$ [Y%],$Q)$

Where —

– M is the MDSH Adjustment that shall be deducted from the amount of profit allocated to a market for a Period.[180]

– EP stands for accounting profit or loss in a jurisdiction. It is the Elimination Profit of the Covered Group in a market for a Period. Its calculation also starts from the financial accounting profit and loss, like "P", but with different adjustments.[181]

– PER stands for routine profits in a country. It is the Portion of Elimination Profit of the Covered Group in a market that arises from the tangible assets and staff. It is an under-work concept that the OECD has not fully determined. The OECD assumes that a markup of the depreciation and payroll can price the routine profit. PER is calculated as the total cost of Depreciation and Payroll in a jurisdiction × the higher of Elimination Threshold Return on Depreciation and Payroll (hereinafter ETRDP, represents the global rate of return for tangible assets and staff for an MNE) of a Covered Group or 40%.[182] In other words, the OECD allows at least 40% of the depreciation and payroll costs to offset the accounting profit and loss. The larger the percentage is, the small the MDSH is. To summarise:

[180] OECD, 2022 *Progress Report*, above fn 154, at 17, Article 6(5).
[181] The adjustment for EP is in p85, Schedule I, Section 2(1), while the adjustment for P is at 15, Article 5(2). See 2022 *Progress Report,* above fn 154.
[182] The OECD introduced the concept of "Elimination Threshold Return on Depreciation and Payroll of a Covered Group", which is $\frac{Covered\ Group's\ Revenue\times 10\%}{Covered\ Group'sDepreciation\ and\ Payroll}$ This ratio describes the MNE's overall rate of return for tangible assets and staff (routine rate of return). See OECD, 2022 *Progress Report*, above fn 151, at 26.

$$PER = Total\ cost\ of\ Depreciation\ and\ Payroll \times MAX(\frac{Covered\ Group's\ Revenue \times 10\%}{Covered\ Group's Depreciation\ and\ Payroll}, 40\%)$$

–(EP-PER) refers to residual profits in a country.

– Y is the offset percentage, meaning the portion of a Jurisdiction's residual profits (i.e. EP- PEP) that is eligible for offset under the MDSH mechanism.[183] When Y% is 100%, or one, the entire residual profits are used to offset Amount A. The smaller Y% is, the lower M is. Consequently, the more likely the country gets an Amount A.

– Q is the share of Amount A to a country. It is the amount of profit of the Covered Group allocated to a Jurisdiction calculated in the last section.[184]

– MIN(,) means that M, the amount of the adjustment, is the lower of (EP – PEP) × Y% or Q.[185]

The above calculation is meaningful only when the residual profits are small enough. Let us assume Y% equals one. When (EP – PEP) is bigger than Q, the residual profits of a jurisdiction are larger than its share of Amount A. In this case, the share of Amount A in this jurisdiction is reduced to Zero. The country will not share any profits as a market. On the contrary, when residual profits are small, the MDSH adjustment will be minimum or simply not applicable. For example, if a digital business sells in a country without a physical presence, its EP will be zero as there is no accounting profit or loss, and PER will

[183] OECD, 2022 *Progress Report*, above fn 154, at 17, Article 6(5).
[184] OECD, 2022 *Progress Report*, above fn 154, at 17, Article 6(5).
[185] OECD, 2022 *Progress Report*, above fn 154, at 17, Article 6(5).

be zero because the MNE does not have tangible assets or staff in the country. Hence, M will be zero. In this case, the country will get a full share of Amount A according to the quantum equation.

There are two situations where the MDSH is likely to offsets all Amount A in a country. In other words, (EP – PEP) is more significant than Q. Situation one is when EP is much larger than PER. The market may not be big, but the significant difference between the EP and PER gives rise to significant residual profits. Likely, the country contributes intangibles, or the local marketing team does exceptionally well. Situation two is when the market is enormous. EP and PER are comparatively bigger, which makes (EP – PEP) significant. In this situation, most of the profits arising in the jurisdiction are generated by providing routine functions. Though it shares minimal residual profits, the MDSH will offset most of its Amount A, if not all. It may create an unpleasant consequence that two countries made a similar amount of consumption purchased from an MNE. One of them performs supply-side functions, but the other does not. Due to the MDSH, they may end up sharing a similar amount of profits.

The MDSH is called a "Marketing and Distribution Profit" Safe Harbor, but it is not. EP includes all profit generated by market jurisdiction PEs, not limited to the returns from marketing and distribution functions. Assume a country has a PE for a digital company providing contract research services. It is also a targeted market where the MNE sells goods online. In this case, the returns arising from contract research will reduce Amount A as MDSH.

The MDSH makes Amount A economically unsound. It shows that in OECD's design, the supply-side source countries get primary taxing rights over the market jurisdictions. A

country will only be rewarded as a market when it does little or none on the supply side. OECD cannot claim that market jurisdictions should enjoy profits for being markets because, in this case, all markets have the same rights to Amount A. It cannot explain the existence of the MDSH. Likewise, it cannot declare otherwise. In this way, Amount A lost its theoretical underpinnings.

The BEPS Monitoring Group suggested having a high ETRDP or removing the MDSH entirely,[186] so Amount A will benefit more market jurisdictions in general. However, the MDSH will not go away. Without MDSH, Amount A will become a reallocation of taxing rights from intangible rich countries to all markets. It is a crucial step that helps the OECD reallocate profits only to the targeted markets: those who make online purchases but do not collect taxes. It also helps to exempt most of the Amount A for MNEs that mainly generate profits domestically. Moreover, it significantly reduces Amount A, so the ceding countries will not provide too much relief. Nevertheless, the rate of 40% does have robust data support. The OECD may want to adjust the percentage based on empirical data.

3.4.1.5 Elimination of double taxation

Though Amount A is described as a new layer of tax, the MNEs are not expected to bear additional tax burden arising from Amount A. While some market jurisdictions are expected to gain tax revenue, those that earn the most residual profits are obliged to provide relief. They are categorized into groups and relief Amount A in a particular order.

[186] The BEPS Monitoring Group, 'Comments on Progress Report on Amount A of Pillar 1' (2022) 107(11) *Tax Notes International* 1251, at 1254.

The elimination of double taxation is subject to Articles 7-11.[187] Before coming to the details, there are a couple of concepts that need to be clarified:

(1) Jurisdictional Return on Depreciation and Payroll (hereinafter JRDP) for a Period describes the rate of return to routine functions in a jurisdiction. It is calculated as:[188]

$$JRDP = \frac{Elimination\ Profit\ for\ that\ period\ in\ that\ Jurisdiction}{Depreciation\ and\ Payroll\ in\ that\ Period\ for\ that\ Jurisdiction}$$

(2) Return on Depreciation and Payroll (hereinafter RDP) for a Period is like JRDP but on a global level. It is calculated as:[189]

$$RDP = \frac{Total\ Elimination\ Profit\ for\ the\ Covered\ Group\ for\ that\ Period}{Total\ Depreciation\ and\ Payroll\ in\ that\ Period\ for\ the\ Covered\ Group}$$

(3) Adjusted Jurisdictional Return on Depreciation and Payroll (hereinafter AJRDP) for a Period is a dynamic ratio. It is adjusted every time a jurisdiction provides a portion of relief at a tier. It is calculated as:[190]

$$AJRDP =$$

[187] OECD, 2022 *Progress Report*, above fn 154, at 18-21, Article 7-11.
[188] OECD, 2022 *Progress Report*, above fn 154, at 93, Schedule J (1).
[189] The OECD said it would define the RDP in Schedule J, but it did not. Only the JRDP was defined. Yet, based on the available information, the calculation of this ratio can be reasonably speculated. See 2022 *Progress Report,* above fn 154, at 29.
[190] The OECD specified that the AJRDP is "recalculated after subtracting from the Elimination Profit used in that calculation the total Amount A Profit, if any, with respect to which the obligation to eliminate double taxation has already been allocated to that Specified Jurisdiction…" See OECD, 2022 *Progress Report*, above fn 154, at 18, Article 9(2)(b)(ii). A Relieving Jurisdiction may be allocated to offset Amount A in multiple steps, so AJRDP is a dynamic ratio.

$$\frac{Elimination\ Profit\ in\ that\ Jurisdiction - Elimination\ Profit\ offset\ by\ Amount\ A\ allocation}{Depreciation\ and\ Payroll\ in\ that\ Period\ for\ that\ Jurisdiction}$$

(4) ETRDP for a Period was also used in MDSH. It is calculated as:[191]

$$ETRDP = \frac{Covered\ Group's\ Revenue \times 10\%}{Covered\ Group's\ Depreciation\ and\ Payroll}$$

Ratios (1) and (3) describe the unit return for depreciation and payroll (routine functions). The higher they are, with a $1 cost spent on depreciation or payroll, the higher their return to the MNE. For example, where JRDP is 3, it means that with $1 spent on depreciation or payroll in a particular country, the MNE will earn a $3 return. Where AJRDP is 2, it means that after surrendering part of the return to credit Amount A, with a $1 spent on depreciation or payroll, the notional return in a particular country can still reach $2.

Ratio (2) is the same concept as the ratio (1) but at the group/global level. The last ratio describes the overall routine rate of return for an MNE. It is used as an average, describing the overall performance of a Covered Group. For instance, where the RDP is 10, on average across the world, with $1 spent on depreciation or payroll, the MNE will get a $10 return.

[191] See OECD, 2022 *Progress Report*, above fn 154, at 26.

Ratio (4) is also a group/global level ratio. It is a threshold that is often compared with 40%. It has been used in MDSH to calculate PER.

To eliminate double taxation, the OECD first chooses the Relieving Jurisdictions (or "Specific Jurisdictions" as the OECD named them) that make the most EP, regardless of their profitability.[192] These jurisdictions are then grouped into four tiers:[193]

Tier 1 Jurisdictions have JRDP/RDP > 1500%. It means that with every dollar spent on depreciation or payroll, these jurisdictions have a return more than 15 times the group on average. The jurisdictions of this tier get most of the residual profits.

Tier 2 Jurisdictions have AJRDP/RDP > 150%. It means that with every dollar spent on depreciation or payroll, these jurisdictions have a return more than 1.5 times the group on average. In this tier, AJRDP rather than JRDP is used, indicating that the jurisdictions in tier 1 will join the tier 2 countries after they surrender part of their tax base credit the Amount A.

Tier 3A Jurisdictions have AJRDP >ETRDP and AJRDP > 40%. In these jurisdictions, with every dollar spent on depreciation and payroll, the return needs to be at least $0.4. The ETRDP is again used in conjunction with the 40% threshold.

[192] The OECD specified that "…a Specified Jurisdiction with respect to a Covered Group for a Period means: a. each Jurisdiction that is part of the smallest group of Jurisdictions with respect to which the aggregate Elimination Profit totals at least 95 per cent of a Covered Group's total Elimination Profit for the Period (giving priority to Jurisdictions with higher Elimination Profit over those with lower Elimination Profit); and b. each Jurisdiction not identified in subparagraph (a) with respect to which Elimination Profit, as defined in Schedule I (Elimination tax base), is equal to or greater than EUR 50 million for the Period. See OECD, 2022 *Progress Report*, above fn 154, at 18, Article 8.

[193] OECD, 2022 *Progress Report*, above fn 154, at 19, Article 9(5).

Tier 3B Jurisdictions have AJRDP > ETRDP. Tier 3B countries may not exist if the ETRDP exceeds 40%.

- Tier 1

The jurisdiction in tier 1 that has the highest JRDP will surrender first:

> *"…Amount A Profit that is allocated to the Specified Jurisdiction in Tier 1 with that Covered Group's [JRDP] shall be equal to the lowest of:*
> *a. the amount that reduces the [AJRDP] of that Specified Jurisdiction until it is equal to [JRDP] of the Specified Jurisdiction with the second highest [JRDP];*
> *b. the Amount A Profit of that Covered Group; and*
> *c. the amount that reduces the [AJRDP] for that Specified Jurisdiction to 1500 per cent of the [RDP] for the Covered Group."*[194]

Where Tier 1 has multiple countries, the jurisdiction with the highest JRDP will be reduced by "absorbing" a portion of Amount A until its AJRDP equals the JRDP of the second highest jurisdiction. From there, the two jurisdictions will surrender their tax base together in proportion, further dropping their AJRDP to join the third highest country, according to Article 9(7). Where Amount A is small enough to be fully "absorbed" by the country with the highest JRDP and keeps its AJRDP larger than the JRDP of the second highest jurisdiction. The other countries will not have to surrender. Where Tier 1

[194] OECD, 2022 Progress Report, above fn 154, at 19, Article 9(6).

has only one country, this particular country will reduce its JRDP to join Tier 2 first and surrender with the Tier 2 jurisdictions.

This process continues until Amount A is fully credited or all the jurisdictions in tier 1 have reached the bottom line of its tier: the AJRDP equals 1500% of RDP. The jurisdictions in tier 1 then join the ones in tier 2. They will further surrender in the subsequent steps.[195] Here is a picture showing the process of this step:

[195] Article 9(10)(b) provided that "The Jurisdictional Tier 2 Residual Profit of a Specified Jurisdiction … is the [EP] of that Specified Jurisdiction reduced by… b. any Amount A Profit for which the obligation to eliminate double taxation was allocated to such Specified Jurisdiction in Tier 1." See OECD, 2022 Progress Report, above fn 154, at 20.

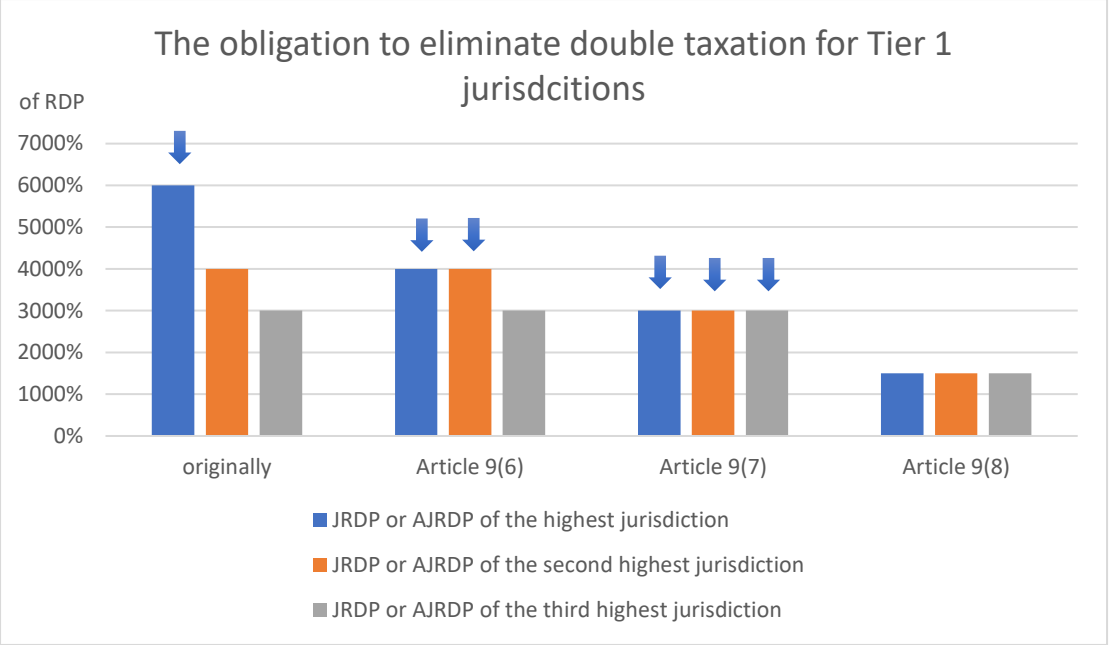

Chart 1

- Tier 2

If Amount A is not fully credited by the Tier 1 jurisdictions, the jurisdictions in Tier 2 will continue surrendering, but in a different way:

> *"Any obligation… to Amount A Profit… remains unallocated after applying paragraphs 6 through 8 is allocated to each Specified Jurisdictions in Tier 2 in proportion to the ratio of the Jurisdictional Tier 2 Residual Profit of that Specified Jurisdiction to the sum of the Jurisdictional Tier 2 Residual Profit of all Specified Jurisdictions in Tier 2, until either:*
>
> *a. the obligation to eliminate double taxation with respect to the remaining Amount A Profit of that Covered Group is fully allocated; or*

b. the amount allocated with respect to that Covered Group reduces the [AJRDP] for such Specified Jurisdiction to 150 per cent of the Return on Depreciation and Payroll for the Covered Group."[196]

In which, the Residual Profit of a jurisdiction is defined as:[197]

$$EP\ of\ a\ jurisdiction - 150\% \times Depreciation\ and\ Payroll\ of\ a\ Jurisdiction - obligation\ surrenderred\ in\ Tier\ 1$$

To view it more simply, it collects the Residual Profit in all Tier 2 jurisdictions and offsets it with the remaining Amount A. If sufficient, the difference will be returned to the Tier 2 jurisdictions in proportion to their share of the total Residual Profits. If not, the AJRDP of these jurisdictions are reduced to the bottom line of Tier 2, so they will join the Tier 3A jurisdictions, further reducing their AJRDP.

- Tier 3A

The Tier 3A jurisdictions surrender their tax bases in the same way as the jurisdictions in Tier 2,[198] except the Residual Profit in this tier is defined as:[199]

[196] OECD, 2022 *Progress Report*, above fn 154, at 20, Article 9(9).
[197] "The Jurisdictional Tier 2 Residual Profit of a Specified Jurisdiction with respect to a Covered Group for a Period is the Elimination Profit of that Specified Jurisdiction reduced by: a. the portion of the [EP] of that Specified Jurisdiction that would result in a [JRDP] equal to 150 per cent of the [RDP] for the Covered Group; and b. any Amount A Profit for which the obligation to eliminate double taxation was allocated to such Specified Jurisdiction in Tier 1." SEE OECD, 2022 *Progress Report*, above fn 154, at 20, Article 9(10).
[198] OECD, 2022 *Progress Report*, above fn 154, at 20, Article 9(11).
[199] OECD, 2022 *Progress Report*, above fn 154, at 21, Article 9(12).

$$EP\ of\ a\ jurisdiction$$
$$- MAX\ (ETRDP, 40\%) \times Depreciation\ and\ Payroll\ of\ a\ Jurisdiction$$
$$- obligation\ surrenderred\ in\ Tier\ 1\ and\ 2$$

In which the higher of ETPRD, or 40% is the bottom line of Tier 3A. If the Residual Profit is insufficient to offset Amount A, the Tier 3 Jurisdictions will join the ones in Tier 3B.

- Tier 3B

The Tier 3B jurisdictions will credit Amount A in the same way as the tier 2 and 3A,[200] except the Residual Profit in this tier is defined as:[201]

$$EP\ of\ a\ jurisdiction - ETRDP \times Depreciation\ and\ Payroll\ of\ a\ Jurisdiction$$
$$- obligation\ surrenderred\ in\ Tier\ 1, 2, and\ 3A$$

If Amount A is still not fully credited at this level, potentially, the MNE will suffer double taxation. It is unlikely but still possible. The MNEs with a high level of tangible assets and payroll and their return on depreciation and payroll are not significantly distinctive all over the world will likely suffer double taxation.

- Who are the "Specified Jurisdictions"?

From the above analysis, one can tell that the OECD intends to resolve the double taxation by forcing the countries with intangible but comparatively no tangible assets or staff to

[200] OECD, 2022 *Progress Report*, above fn 154, at 21, Article 9(13).
[201] OECD, 2022 *Progress Report,* above fn 154, at 21, Article 9(14).

"cede". These countries can be tax havens that legally own the intangibles with little or no economic activities. They can also be intangible-rich countries, such as the US. The amortisation of the intangibles is not considered a part of "depreciation". It will worsen if the intangible-rich countries are so efficient that they have small local crews.

The market jurisdictions can also be the "Specified Jurisdictions" that offset credits or exemptions to Amount A they should have collected. This is because the main outgoings to a market jurisdiction PE are payroll and marketing expenses, such as advertising. It may not have many tangible assets that give rise to depreciation, and the marketing expenses are costs that the OECD do not consider "routine" for Amount A purposes. The only outgoing that will reduce its JRDP will be the payroll. Many of these countries, especially the developing ones, have a much lower human resource expenditure than the developed countries. It put the whole thing into a strange circle just as the traditional ALP: under the same profitability, the more efficient a PE is or the cheaper labour a country has, the higher JRDP the country has, the more Amount A obligation it will surrender.

The OECD provides an overview summarizing the above process for Amount A:[202]

[202] OECD, Factsheet on Progress Report on Amount A of Pillar One (July 2022), at 3.

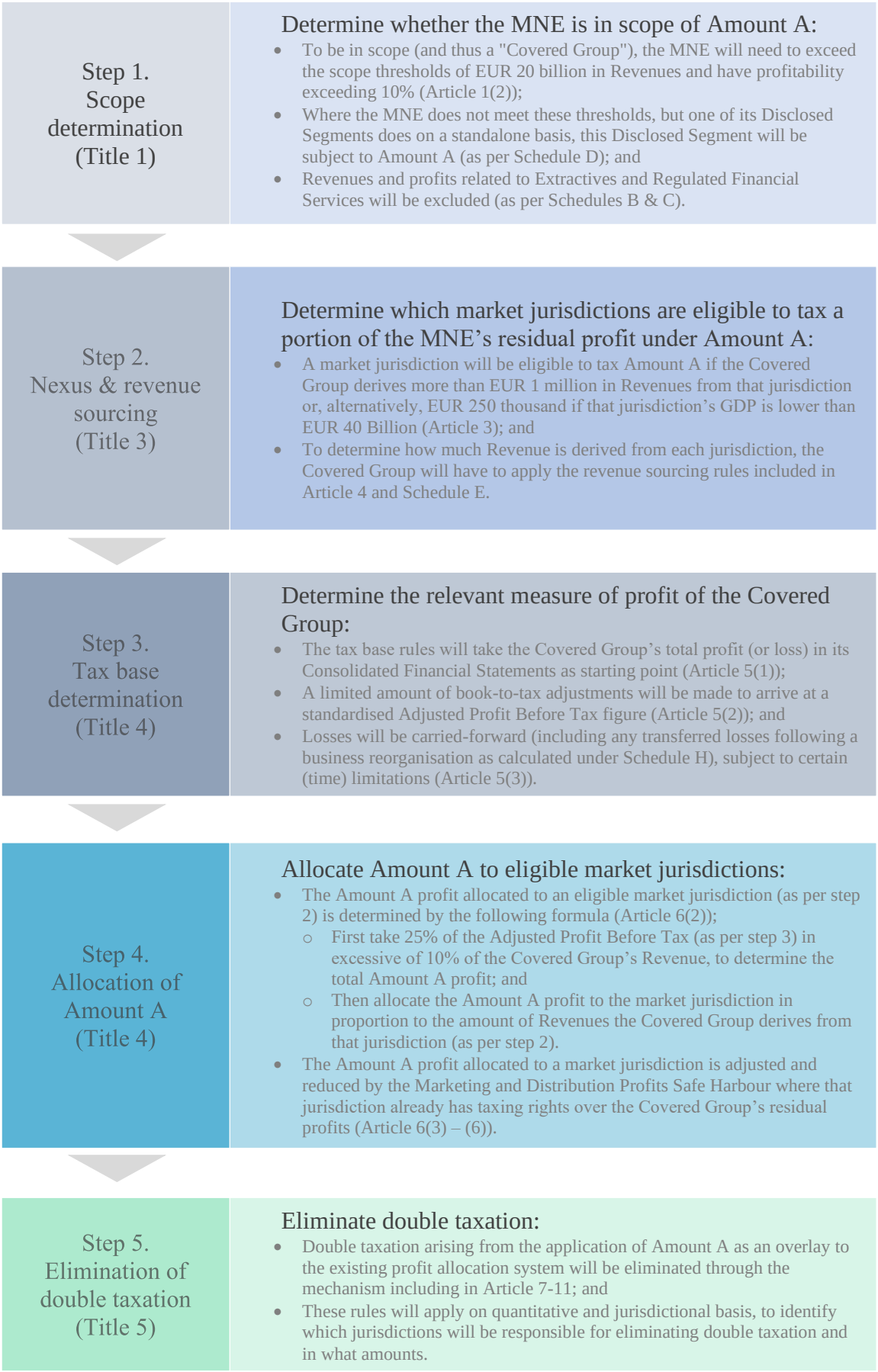

Figure 2: Overview of the process map

3.4.2 Who will benefit from Amount A?

Amount A is not creating a new tax right but is instead redistributing some of the existing taxing rights from certain countries to others, resulting in winners and losers. The countries that have a significant amount of intangible assets, such as the United States or tax havens, will lose because they share most of the residual profits under the ALP, leading to high JRDPs. These intangible-rich countries will likely be placed in Tier 1 and will provide the most credits to Amount A. However, their tax credits will eventually surpass the benefits they receive as a market.

On the other hand, countries that provide supply-side functions, such as tangible assets or staff, will lose out as well. These countries will have their share of Amount A reduced first under MDSH because ER-PER is likely not zero, and they will be obligated to provide double taxation relief to Amount A. The more efficient they are, the more residual profits they earn, leading to a higher Tier and providing credits to Amount A. Emerging markets such as China and India, which creatively interpreted the OECD model to share more profits (see Chapter 7), will also be negatively affected by Amount A. For instance, China will stay out of most of the Amount A calculations for the digital giants because the Chinese government have blocked many digital giants such as Google, eBay and Facebook in mainland China. Chinese residents make online purchases on local e-commerce platforms such as JD.com and Taobao. The remaining in-scope MNEs that operate in Chinese markets most likely have Chinese PEs which benefit from the creative interpretations. A unique case is Amazon, which terminated its Chinese site in 2019 but kept Chinese operation centres helping Chinese businesses to sell on Amazon's global

site.[203] The profits arising from these transactions will not be allocated to China under the revenue sourcing rules but to the destination of consumption. Also, the Chinese PEs of Amazon are not likely to have too many tangible assets and staff due to the nature of the business they provide. Hence, China will not share much Amount A in the Amazon case, on contrary, it is likely to be a relieving jurisdiction.

The winners will be the markets that do not perform supply-side functions, owning few tangible assets and staff. Many digital giants operate in only selective countries and supply all countries in a region. For example, between 2005 and 2006, Amazon only operates in UK, Germany and France in Europe,[204] with no PEs and little to no taxes paid in other countries. These countries will not be reduced by MDSH, or double taxation relieving and will not share much of Amount A.

Small markets are excluded by the nexus rule, making them ineligible for Amount A if they source less than EUR 1 million in revenue for a particular Covered Group. This threshold is reduced to EUR 0.25 million for countries with less than EUR 40 billion in GDP, but it still rules out several small markets.

The allocation of taxing rights among winners is not fair, with larger markets benefiting more than smaller ones, despite larger markets having lower mark-ups due to higher competition and product variety.[205] Additionally, Amount A proportionately sets aside some of the profits from all market jurisdictions but allocates them based on revenue

[203] Zhao Shi, 'The Chinese Market Taught Amazon another Lesson' (4 June 2022) < https://cloud.ofweek.com/news/2022-06/ART-178800-8420-30563278.html> (in Chinese) accessed on 6 January 2023.
[204] *Amazon.com v. Commissioner* (2017) 148 T.C. No. 8, at 13. Amazon has a subsidiary in Luxembourg, holding the intangibles used in Europe. See ibid at 1.
[205] Marcus Asplund and Volker Nocke, 'Firm Turnover in Imperfectly Competitive Markets' (2006) 73 *The Review of Economic Studies* 295.

rather than profit. Since larger markets have more customers and sales, they will receive a larger share of Amount A. As a result, Amount A shifts profits from high-profit markets to high-sales markets.

In summary, Amount A will reallocate taxing rights from intangible-rich countries and countries that have found ways to share more profits under the ALP to markets that do not have permanent establishments. This reform appears to target the most profitable MNEs, while exempting those with few tangible assets and staff, most of which are digital giants.

3.4.3 How does the Two-Pillar Approach work with the ALP?

The Two-Pillar Approach can be broken down into three main parts: Amount A, Amount B, and Pillar Two. Amount B is integrated within the ALP, while Amount A operates independently with its own nexus and principles that run parallel to the ALP. Ultimately, Pillar Two encompasses all these components.

Amount A is a separate solution that has limited interaction with the ALP. It collects profits from MNEs with a worldwide turnover of more than €20 billion and allocates them to eligible market jurisdictions based on revenue sourcing rules. If a country has already taxed a portion of the residual profits under the ALP, the amount shared by that particular country will be reduced. Any residual profits earned by a country will be credited accordingly. Under Amount A, residual profits refer to a concept that is determined by subtracting a return for tangible assets and payroll from the accounting profits. Thus, implementing Amount A technically shifts some profits from highly

profitable countries to market jurisdictions with limited value-added activities within their borders.

Amount B is integrated within the ALP and establishes benchmarking sets for each region. These artificial comparables provide a typical profile for routine distributors. The activities involved in distribution and marketing are referred to as "baseline distributions and marketing" and are compensated with predetermined standardized returns. If the activities are not adequately comparable, the ALP will intervene. Like other controlled transactions, standard transfer pricing rules will be used to price the transaction.

Finally, after Pillar One and the ALP, Pillar Two imposes a global minimum tax of 15% on Excessive Profit.

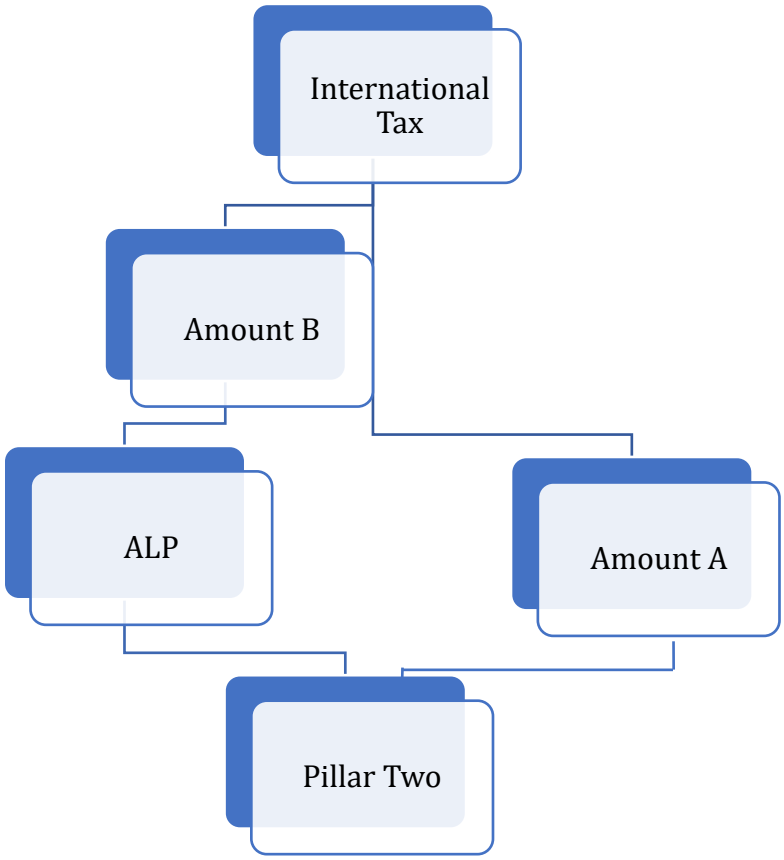

Figure 3 The relationship of Two-Pillar Approach and ALP

3.4.4 The potential outcome of the Amount A

The Two-Pillar Approach should be a package deal for political reasons. However, it is increasingly apparent that the two Pillars will go to different ends.

Amount A is a controversial issue, which has been subject to numerous discussions among academics,[206] but it only applies to a small number of taxpayers. Amount A catches less than 100 MNEs with a €20 billion revenue threshold, 10% profitability and a scope that excludes extractives and regulated financial industries.

The design of the Amount A seemingly benefits all market jurisdictions, but it is not. It benefits the big markets that host little supply-side value-added activities and discriminates against the markets that earn residual profits by any means, including LSAs, intangibles, or simply outperforming the comparables. They will share little Amount A, or worse, become relieving countries providing credits to Amount A. Amount A should reward the market jurisdiction for making purchases. It should not simultaneously deny the additional effort made by the local teams.

The future of Amount A is not promising. The departure of Pascal Saint-Amans, director of the OECD Centre for Tax Policy and Administration, makes consensus on many open and critical points even less likely in the future.[207] Progress of Amount A has in fact stalled.

[206] Mindy Herzfeld, 'Ignoring Pillar 1 Won't Make It Go Away' (2022) 107 (12) *Tax Notes International* 1323, at 1323. The author talked about Pillar One, but the reasons she provided referred to Amount A because the detailed discussion drafts were not published back then. Amount B received even less attention. See Alistiar Pepper, Thomas D. Bettge and Jessie Coleman, 'Amount B: The Forgotten Piece of the Pillar 1 Jigsaw' (2022) 107 (2) *Tax Notes International* 143, at 143.
[207] Stephanie Soong Johnston, 'Saint-Amans to Leave OECD at End of October' (2022) 107 (12) *Tax Notes International* 1218.

The winners and losers of Amount A are so evident that the intangible-rich countries, such as the US, are not keen. However, unlike Pillar Two, which is incompatible with existing bilateral tax treaties,[208] Amount A is explicitly conditioned on countries agreeing to a multilateral convention.[209] The US Congress will not likely make it a part of Amount A, and its extensive treaty network will make it a de facto veto of Amount A.[210]

The unsettledness of Amount A will potentially drive the whole Two-Pillar Approach to stall. Without a timely deal, the parties will leave the table and restart unilateral DSTs. Alternatively, the EU may want to explore a way to turn Amount A into a regional project.

3.5 Summary

FA stands out as a proposed alternative to the ALP for profit allocation among countries, particularly due to its inclusion of a formula that considers a company's supply and demand activities across various locations, notably incorporating the sales component. Proponents argue that FA offers a more equitable and efficient means of profit allocation, especially crucial for digital multinationals.

Despite its promise, the implementation of FA, including initiatives like Amount A, faces formidable political obstacles. The complexity of establishing a consensus among countries with diverse economic priorities and tax systems significantly complicates the feasibility of FA. Given these challenges, there is a pressing need to explore feasible

[208] OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (2021), at 173 to 177.
[209] OECD, 2022 Progress Report, above fn 154, at 4.
[210] Matthew Herrington et al., 'The Diverging Paths of Pillar 1 and 2' (2022) 107 (1) *Tax Notes International* 29, at 32.

alternatives within the ALP framework to address the complexities of profit allocation in the current political landscape.

PART TWO: ALLOCATING APPROPRIATE SHARE OF PROFITS TO MARKET JURISDICTIONS USING TRANSFER PRICING TOOLKITS

Chapter 4

Physical Presence

4.1 Introduction

Chapter 2 of this thesis argues that the market jurisdictions should be eligible to collect income taxes solely for being the destinations of sales. However, existing international taxation rules, particularly the OECD model, which is based on the arm's length principle (hereinafter ALP), do not align with this perspective. According to the ALP, market jurisdictions must pass several "obstacles" before they can claim an appropriate share of income tax on MNE's income derived within their borders.

The subsequent chapters (Chapters 4 to 6) undertake a comprehensive review of various OECD Transfer Pricing Guidelines (hereinafter OECD Guidelines)[1] and relevant OECD

[1] They are OECD, *Transfer Pricing and Multinational Enterprises* (1979); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022).

Model Tax Conventions, intending to provide insight into how market jurisdictions might explore chances within these frameworks to potentially secure a portion of residual profits and, consequently, an appropriate share of taxing rights under the OECD ALP model.

The first requirement for market jurisdictions to partake in international profit allocation under the ALP is the physical presence, typically in the form of subsidiaries or branches of the MNEs, within the borders of the market jurisdictions. Chapter 4 outlines the changes and developments in the OECD's stance on physical presence over time, as well as the intrinsic problems associated with the "permanent establishment" (hereinafter PE) concept. With a physical presence established, the market jurisdiction is poised to claim a portion of routine profits derived within its borders, contingent upon the extent of value-added activities conducted within the jurisdiction.[2]

Secondly, market jurisdictions often encounter transfer pricing challenges and the local marketing and distribution teams may be structured as "limited risk distributors".[3] Under the ALP, the best way for a jurisdiction to share residual profits is through ownership, investment, or exploration in intangible assets. For a market jurisdiction PE or subsidiary, the relevant intangible asset is most likely the marketing intangible. Chapter 5 outlines the types of marketing intangibles a market jurisdiction PE or subsidiary can acquire or develop, including the creation of second kind of marketing intangibles such as customer lists, or the enhancement and exploitation of existing marketing intangibles like trademarks.

[2] See "Glossy of Terms" for the definition of routine profits and residual profits.
[3] See Chapter 9 Coca-Cola Case for how MNEs can structure the subsidiaries in market countries as "limited risk distributors".

Lastly, with the contribution of an intangible asset, a market jurisdiction's PE may participate in profit allocation through the profit split method (hereinafter PSM) or benefit from comparable adjustments in favour of it. Chapter 6 elucidates the development of the OECD version PSM alongside the US Section 482, detailing the circumstances and methods for its application. Additionally, Chapter 6 provides a summary of Chapters 4 to 6 and discusses the fundamental challenges inherent in the traditional OECD international tax regime.

4.2 OECD Model Tax Conventions

The modern international taxation system, based on the ALP, operates under the assumption that the parties of a controlled transaction (transaction between related entities)[4] operate as independent entities rather than inseparable parts of a single enterprise.[5] In this framework, a fair "transfer price" is determined as if the transaction was uncontrolled for the purpose of allocating taxing rights among relevant countries. For a market jurisdiction to participate in this allocation process, it must first attain status as a source country. This necessitates the entities involved in the transaction establishing a physical presence within its borders.

The transfer pricing analysis is conducted on a per-entity basis. In this context, the "entity" does not exclusively refer to subsidiaries. It may also refer to branches, which are not separate legal entities. Regardless of its form, any such entity will be subject to taxation

[4] See Glossy of Terms of this paper.
[5] For the most recent OECD guidance of the ALP, see the 2022 Report, above fn 1, Chapter I, Section B; OECD, 'Article 9 Associated enterprises', in *Model Tax Convention on Income and on Capital 2017* (2019) Article 9(1).

in the source countries if it constitutes a PE. A PE sets the boundary for a business in a geographic sense. It makes a difference between "tax" and "no tax".

The concept of PE has a more extended history than the current international taxation regime.[6] It was developed in the middle of the 19th century in German to avoid double taxation among the Prussian regional municipalities.[7] The League of Nations introduced the concept in its commentary to the 1928 draft Model Tax Convention based on 1927 report prepared by a Committee of Technical Experts (see Section 2.2.1.2).[8] Wells and Lowell have observed that "[t]he learning that can be derived from the policies developed in the 1920s is that tax revenues will follow treaty policy design."[9] Being an essential part of the international taxation system, the Model Tax Conventions and the 1923 Report discussed in Chapter 2, set the international tax order for the following century. This chapter examines the concept of PE in the OECD Model Tax Conventions extensively, highlighting the challenging situation that market countries encounter.

4.2.1 OECD Model Tax Convention 1977

[6] For a discussion of the development of international tax treaties, see e.g., Sunita Jogarajan, *Double Taxation and the League of Nations* (Cambridge University Press, 2018); Sol Picciotto, 'Is the International Tax System Fit for Purpose, Especially for Developing Countries?' (2013) *International Centre for Tax and Development*, working Paper 13.
[7] Arvid Aage Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law and Taxation Publishers, 1991), at 72. Quoted in Michael Kobetsky, 'History of Tax Treaties and the Permanent Establishment Concept' in Michael Kobetsky (ed), *International Taxation of Permanent Establishments* (Cambridge University Press, 2011) 106, at 110. The first agreement for the prevention of double taxation was introduced some 20 years after that between Great Britain and Switzerland, see Sunita Jogarajan, 'The Conclusion and Termination of the 'First' Double Taxation Treaty' (2012) (3) *British Tax Review* 283.
[8] *Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, Report Document C. 216. M. 85 (London, April 12th, 1927), at 15.
[9] Bret Wells & Cym H. Lowell, 'Income Tax Treaty Policy in the 21st Century: Residence vs. Source' (2014) 5(1) *Columbia Journal of Tax Law* 1, at 39.

The concept of the PE first appeared in the OECD Model Tax Convention in 1963 and was slightly modified in OECD Model Tax Convention 1977 Article 5.[10] These changes predominantly reinforced taxation by the residence state while constricting the scope of taxation in the source countries.[11] Today, a market jurisdiction would have deemed to have a PE in a specific country if it maintains a "fixed place of business" or operates through a dependent agency. The two tests were then limited by a third test that examined the nature of the activities undertaken by the MNEs.[12]

- The fixed place of business test

In Article 5(1), the OECD specified that the PE was "…a fixed place of business through which the business of an enterprise is wholly or partly carried on."[13] To clarify, the OECD provided in the Commentary of Article 5 that the MNE need to have:

> *"- the existence of a 'place of business', i.e. a facility such as premises or, in certain instances, machinery or equipment;*
>
> *-this place of business must be 'fixed', i.e. it must be established at a distinct place with a certain degree of permanence;*

[10] OECD, *Model Double Taxation Convention on Income and on Capital* (1977), Article 5.
[11] Timur Sokolov, 'The History of Article 5 OECD Model Convention', in Michael Lang, Florian Brugger and Patrick Plansky (eds) *Permanent Establishments in International and EU Tax Law* (Wien: Linde, 1st, 2011) 13 to 31, at 28.
[12] David R. Davis, *Principles of International Double Taxation Relief* (Sweet & Maxwell, 1985). Quoted by Jinyan Li, 'The Concept of Permanent Establishment in China's Tax Treaties' (1989) 7(1) *International Tax & Business Lawyer* 120, 121.
[13] OECD Model Tax Convention 1977, above fn 10, Article 5(1).

- the carrying on of the business of the enterprise through this fixed place of business…"[14]

It may include "a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop, and f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources"[15]

- The agency/relationship test

According to Article 5(5), an MNE maintains a PE if a dependent agent "acts on behalf of it" and "habitually exercises…an authority to conclude contracts in the name of the enterprise".[16] In this case, the MNE is deemed to have undertaken all the activities.

- The nature of activities test

The aforementioned tests were restricted by the nature of activities outlined in Article 5(4).[17] If an MNE engages solely in preparatory or auxiliary activities within a market jurisdiction, such as storing, displaying, or delivering goods from a facility, purchasing

[14] OECD, 'Commentary on Article 5: Concerning the definition of permanent establishment' in *Model Tax Convention on Income and on Capital 1977* (1977), para 2.
[15] OECD Model Tax Convention 1977, above fn 10, Article 5(2).
[16] OECD Model Tax Convention 1977, above fn 10, Article 5(5). If the MNE carries business through independent agents such as a broker or general commission agent. It is not deemed to have a PE. Ibid, Article 5(6). The exclusion of independent agents was proposed by the International Chamber of Commerce (ICC) and the League of Nation's Expert Committee adopted the recommendation. See Bret Wells & Cym H. Lowell, above fn 9, at 26.
[17] OECD Model Tax Convention 1977, above fn 10, Article 5(4).

goods, or collecting information, it does not constitute a PE in that country.[18] Each fixed place of business or agent is evaluated independently in this regard.

It is worth noting that advertising activities are also considered preparatory or auxiliary in nature. Hence, a fixed place of business dedicated exclusively to advertising purposes does not constitute a PE.[19]

Arguably, the nature of the activities test dominated Article 5. When considering these three tests from an alternative perspective, it can be argued that the OECD effectively segmented business activities into distinct categories: preparatory or auxiliary activities, and the other activities (this thesis refers to them as core business activities). A market jurisdiction is deemed to have a PE if:

(1) any of the core business activities take place within its border, and

(2) it maintains a fixed place of business or a dependent agent within its border.

In case where a market jurisdiction solely accommodates activities such as marketing, displaying, and storage, which are preparatory or auxiliary in nature, no PE is established, regardless of whether there is a fixed place of business or a dependent agent present. As a result, MNEs can easily structure their operations to artificially avoid having a PE in a market jurisdiction.

[18] OECD Model Tax Convention 1977, above fn 10, Article 5(4).
[19] OECD Model Tax Convention 1977 Commentary on Article 5, above fn 14, para 22. For a real-life based case regarding the issue of promotion activity by itself does not constitute PE, see Sven Hentschel, *The Taxation of Permanent Establishments* (Wiesbaden: Springer Fachmedien Wiesbaden GmBH, 1st ed, 2021), at 341 to 347.

For instance, in the 1970s, the OECD recognised that it was possible for an insurance company to "do large-scale business in a State without being taxed in that State on their profits arising from such business". [20] By withholding authorisation from sales representatives to conclude contracts on behalf of the company, insurance companies restricted their activities to those of a preparatory or auxiliary nature, thus exempted under Article 5(4). As a result, many treaties included provisions deeming the market jurisdictions (the states where the insurance companies collect premiums) to have PEs.[21] Due to the limited coverage, the anti-avoidance provision didn't achieve a satisfying outcome.[22]

In a case where a market jurisdiction hosts core business activities within its border, MNEs may perform diverse functions across different fixed places of business or through different agents. Consequently, only the fixed place of business or dependent agent engaged in core business activities are recognised as PEs. Preparatory or auxiliary activities conducted by other places or agents will be exempted, as each location or agent is assessed independently. This selective approach contributes to the partial achievement of PE avoidance strategies. This phenomenon often referred to as the "fragmentation of contracts".[23]

[20] OECD Model Tax Convention 1977 Commentary on Article 5, above fn 14, para 38.
[21] OECD Model Tax Convention 1977 Commentary on Article 5, above fn 14, para 38.
[22] See the Canadian Tax Court decisions in *American Income Life Insurance Company v. Canada* [2008] TCC 306, Canada v. *Knights of Columbus* [2008] TCC 307, where two US insurance companies had substantial numbers of Canadian resident sales staff and a variety of other representatives but were held not to have PEs in Canada because they did not have offices of their own, and the salespeople could not finalize the issue of policies as underwriting decisions were taken in the US head office.
[23] Sven Hentschel, above fn 19, at 78.

4.2.2 OECD Model Tax Convention 2017

Article 5 of the Model Tax Convention remained unchanged until the release of the BEPS Final Reports in 2015. The BEPS Final Report of Action 7 proposed several modifications to Article 5 with the aim of broadening the scope of PE concept, leading to amendments in the Model Tax Convention of 2017.[24] The major changes are as follows:

- The insertion of Article 5(4.1)

The new paragraph views the overall business activities of an MNE in a state to determine the PE status. The preparatory or auxiliary business activities, which were exempted previously, are not exempted if the MNE in question has a PE in the same state or the overall activities carried out in more than one place in the same state are not in a preparatory or auxiliary nature.[25] This is a narrow application of enterprise doctrine at the state level (Chapter 6 discusses the enterprise doctrine).

Article 5(4.1) was inserted to overcome PE avoidance by "fragmentation of contracts", where the MNEs divided the business operations in a country into smaller parts and

[24] OECD, 'Article 5 Permanent establishment', in *Model Tax Convention on Income and on Capital 2017* (2019).

[25] The newly inserted paragraph says:
"4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and
a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or
b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,
provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation."
OECD Model Tax Convention 2017, above fn 24, Article 5(4.1).

undertook them in different places. Many of these operations would perform functions such as marketing or storage, which were of preparatory or auxiliary nature. Hence, only the core business activities, such as sales, would be taxed. However, the recently inserted Article 5(4.1) is unlikely to offer adequate support to market jurisdictions seeking to establish PEs because it fails to address the fundamental issue that engaging in marketing functions alone does not qualify as a PE.

A recent Finland case highlighted the problem.[26] A Swedish company that was part of an MNE performed research, manufacturing, marketing, and sales activities of biopharmaceutical products in Nordic countries. In Finland, the company employed three individuals to carry out marketing activities, including promoting its products and related research to healthcare professionals. These employees were not involved in managing trading stocks or distribution services, nor were they authorized to engage in sales activities on behalf of the company. Furthermore, their salaries were not contingent on sales volume. In light of these circumstances, the Supreme Administrative Court concluded that the Swedish company did not have a PE in Finland, as the activities performed by the employees were considered preparatory or auxiliary marketing functions, thus exempted from PE status.

The key to this planning lies in the Swedish company's complete separation of marketing and sales functions, assigning them to distinct teams. This echoes the fundamental issue identified by the OECD decades ago with insurance companies, a trend that may become more prevalent in the future with technological advancements. Marketing personnel engage with customers either in person or online, directing them to place orders through

[26] ECLI:FI:KHO:2021:171 (Finland) 3 December 2021. Quoted in Nedelina Vasilkova, Neha Mohan and Patrick T.F. Schrievers, 'Revisiting the Home Office PE Issue in Light of COVID-19 Health and Social Measures' (2022) 7(107) *Tax Notes International* 789.

a centrally managed website. Consequently, Article 5(4) undermines the taxing authority of market jurisdictions.

It is worth noting that due to the Covid-19 pandemic, the Swedish company didn't provide office space to its three Finnish employees, who were working from home. Internationally, tax authorities and courts haven't yet reached a consensus on whether a home office constitutes a PE. However, home offices generally don't violate the definition of a "fixed place of business." In Finland, home offices may be considered PEs when companies don't provide workplace facilities for Finnish employees.[27]

According to Danish revenue authorities, the crucial factor is the employee's actual behaviour, i.e., whether their work is carried out from their address in Denmark. Other relevant factors in determining whether a home office constitutes a PE include (i) whether the employee lacks another permanent workplace, and (ii) whether the company agrees to the employee working from home, either explicitly or implicitly.[28]

The influence of this issue could be significant for market jurisdictions, especially given the widespread adoption of remote work during the pandemic. Many businesses have adapted well to this new mode of work, suggesting that after the pandemic, they may be reluctant to invest in maintaining dedicated office spaces solely for marketing activities.

- The amendment of Article 5(5)

[27] VH/5426/00.01.00/2020 (Finland) January 2021, an unofficial English translation is available in <https://www.vero.fi/en/detailed-guidance/guidance/47806/income-taxation-of-nonresident-foreign-corporate-entities/>, accessed on 1 November 2022.
[28] Nedelina Vasilkova, Neha Mohan and Patrick T.F. Schrievers, above fn 26, at 791.

Article 5(5) previously included a dependent agent with the authority to habitually conclude contracts in the enterprise's name as PE.[29] The new paragraph enlarges the scope of its application by adding "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise". Interesting, in the commentary of the newly amended Article 5(5), the OECD provided a nearly identical example as the Finnish case which strengthened the position that no PE would be found in the markets:

> *"Where, for example, representatives of a pharmaceutical enterprise actively promote drugs produced by that enterprise by contacting doctors that subsequently prescribe these drugs, that marketing activity does not directly result in the conclusion of contracts between the doctors and the enterprise so that the paragraph does not apply even though the sales of these drugs may significantly increase as a result of that marketing activity."*[30]

Apart from that, the OECD provided another case to further explain the newly amended Article 5(5):

> *"The phrase 'habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise' therefore applies where, for example, a person solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the*

[29] The concept "in the name of the enterprise" has been extended to include contracts that "a) in the name of the enterprise, or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or c) for the provision of services by that enterprise". OECD Model Tax Convention 2017, above fn 24, Article 5(5).
[30] OECD, 'Commentary on Article 5: Concerning the definition of permanent establishment' in *Model Tax Convention on Income and on Capital 2017* (2019), para 89.

> *enterprise routinely approves these transactions. It does not apply, however, where a person merely promotes and markets goods or services of an enterprise in a way that does not directly result in the conclusion of contracts."*[31]

The amendment of Article 5(5) reflects another effort by the OECD to address the artificial avoidance of PEs. However, in today's era of advanced information technology, such as QR codes on flyers and the pre-filling function of smartphones, it's relatively easy to ensure that marketing staff to be separated from sales activities. Consequently, their role doesn't involve "leading to the conclusion of contracts," raising doubts about the extent to which this paragraph will safeguard the taxing rights of market jurisdictions. Nevertheless, market jurisdictions can bolster this stance when implementing it domestically.

- The amendment of Article 5(6)

Article 5(6) was amended so that the concept of "independent agent" was clearer:

> *"a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise."*[32]

[31] Ibid, para 89.
[32] OECD Model Tax Convention 2017, above fn 24, Article 5(6).

"Closely related" is a new concept that never appeared in any predecessor Model Conventions or commentaries. The newly inserted Article 5(8) generally sets "closely related" to be 50% ownership, or one entity controls another.[33]

4.3 Findings about the PE concept

The allocation of profits under the OECD model in the treaties necessitates a PE.[34] While having a PE alone does not ensure that profits can be allocated to the source jurisdictions without considering the advantages of local marketing intangibles,[35] having a PE is the essential first step.

The OECD's willingness to expand the PE concept signals its readiness to allocate more income to source jurisdictions, including market jurisdictions. However, significant revisions are needed to revitalise the concept. With the help of technology, even a non-digital MNE can easily avoid PEs in market jurisdictions by separating and shifting the core business activities away from the markets. While BEPS Action 7 made a commendable attempt, it's like trying to strengthen a building by adding structural

[33] Paragraph 8 provides: "For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises."
This concept is also relevant to the newly inserted paragraph 4.1, as previously discussed. OECD Model Tax Convention 2017, above fn 24, Article 5(8).
[34] Kobetsky, Michael, 'Principles and Policy' in Michael Kobetsky (ed), International Taxation of Permanent Establishments (Cambridge University Press, 2011) 11, at 13.
[35] Marc M. Levy, Monique Van Herksen, Stephan Schnorberger, et al., 'The Quest for Marketing Intangibles' (2005) 11(16) *Journal of International Taxation* 28, at 38.

supports on the ground floor, only to find that the building was resting on a foundation of quicksand.

It is unclear when and how the countries will domesticate and legislate the Two-Pillar Approach and to what extent the Amount A will help the market countries collect an appropriate share of taxing rights. If we must live with the current international taxation system provisionally, it's essential to re-examine the concept of PE structurally. This section highlights the core issues with the PE concept and offers recommendations to assist the OECD in preparing for this reassessment.

4.3.1 The outdated understanding of internet

The OECD's understanding of the internet is out-of-date. For instance, the Commentary of Article 5, paragraph 123 provided a website's location is where its server locates:

> *"…an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a 'place of business' as there is no 'facility such as premises or, in certain instances, machinery or equipment' … On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a 'fixed place of business' of the enterprise that operates that server."*[36]

[36] OECD Model Tax Convention 2017 Commentary on Article 5, above fn 30, para 123.

The OECD clearly tried to find something "fixed" to establish the nexus, and this paragraph was inserted in 2003 when most people were still using cable internet. Back then, limited by the speed, the servers won't be too far away from the users, which made them comparatively immovable. But now, fibre optic is widely used. They are 20 times faster than cable, so the servers can be anywhere in the world if the users are not extremely sensitive about the speed. It means that the MNEs can put their servers in the tax heavens as they wish. To make profit shifting easier, the OECD doesn't have personnel requirements to locate the PE where the servers are.[37]

The nexus rule based on location of servers has minimal application. A digital company that sells goods online, like Amazon, does not need to worry about the location of the servers because it is not in the business of operating servers. The operation of the servers is of preparatory or auxiliary nature to such businesses, therefore, exempted by Article 5(4).[38] The MNEs operating servers as part of their primary business can still choose to use an Internet Service Provider rather than owning servers themselves. They won't have a physical presence in the location of the servers because the servers are not at the MNE's disposal.[39] Thus, the nexus rule only matters to internet service providers that are in the business of operating servers. For them, technological developments will only make profit shifting more plausible.

Surprisingly, this impractical position was only amended by the BEPS Action 7, not deleted. Failing to build adequate nexus between the digital companies and the markets was one of the reasons that triggered the Two-Pillar Approach. It indicates that the OECD

[37] Ibid, para 127.
[38] Interestingly, online merchandisers like Amazon were still called "e-tailers" in the commentary, which proves the relevant discussions are out-of-date from another aspect. See OECD Model Tax Convention 2017 Commentary on Article 5, above fn 30, para 130.
[39] Ibid, para 124.

may have recognised that the current concept of PE does not effectively apply to the internet. It attempted to address this issue and adapt to the internet's advancements but was unsuccessful due to its outdated understanding of the internet.

4.3.2 Change of consumer shopping pattern

The OECD need to be aware that the shopping patterns of individuals have changed significantly with the maturity of e-commerce.[40] A good example is that the young generations are unwilling to pay a premium for the clothes in the store. They would like to do window shopping in the shopping mall, try out clothes, and order from online stores for a lower price. Though the physical stores do not contribute much to sales, they have done a great job in marketing. In this example, they are still PE because they still sell. In the future, there will be more and more physical stores that only undertake marketing and displaying functions, which will not be PEs.

The Chinese online fast fashion merchandise "Shein" was a great example and pioneer using physical store for marketing and display purpose only. Shein recently reported worth more than $100 billion US dollars.[41] It mainly targets young people 25 years or under.[42] Customers all over the world order through Shein's App or website, and Shein

[40] At the end of the 20th century, visionary academics foresaw the rise of the internet and the change of business mode. They predicted that sooner or later, the source countries would call for new international tax principles to restore the pre-existing tax equilibrium. See, e.g., Charles E. McLure Jr., Source-Based Taxation and Alternatives to the Concept of Permanent Establishment in 2000 World Tax Conference Report, <https://www.cesifo.org/DocDL/Forum300-focus2.pdf>, at 11; Richard L. Doernberg and Luc Hinnekens, *Electronic Commerce and International Commerce* (The Hague: Kluwer Law International for the International Fiscal Association, 1999), at 300 and 301.
[41] Olivia Rockeman, 'Shein's US Expansion Adds Pressure for Its Fast-Fashion Competitors' (2 November 2022) *Bloomberg* <https://www.bloomberg.com/news/articles/2022-11-01/shein-delivery-times-to-decrease-with-warehouses-opening?leadSource=uverify%20wall> accessed on 4 November 2022.
[42] Yvonne Lau, 'Thought Zara was inexpensive? China's $100 billion startup Shein is undercutting the fast fashion industry with even cheaper clothes.' (1 June 2022) *Fortune*

centrally manages the orders and ship directly from its China warehouse.[43] It plans to open a permanent shop in Tokyo, only providing display and try-out services to the shoppers. The shoppers will use their smartphones to place orders by scan QR codes and get speedy international delivery from the centrally managed warehouse.[44] The store will not constitute PE under Article 5, which means the Japanese tax authority will not have taxing right over Shein.[45] It is the same result if Shein has a warehouse in Japan because storing is also of preparatory or auxiliary nature according to Article 5(4).[46]

Previously, the international taxation regime didn't consider the individual's behaviour and shopping pattern because they were too minor. Now, digital giants make online B2C (business-to-customer) so common that it constitutes a large part of their businesses. The MNE's study of customer behaviour is so well advanced with the help of big data. The international taxation regime must catch up.

Pascal Saint-Amans, the OECD's previous Director of the Centre for Tax Policy and Administration, who initialled and led the BEPS Project, commented that the overall amendments of the PE concept in OECD Model Tax Convention 2017 was made to ensure that "a business' core activities cannot inappropriately benefit from the exception for

<https://fortune.com/2022/05/31/shein-zara-dupes-china-usa-fast-fashion-startup-genz/> accessed on 4 November 2022.

[43] Shein has its Indiana Facility in the US in 2022 and about to have a warehouse in Toronto, Canada in 2023. See Shein Official website <https://www.sheingroup.com/newsroom/> accessed on 4 November 2022. The company also relocated the headquarter to Singapore in late 2021. See Rachel Douglass, 'Shein Reportedly Expands Singapore Office, Relocates Administrative Home, *Fashion United* <https://fashionunited.uk/news/business/shein-reportedly-expands-singapore-office-relocates-administrative-home/2022021861462> accessed on 4 November 2022.

[44] Reuters, 'Chinese fashion retailer Shein to open permanent 'event space' in Tokyo' (1 November 2022) *Reuters* <https://www.reuters.com/business/retail-consumer/chinese-fashion-retailer-shein-open-permanent-event-space-tokyo-2022-11-01/> accessed on 4 November 2022.

[45] It is so given the staff in the physical store do not help the shoppers with, for example, scanning the QR code. Hence, they are not "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise". OECD Model Tax Convention 2017, above fn 24, Article 5(5).

[46] Ibid, Article 5(4).

preparatory and auxiliary activities, an issue that is particularly relevant in the digital economy."[47] If this statement indifferently applies to the minor changes in Article 5(4) of the 2017 Model Tax Convention,[48] it is likely that Shein's physical store used solely for marketing and display purposes will not be excluded by Article 5(4) as the sales activities inappropriately benefit from the marketing and displaying activities provided by the physical store. However, it will depend on to what extent the tax treaty between China and Japan will adopt this change.[49]

4.3.3 Change of business mode

The OECD needs to catch up with the fast-changing business mode.[50] The entire Article 5 would only build a nexus between income and the places where core business activities

[47] Pascal Saint-Amans and Raffaele Russo, 'The BEPS Package: Promise Kept' (2016) 70(4) *Bulletin for International Taxation* (IBFD) 236, at 238, accessed 24 May 2023. Saint-Amans was the Director of the Center for Tax Policy and Administration at the OECD from 1 February 2012 to 31 October 2022. He played a key role in the OECD BEPS Project.

[48] Article 5(4) provides that:
"4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity ~~of a preparatory or auxiliary character;~~
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), ~~provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.~~
provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character."
See OECD Model Tax Convention 2017, above fn 24, Article 5(4).

[49] Since Shein has just moved its headquarter to Singapore, the relevant treaty may be the treaty between Singapore and Japan.

[50] For a discussion of how MNEs are reshaped using the information and communication technology to lower their transactional costs, see Subramanian Rangan and Metin Sengul, 'Information Technology and

take place. That is to say, only the markets with the OECD-defined core business activities taking place within their borders have taxing rights over all activities, preparatory or core. The markets that do not have core business activities within their borders will have no PE, thus no right to tax. However, nowadays, core business activities such as sales can take place anywhere. The development of technologies enables MNEs to have all sorts of remote ways to approach customers. Even with the new Article 5(5), sales can still be completely separated from other activities, such as marketing. It is possible to leave the exempted activities to be performed in the market jurisdictions and re-allocate the core business activities to low-tax countries or anywhere the MNEs prefer.

The OECD traditionally would like to find something comparatively "fixed" to build the nexus. With the internet, sales activities are arguably the most movable activity. In contrast, marketing activities are relatively immovable. In specific industries, it remains necessary for salespeople to personally visit their customers and physically present the products. This is particularly true in sectors such as pharmaceuticals, where clients derive significant value from firsthand product experiences. Also, salespeople in these industries often intend to establish long-term relationships with their clients by making personal visits, which also highlights the importance of making directly local marketing in market jurisdictions. These MNEs may centrally take online orders, but the marketing activities must be done locally to approach customers. Hence, under the fast-changing business mode, sales cannot be considered an immovable factor that consistently benefits the real markets.

Transnational Integration: Theory and Evidence on the Evolution of the Modern Multinational Enterprise' (2009) 40(9) *Journal of International Business Studies* 1496.

4.4 Suggestions to revive PE concept

This thesis contends that market jurisdictions should be granted a share of taxing rights for the customers they contribute to (see Chapter 2). However, the current definition of PE allows sales to be booked anywhere, leading to the misallocation of profits attributable to sales. Therefore, this thesis advocates for the expansion of the PE concept to address this issue.

Admittedly, marketing does not necessarily lead to sales, which is why it was of a preparatory or auxiliary nature in the first place. Yet, information technology does not just create obstacles to international taxation, but also brings positive effects, such as online orders are fully traceable.

The thesis proposes that the PE concept could have two (rather than one) limbs. The first limb could be the existing "fixed place of business" and "dependent agent", which would be limited by the nature of the activities test and exempt activities that are auxiliary or preparatory in nature. The second limb could simply use "sales" as the nexus between income and market jurisdictions, and the location of "sales" would refer to the location of third-party customers, which is consistent with the definition of "market jurisdiction" in Section 1.3. In Shein's case, if the Japanese physical store failed the first limb, it would be caught by the second limb because the online order system would capture the orders placed in Japan. Consequently, Japan should have a PE of Shein regardless of the nature of activities within its border. When a PE exists, Shein will have to pay tax in Japan for all

value-added activities, including the marketing and displaying function provided by the physical store.

Another approach is to view the activities such as marketing and displaying that aim to sell in the same way or as a bundle with the sales activities. For example, marketing activities have no other purpose but to facilitate sales, so the MNE is deemed to have undertaken sales activities in the market. Consequently, the market jurisdiction is deemed to have a PE. A different example is information collection. If a marketing research firm, such as Nielsen Corporation, collects information to make a database for sale, this may be of preparatory or auxiliary nature, and thus not taxable under the thesis proposal.[51] However, if a merchandiser such as Procter & Gamble collects information regarding customer preferences to improve sales of their products, it should be considered part of the sales activities. This position is consistent with what Pascal Saint-Amans mentioned that "core activities cannot inappropriately benefit from the exception for preparatory and auxiliary activities".[52]

PE is essential for a marketing jurisdiction to have taxing rights, even if the profits arise within its border. With the amendments mentioned above, the PE concept may capture online sales activities and the auxiliary or preparatory nature activities separated from the core business activities for market jurisdictions. However, the market jurisdictions will not share appropriate taxing rights because these are routine activities and are highly likely priced by a traditional transfer pricing method, such as the cost plus method. Chapters 5 and 6 will discuss how to help the market jurisdictions share a larger portion

[51] The reasons that the jurisdictions from whom the database information was based are not taxable because they are not market jurisdictions.
[52] Pascal Saint-Amans and Raffaele Russo, above fn 45, at 238, accessed 24 May 2023.

of the taxing rights using transfer pricing toolkits, such as marketing intangibles and the profit split method.

Chapter 5

Marketing Intangibles

5.1 Introduction

Once an MNE establishes a physical presence in a particular market jurisdiction, it gains taxing rights over the profits generated from that presence (see Chapter 4). However, the market jurisdiction is typically entitled only to routine profits if the permanent establishment (hereinafter PE) engages solely in routine functions. To access residual profits, a market jurisdiction PE must possess or exploit an intangible asset.

This chapter investigates the concept of "marketing intangible." Section 5.3 reveals the significance of marketing intangibles for market countries. It subsequently examines two key questions: firstly, the feasibility of a market jurisdiction PE creating its own marketing intangible (see Section 5.4), and secondly, the capacity for a marketing country PE to enhance the value of existing intangibles (see Section 5.5). The discussion then proceeds to investigate the interaction between markets and marketing intangibles (see Section 5.6), followed by a reassessment of marketing intangibles (see Sections 5.7 and 5.8).

The relevant paragraphs concerning intangible assets experienced major reforms in 1994 and 2013, respectively. Therefore, the OECD Transfer Pricing Guidelines 1995 (hereinafter the 1995 Guideline) and the OECD Transfer Pricing Guidelines 2010 (hereinafter the 2010 Guideline) have the same Chapter VI “Special Considerations for

Intangible Property", with minor changes. For this reason, this chapter will discuss these two Guidelines together unless their positions differ. Similarly, the OECD Transfer Pricing Guidelines 2017 (hereinafter the 2017 Guideline) and the OECD Transfer Pricing Guidelines 2022 (hereinafter the 2022 Guideline) share the same Chapter VI, and therefore will be discussed collectively.

5.2 Why marketing intangibles are significant to market jurisdictions?

Marketing intangibles are essential to the market jurisdictions as they play a crucial role within the current international taxation framework. Consider an MNE with a headquarters in the residence jurisdiction, a manufacturing unit in the source jurisdiction, and a distributor in the market jurisdiction (referred to as the source jurisdiction under the current international taxation system). The headquarters typically owns all intangibles, including marketing and trade-related intangibles. The manufacturer handles manufacturing functions, while the distributor manages marketing and distribution activities.

In transfer pricing analysis, the manufacturer and distributor are usually the "tested parties" and their contributions are compared against third-party data to determine if the MNE has operated at arm's length because valuing intangible assets provided by the headquarters in controlled transactions can be complicated and challenging.[1] Typically,

[1] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), para 3.18 to 3.20.

manufacturing and distribution functions are priced using one-sided methods like the resale price method, cost-plus method, or transactional net margin method (hereinafter TNMM),[2] or the comparable uncontrolled price (hereinafter CUP) method, which relies on comparable data. Consequently, the group synergies, which are earned by all group members for being a group rather than separate entities (see Section 6.2), will be allocated to the headquarter due to the intangibles.[3] The only exception is the profit split method (hereinafter the PSM), which tests all parties in the controlled transaction[4] and does not rely on comparable data (see Chapter 6 for how to apply the PSM). It is the transfer pricing method that is most likely to allocate an appropriate share of taxing rights to the market jurisdictions.

For the PSM to be the most appropriate method from the market jurisdiction's perspective, two likely scenarios exist:[5]

- The distributor in the market jurisdiction creates its own marketing intangible.
- The distributor performs functions, uses assets, and assumes risks for development, enhancement, maintenance, protection and exploitation (hereinafter DEMPE) functions, enhancing the value of the existing intangibles.[6]

[2] Ibid, para 3.20.
[3] The 2022 Report requires a two-sided analysis, irrespective of which transfer pricing is ultimately found to be the most appropriate method in the functional analysis stage. It aims to accurately delineate a transaction so that the parties performing the DEMPE functions will not be hidden. Yet, when a particular method is chosen to be the most appropriate, the analysis is still one-sided for all the methods except the comparable uncontrolled price (hereinafter CUP) method and profit split method (hereinafter PSM). See ibid, para 2.21, 2.69, 2.125 and 3.20. The pre-2022 reports would generally test the party that provided relatively simple functions directly.
[4] Ibid, para 3.21.
[5] These contributions need to be unique and valuable. Not all intangibles or activities that enhance the value of intangibles are of these two characters. See ibid 1, para 2.126.
[6] Ibid, para 6.71.

However, there is a significant difference between these two situations. If the distributor creates its own intangible asset, related expenditures may be capitalised and accumulated as the value of the intangible. It stays on the balance sheet of the distributor and will provide lasting benefits to the distributor. Conversely, if the distributor enhances existing intangibles owned by related party through DEMPE activities, it only enjoys only short-term residual profits arising from the DEMPE activities. Upon agreement termination, the intangibles revert to the owner. The transfer pricing examiner is not obliged to find out the history of the intangibles as to which parties have participated in the DEMPE activities of this asset and the accurate delineation of each of these transactions to divide the economic ownerships among relevant parties.

In a worst-case scenario, if a related party — the manufacturer in the example, is in a low-tax jurisdiction, the headquarters may structure distribution service contracts to make the manufacturer seemingly responsible for DEMPE functions (see Chapter 9). Consequently, the distributor and market jurisdiction lose rights associated with exploited intangibles, including sharing residual profits. Therefore, from the perspective of market jurisdictions, owning marketing intangibles provides greater security and ensures lasting taxing rights over residual profits.

5.3 Definition

5.3.1 The 1979 Guideline

The 1979 Guideline discussed the treatment of trademarks in Chapter III, Section II Transfer Pricing Aspects of Use of Trademarks. While this Guideline did not introduce the

concept of "marketing intangible", the term "intangible property" referred to various types of industrial and artistic property rights, including trademarks and trade names.[7] Furthermore, it examined the transfer pricing consideration associated with trademarks, a category that aligns with contemporary understandings of marketing intangibles today.

5.3.2 The 1995 Guideline and the 2010 Guideline

The 1995 Guideline defined the term "marketing intangible" for the first time, and the 2010 Guideline inherited the definition:

> *"An intangible that is concerned with marketing activities, which aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned."*[8]

This definition included two kinds of marketing intangibles. The first kind was the ones that "aid in the commercial exploitation of a product or service", like trademarks and trade names.[9] These marketing intangibles generated increasing benefit over time, unlike trade intangibles which could be exploited only for a limited time and the economic activity was bound with a particular entity.[10] The second kind of marketing intangibles were the ones that "have an important promotional value for the product", such as

[7] OECD, *Transfer Pricing and Multinational Enterprises* (1979), para 76.
[8] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995), at G-6 Glossary; OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010), at 27 Glossary.
[9] The 2010 Report, above fn 8, para 6.4.
[10] See Rohan Shah, Ajit Tolani and Ashish Bhatnagar, 'Transfer Pricing Issues Relating to Marketing Intangibles' (2013) 2(19) *Asia-Pacific Tax Bulletin* 142, at 144.

customer lists, distribution channels, and unique names, symbols, or pictures.[11] Though both Guidelines discussed both kinds of marketing intangibles, many examples still focused on trademarks and trade names. It was ambiguous whether these positions apply to the second kind of marketing intangibles.

It was worth noting that the OECD only outlined a limited number of the second kind of marketing intangibles, which might negatively influence the chances of a market jurisdiction distributor creating marketing intangibles of its own.

5.3.3 The 2017 Guideline and the 2022 Guideline

The 2017 Guideline and the 2022 Guideline inherited the definition of marketing intangible from the previous Guidelines, but instead of clearly distinguishing the two kinds of marketing intangibles, they discussed the definition in a more general way:

> *"An intangible (within the meaning of paragraph 6.6) that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and*

[11] The 2010 Report, above fn 8, para 6.4. The second kind of marketing intangible was believed to have gained prominence in the late 1980s in a US case (settled prior to litigation), in which the US distributor of Club Med, a non-US company, spent "too much" marketing and promotional expenditure. The US tax authority Internal Revenue Service (hereinafter IRS) considered either disallowing a portion of the marketing expenditure or establishing a fee for the additional marketing efforts performed by the US distributor. The latter indicated a quasi-intangible existed, which required the associated entity to pay. See Marc M. Levy, Monique Van Herksen, Stephan Schnorberger, et al., 'The Quest for Marketing Intangibles' (2005) 11(16) *Journal of International Taxation* 28, at 30.

> *customer data that is used or aids in marketing and selling goods or services to customers."*[12]

This definition made clear that the purpose of the marketing intangibles was to sell.

5.4 The creation of marketing intangibles

The two types of marketing intangibles are distinct on this issue. Trademarks can be created with hardly any barrier. Not like a patent, which is usually created through risky and costly research and development, the legal creation of a trademark is not expensive.[13] Compared to a patent, which "gives an exclusive right to use a given invention for a limited period of time", a trademark does not block competition or create an economic monopoly, as competitors can sell the same or similar goods using a different trademark.[14] Though trademarks need to be registered in each country separately for protection, it is usually the parent company (or subsidiaries in low-tax countries in some cases) that registers all the major trademarks, and the subsidiaries in market jurisdictions use them as licensees.[15] Thus, in order to share an appropriate level of taxing rights, it is essential for the market jurisdiction subsidiary or PE to create a second kind of intangible of its own.[16]

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[12] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017), at 27 Glossary; the 2022 Report, above fn 1, at 23 Glossary.
[13] The 1979 Report, above fn 7, para 126.
[14] The 1979 Report, above fn 7, para 126.
[15] For example, the case of Coca-Cola shows that the headquarter owns the trademarks, and the subsidiaries in the market countries uses them as a licensee. See *Coca-Cola Company v. Commissioner*, 149 T.C. No. 21 (2017), at 7.
[16] The OECD applied the same analysis for marketing intangibles presented in the OECD Guidelines to determine which party created marketing intangibles in the "PE" concept. See OECD, *Report on the Attribution of Profits to Permanent Establishments* (2008), para 128.

There is no such event that marks the creation of a second kind of marketing intangible. The OECD's position was ambiguous about it.[17] Without many details from the OECD Guidelines, this part will focus on the clues from the 2010 Guideline to picture the OECD's general position.[18]

5.4.1 Potential ways of creating a marketing intangible: inspired by the trade intangibles

The OECD outlined three kinds of arrangements that might create a trade intangible. Marketing intangibles could potentially be created in similar ways. The OECD provided that:

> *"Trade intangibles often are created through risky and costly research and development (R&D) activities… The developer may perform the research activity in its own name, i.e. with the intention of having legal and economic ownership of any resulting trade intangible, on behalf of one or more other group members under an arrangement of contract research where the beneficiary or beneficiaries have legal and economic ownership of the intangible, or on behalf of itself and one or more other group members under an arrangement in which the members involved are engaged in a joint activity and have economic ownership of the intangible (also discussed in Chapter VIII on cost contribution*

[17] The OECD's elucidation was not helpful: "not all marketing activities result in the creation of a marketing intangible", just like "not all research and development expenditures produce a valuable trade intangible". The 2010 Report, above fn 8, para 6.6.
[18] The other OECD Guidelines hardly provided any more clues: the 1995 and 2010 reports had the same Chapter VI; the 2017 and 2022 Reports focused on the activities that contributed to the development, enhancement, maintenance, protection and exploitation of the intangibles.

> *arrangements). Reciprocal licensing (cross-licensing) is not uncommon, and there may be other more complicated arrangements as well."*[19]

In the first scenario, when a developer researches to create a trade intangible, it bears all the risks and has the legal and economic ownership of any resulting intangibles.[20] Likewise, an entity promoting goods under its own trademark bears all the relevant risks and has the ownership of the potential resulting marketing intangibles, if any. It applies where the market jurisdiction subsidiary or PE register trademarks or creates new brands that only trade in the local market. This scenario is not applicable to market jurisdiction distributors who are licensees.

In the second scenario, the developer of a trade intangible provides intra-group research service under a contract research agreement. In this case, all expenses are reimbursed whether the research is successful or not. The developer does not bear the risk or own the intangible property, legally or economically, deriving from the research. Thus, a cost plus method may be appropriate.[21]

The same treatment applies to marketing activities. The distributor only performs routine marketing services required by the agreement or acts as a risk-less agent where all the marketing expenditures are reimbursed regardless of the success of the products. In this service relationship, the distributor should only enjoy routine profits, possibly on a cost plus basis.[22] Likewise, it will not have legal or economic ownership of the resulting marketing intangibles. In contrast, a distributor who risks its own resources in

[19] The 2010 Report, above fn 8, para 6.3.
[20] Ibid, para 6.3.
[21] Ibid, para 7.41 and 2.55.
[22] Ibid, para 6.37.

performing marketing should receive a higher return than a risk-free agent.[23] However, it does not necessarily indicate that the distributor will be creating a new marketing intangible of its own (see Section 5.5). It often requires the market jurisdiction tax authorities to spend sufficient time analysing the "economics of the transaction", which now referred to as the "accurate delineation of the transaction".[24]

It is worth noting that contract research can be in-depth and frontier, where the developer has the discretion to work within broadly defined categories.[25] If the functions provided by a developer are materially different from what the third party in the comparable transaction has provided, they are likely to be compensated in comparability adjustment.[26] Liken it to marketing activities, a distributor may make an extra effort to provide extensive marketing campaigns, take initials in making marketing campaigns, or tailor marketing campaigns to suit local needs. The additional effort will also be reflected in comparability adjustment.[27]

In the third scenario, a developer does research for himself and one or more other group members under an agreement, such as Cost Contribution Agreements (thereinafter CCAs), and jointly owns the intangibles.[28] Each participant of the CCA is entitled to exploit its interest in the intangible separately as an effective owner, not a licensee.[29] The legal owner may be one or more participants, but economically all the participants are co-owners.[30] The CCAs may not be common in developing marketing intangibles. However,

[23] Ibid, para 1.47.
[24] See Rohan Shah, Ajit Tolani and Ashish Bhatnagar, above fn 10, at 144.
[25] The 2010 Report, above fn 7, para 7.41 and 2.55.
[26] Ibid, para 1.43.
[27] Ibid, para 6.38.
[28] Ibid, para 8.3.
[29] Ibid, para 8.3 and 8.6.
[30] Ibid, para 8.6.

if it is adopted, each party's contribution depends on, inter alia, the contractual terms and economic circumstances, such as sharing of risks and costs,[31] which consequently determines whether a distributor shares the additional profits attributable to marketing intangibles.[32]

These three scenarios arguably suggest that from a distributor's perspective, marketing intangibles can't be developed in the same ways as the trade intangibles. It is not surprising. A trade intangible is developed by research and development activities that have no other purposes, while a second kind of marketing intangible is a derivative of marketing activities. The primary purpose of marketing is not to develop intangibles but to sell. Hence, the research and development will usually have a clear consequence as to whether a new asset is created, while it is difficult to determine whether a second kind of marketing intangible is created through marketing activities.

5.4.2 Key elements of creating a marketing intangible

Although it does not directly depict a scenario in which a distributor may generate marketing intangibles, paragraph 6.7 establishes several crucial factors:

> *"…marketing activities may encompass a wide range of business activities… Some of these activities may not have an impact beyond the year in which they are performed, and so would properly be treated as current expenses rather than*

[31] Ibid, para 8.14.
[32] The CCA can be problematic. See e.g., Antong Ting, 'iTax—Apple's International Tax Structure and the Double Non-Taxation Issue' (2014) 1 British Tax Review. The author discussed how the Cost Sharing Agreement, the US version of CCA, helped shelter tax for Apple Inc.

> *as capitalisable expenditures. Other activities may have both short-term and long-term effect. The treatment of such activities is likely to be important in a functional analysis carried out in order to establish comparability for the purposes of transfer pricing. In some cases, the costs of marketing activities and, with respect to trade activities, R&D expenditures, may be sought to be recovered through the charging for associated goods and services, whereas in other cases there may have been created intangible property on which a royalty is separately charged, or a combination of the two."*[33]

This paragraph did not answer the question but passed on some helpful information:

(1) it was likely to create a marketing intangible when marketing activities had a long-term impact.
(2) the OECD closely linked the creation of marketing intangibles to the marketing expenditure spent.
(3) marketing intangibles were possibly created when the cost of marketing activities might not be covered through charging the associated entities.

It is worth noting that some jurisdictions did not follow closely with these rules while domesticating. For example, the Japanese tax authority believes that the Japanese market is so unique and challenging that a foreign MNE can only succeed in Japan by developing unique marketing insight and know-how at the local entity level. Hence, the Japanese tax authority does not attribute too much profit to foreign-owned trademarks unless local entity has made substantial effort developing it.[34]

[33] The 2010 Report, above fn 7, para 6.7.
[34] See e.g., Toshio Miyatake, 'Japanese Transfer Pricing Taxation' (2008) 34 *Japanese Transfer Pricing Taxation* 21, at 24; Nobuo Mori, 'Recent Transfer Pricing Perspective in Japan – Focus on Marketing

Another example is the US. Marketing intangible was a vigorously debased topic, and it has comparatively matured rules regarding the creation of marketing intangibles.[35] The "bright line" test developed in the trial judge of *DHL case*[36] mark the line of distributor creating marketing intangible of its own. The "bright line" test noted that though every licensee or distributor is expected to expend a certain amount of cost to exploit the items of intangible property provided to it, the investment might be cross the "bright line" of routine expenditure into a realm of non-routine. This is when a marketing intangible is likely created.[37]

Likewise, while domesticating the OECD rules, some jurisdictions did not make effort to share profits through creating marketing intangibles, but through enhancing the value of existing intangibles, such as trademarks. The examples are China (see Section 7.3) and India.[38]

5.4.3 Market penetration

Based on the key elements identified in paragraph 6.7, a likely close situation for distributor to create a marketing intangible of its own is the "market penetration"

Intangibles' 2006/07 (14 September 2006) *Transfer Pricing Review*, at 1; also quoted in Michelle Markham, 'Congruence and Divergence in Transfer Pricing in Australia and Japan: Intangibles and Advance Pricing Agreements' (2009) 15(5) *Asia-Pacific Tax Bulletin* 308, at 310.

[35] See e.g., Marc M. Levy, Monique Van Herksen, Stephan Schnorberger, et al., above fn 11; Marc M. Levy, Monique Van Herksen and Stephan Schnorberger, A Closer Focus on Marketing Intangibles – The Corporate Tax Handbook 2008 (Euromoney Publications, 2008).

[36] *DHL Corporation and Subsidiaries v. Commissioner* (1998) T.C. Memo. 1998-461.

[37] See Mark M. Levy, Lawrence W Shapiro, Robert J. Cunningham, et al., 'DHL: Ninth Circuit Sheds Very Little Light on Bright-Line Test' (2002) 13(10) Journal of International Taxation 10.

[38] See *Maruti Suzuki India Ltd v. Additional Commissioner of Income Tax Transfer Pricing Officer of New Delhi* (2010). In this case, the Indian High Court followed the OECD closely by claiming that the foreign associated entity (the owner of the trademark) benefited from the additional marketing expense spent by the Indian subsidiary in the form of branding building and increased awareness of its brand in the Indian market. Hence, the Indian subsidiary should be compensated for that. Ibid, para 84 ix.

strategy. Market penetration is a business strategy MNEs can choose to penetrate a market or increase its market share for long-term benefits. In this case, the enterprise is willing to temporarily charge a price lower than the market price or incur a higher cost for a short period.[39] The distributor undertakes market development activities and spends enormous promotional expenditure at an early stage, which has a long-term influence. Suppose the distributor bears the risk of the activities as well as the expenditures, it fulfilled the requirements outlined in paragraph 6.7.[40] However, no additional asset separated from the trademark can be identified: no customer list, no customer relationships, no customer data or any other defined second kind of intangibles outlined by the OECD.[41] Likely, the OECD would only allow comparability adjustment:

> *"For example, in arm's length transactions a company acting solely as a sales agent with little or no responsibility for long-term market development would generally not bear the costs of a market penetration strategy. Where a company has undertaken market development activities at its own risk and enhances the value of a product through a trademark or trade name or increases goodwill associated with the product, this situation should be reflected in the analysis of functions for the purposes of establishing comparability."*[42]

This treatment has problems in both accounting and taxation:

[39] The 2010 Report, above fn 8, para 1.60.
[40] Ibid, para 6.7.
[41] The market penetration strategy will likely result in a market intangible created in the US by the US distributor because it may have crossed the "bright line" set up in the trial judge of *DHL Corporation and Subsidiaries v. Commissioner* T.C. Memo. 1998-461. See Section 5.4.2.
[42] The 2010 Report, above fn 8, para 1.62. This paragraph provided that this situation would be reflected in the functional analysis, which was before the most appropriate method is chosen, indicating the PSM might be the most appropriate method. This issue will be addressed in the next chapter.

For accounting purposes, market penetration creates no intangible assets for capitalising expenditures. The expenditures will all have to go to the profit and loss account. The timing of incurring the expenditures and generating the profits do not match, which would make unnecessary waves of profit and loss.

For taxation purposes, the comparability adjustments hardly reflect the licensee's effort and expenditure at the early stage. The 1979 Guideline assumed that neither the licensee nor the licensor would be alone in market penetration: "...both producing and marketing entities may combine in such an operation, splitting the risk and sharing the profitable outcome, if any, in some way between them."[43] The parties would share the risks and split the profits, which was equivalent to a PSM. The 2010 Guideline recognized that it was possible for manufacturer or distributor to perform market penetration alone.[44] If the licensee undertakes market penetration alone, presumably, it should expect more relevant future economic benefits. However, in the absence of a marketing intangible, the licensee can't secure future profits.

This is not a new issue, and it was not uncommon for brand or trademark owners to take "free ride" on unrelated distributors. For example, the German company Adidas was the legal owner of the Adidas brand name. Its Japanese distributor Descente was an unrelated company that has been manufacturing and selling Adidas-brand products in Japan for a fee since 1960s. Operating in Japan for more than 28 years, Descente invested significant amounts in developing the Adidas brand in Japan and developed products specifically for the Japanese market to be sold under the Adidas brand. After 28 years, Adidas terminated

[43] The 1979 Report, above fn 7, para 43.
[44] The 2010 Report, above fn 8, para 1.62.

the licensing contract and stripped the brand value, which Descente developed.[45] The US wine distributors also suffered brand value stripping in the 1990s. For example, the US entity Carillon Importer Ltd. lost its distribution rights of a Swedish vodka brand, Absolute, in 1994, which Carillon had been exploiting for many years. Absolute subsequently licensed a new US distributor with the brand value developed by Carillon.[46] Back then, the US was experiencing significant tax reform (See Section 6.3), and the 1994 version Section 482 provided that a full-fledged distributor with long-term exclusive right to distribute products under a tradename was deemed to be the owner of the trademark under Section 1.482(f)(3)(ii)(A).[47] This position was revised in 2006,[48] as the specific circumstances changed in the US.

Indeed, the market penetration strategy increases the value of the licensing agreement, which is a separate intangible asset.[49] But one would reasonably expect the agreement to be greatly impaired if it is sold halfway to a different party. Further, the licensing agreement has a pre-determined contract period. The licensee is entitled to the residual profits that match the effort and expenditures it spent during the period. Still, it will end someday. When the agreement expires, the licensor will have the choice of extending it or moving on to use a different entity performing marketing functions. The trademark,

[45] See Nikkei Business Report, "Cross-Purposes in the Global Strategies of Brand-Name Companies Expose the Limits of Licensing -- Why a Successful Descente Was Cut Off by Germany's Adidas," (23 February 1998) (English translation). Also quoted in Gregory J. Ossi, 'The Significance of Intangible Property Right in Transfer Pricing' (1999) 19 *Tax Notes International* 994, at 1007.
[46] New York Times, 'Carillon Importers Selects Margotes' (31 March 1994) Section D, page 18. Also quoted in Gregory J. Ossi, 'The Significance of Intangible Property Right in Transfer Pricing' (1999) 19 *Tax Notes International* 994, at 1007.
[47] 26 CFR § 1.482-4(f)(3)(ii)(A) (T.D. 8552 1994-2 C.B. 93)
[48] T.D. 9278, 71 FR 44484, Aug. 4, 2006. The regulations in 2009 (T.D. 9456, 74 FR 38842, Aug. 4, 2009) introduced the test of "control", providing that the ownership of an intangible asset not legally protected should be determined by "control". Also see Marc M. Levy and Brian P. Arthur, 'The High Court in India Relies on OECD Approach for Marketing Intangibles in the Maruti Suzuki Case" (2010) 12(38) *Intertax* 672, at 673 to 674.
[49] The OECD provided that "for the purposes of this chapter, the term "intangible property" includes rights to use industrial assets such as patents, trademarks, trade names, designs or models." See ibid, para 6.2.

which holds the accumulated value from the previous work of both parties, will be left to the licensor. On the other end of the spectrum, the licensee will stop sharing the benefits arising from the trademark once it stops being the marketer. The most extreme case would be the licensor explored the market all by itself: performed functions, used assets, and assumed risks. It consequently enjoyed the most or all the benefits arising from the trademark during the contract period. When the licensing agreement ended, the MNE decided to re-assign the marketing function to another entity. The licensor, who did nothing but register a trademark in the market jurisdiction, entered into the new licensing agreement with the contribution of a valuable trademark.

The post-2017 Guidelines, in which the economic ownership was emphasised, did not make any improvement.[50] Paragraph 6.42 provided that in a case of an internally generated intangible, the legal owner would not be entitled to any portion of the returns attributable to the intangible if it was merely the title holder performing no relevant function, using no relevant assets, and assuming no relevant risks. Yet, OECD did not specify what would happen if the MNE terminated the nexus between the relevant parties and the legal owner entered into a new agreement with another party. An accurate delineation of the second transaction would not show the intangible's economic owner from the first transaction. The intangible was thus "washed clean" with the new agreement.

The market penetration strategy is a close example that a licensee can potentially create a second kind of marketing intangible. The failure shows that the defined types and categories of marketing intangibles included in the OECD Guidelines are still minimal,

[50] The 2017 Report, above fn 12, para 6.42; the 2022 Report, above fn 1, para 6.42.

arguably not meeting the economic reality. Likewise, the rules are too stringent for distributors to create marketing intangibles of their own.

5.4.4 Summary

Under the current ALP, owning intangibles is almost the only way to guarantee the enduring sharing of residual profits. The traditional interpretation of the ALP fails to allocate profits to the sales jurisdiction, resulting in a short-term reward for the exploitation of the other party's marketing intangibles, such as trademarks. To secure long-term advantages, the market jurisdiction distributors will need to own local marketing intangible.

However, MNEs operate as single enterprises from all stages through to final sales and any actions taken by the final distributors are directed by the larger MNE for its overall benefit, despite the arm's length principle assuming the 'deeming myth' of separate entities. It is often not in the MNE's best interests to allow a market jurisdiction distributor to own a marketing intangible.

This thesis argues that it is challenging for market jurisdiction distributors to acquire their own marketing intangible. This often depends on the details of the licensing agreement, which is made under the direction of the MNE headquarters. To maximise overall profit, an MNE may structure distributors as low-risk entities that do not share the residual profits.[51] The limited types of defined marketing intangibles also restrict

[51] The good news is that in the post-2010 reports, the contractual assignment of risks will only be respected when it has economic substance. See The 2010 Report, above fn 8, para 9.12. However, it is still to a very large extent rely on the tax authorities to challenge the contracts.

distributors from creating their own marketing intangibles. While distributors may engage in market penetration activities and exploit trademarks, no separate asset is created for their long-term benefit.[52]

5.5 Enhance the value of the licensing marketing intangibles

If the distributor is unable to create a marketing intangible of its own, the second-best choice is to get involved in activities that enhance the value of the existing marketing intangibles, e.g. trademarks.

The pre-2017 Guidelines were ambiguous in terms of what activities would enhance the value of intangibles. The OECD had various lists and examples for different types of intangibles, which increased the difficulties of summarizing the rules that apply to all. Before the DEMPE activities were introduced in the 2017 Guideline,[53] the OECD generally accept that exploitation of intangibles might enhance their value. The Oxford Dictionary defines "exploit" as "to use something well in order to gain as much from it as possible" or "to develop or use something for business or industry".[54] The OECD presented this concept in the 2010 Guideline as something distinguished to "use".[55] The 2017 Guideline provided "exploitation of an intangible includes both the transfer of the intangible or rights in the intangible and the use of the intangible in commercial operations."[56] This

[52] The 2010 Report, above fn 8, para 6.38.
[53] The 2017 Report, above fn 12, para 6.12.
[54] see <https://www.oxfordlearnersdictionaries.com/definition/english/exploit_1?q=exploit>, accessed on 3 November 2022.
[55] Paragraph 9.85 provided that "The determination of an arm's length remuneration for the subsequent ownership, use and exploitation of the transferred asset should take account of …" in which "exploitation" and "use" are two different concepts. See The 2010 Report, above fn 8, para 9.85.
[56] The 2017 Report, above fn 12, at 257 footnote 3.

part looks into the details of what activities can distributors do to enhance the value of the licensing marketing intangibles.

5.5.1 The 1979 Guideline

A new trademark or an existing trademark introduced into a new market may have no value or little value.[57] The value of the trademark changes over time:

> "It will very often be an expensive business to give it a value and to ensure that the value is maintained or increased-intensive and costly advertising campaigns will ordinarily be necessary and so will expenditure, which may well be considerable, on the control of the quality of the trademarked product…"[58]

The above quote mentioned two types of costs: advertising and quality control, which represented the contributions by the licensee and the licensor, respectively. The OECD provided:

> *"The licensing of a trademark is nearly always coupled with efforts by the licensor to keep the image of the product up-to-date and with a strict control of the quality of the product … On the other hand, the licensee would often be expected to co-operate in promoting the trademark for the common benefit and to take account of trends in consumer attitudes. Because co-operation between*

[57] The 1979 Report, above fn 7 para 136.
[58] Ibid, para 126.

> *licensee and licensor is a feature of trademark licensing, it will therefore affect the nature and amount of payments made under the relevant contracts."*[59]

In the above quote, the OECD set the scene of when the licensee increases the value of the licensing intangible through exploitation. This is an interesting position that the value of a trademark, a pre-registered marketing intangible, depends on the cooperation of two parties. In a licensing agreement, the licensor and the licensee of the trademark are expected to cooperatively exploit the trademark and mutually benefit from the exploitation. The licensee promotes the trademark for the common benefit and takes account of trends in consumer attitudes, while the licensor keeps the image of the product up-to-date and performs quality control to endorse the marketing.[60] The marketing function provided by the licensee may benefit both parties, including the licensor.[61] The obligation performed, and the expenditure spent shall match the expected benefits.[62] Therefore, when the value for the licensor increases due to the "efforts and expenditure" by the licensee, the licensee shall be subsidised.[63]

The OECD did not specify how to measure "efforts", but "expenditure" in this context clearly referred to the marketing cost. Likely, the OECD did not specify how and when the licensee's efforts and expenditure might increase the value for the licensor. A reasonable guess would be when the licensee outperformed the independent third party in a

[59] Ibid, para 133.
[60] Ibid, para 133.
[61] This issue is considered in some jurisdictions when domesticating the OECD rules. For example, one of Australia's key matters in determining a distributor's remuneration is "the extent to which the marketing activities would be expected to benefit the owner of the trade name and/or the marketer". See ATO, Marketing Intangibles - Examples to show how the Tax Office will determine an appropriate reward for marketing activities performed by an enterprise using trademarks or trade names it doesn't own (2005) NAT 14586-11.2005, available at <https://www.transferpricingsolutions.com.au/backup/resources/Guide-4-Marketing-intangibles.pdf> accessed on 5 June 2023, at 3.
[62] The 1979 Report, above fn 6, para 136.
[63] Ibid, para 136.

comparable transaction or outperformed the contract obligations. The OECD also did not specify how the licensee would be rewarded, but they recommended adopting a CUP method in arriving at the arm's length price.[64] Therefore, it is highly likely to be adjusted in comparable adjustment.

The transfer pricing analysis of this issue in the 1979 Guideline seemed to be more friendly to the licensee than the subsequent Guidelines. It highlighted the analysis of the costs and savings of both parties to determine an arm's length price:

> *"In arriving at the arm's length price for the right to use a trademark or trade name… it is necessary to assess all the obligations implied by the licensing agreement and the likely costs to be incurred or saved by both parties… it will not be very useful to refer to the costs of developing the trademark as a foundation… whereas it may well be relevant to regard to the costs of maintaining the value of the trademark, including the cost of advertising and quality control…"*[65]

In conclusion, under the 1979 Guideline, a licensee's extra efforts and expenditure would only be reflected in the comparable adjustments. However, the transfer pricing analysis assessed both parties' contributions. Where the extra efforts and expenditures by the licensee were extensive, it was possible for the distributors, consequently the market jurisdictions, to share residual profits as a licensee.[66] At the other end of the spectrum,

[64] Ibid, para 137.
[65] Ibid, para 137. The BEPS Project brought this position back to the table. In the 2022 Report, functional analysis includes "accurate delineation of a transaction", which requires both sides of the controlled transactions to be analysed irrespective of which transfer pricing method is ultimately found to be the most appropriate method. See The 2022 Report, above fn 1, para 2.125.
[66] To maintain the hierarchical structure, the 1979 Report was not strict on the comparability adjustment, so that the adjustments could be massive. Chapter 5.1 discusses this matter.

the "efforts and expenditure" were primarily judged by marketing expenses.[67] A licensee reimbursed for the marketing expenses would not benefit the trademark in any way.

5.5.2 The 1995 Guideline and the 2010 Guideline

The 2010 Guideline inherited the view from the 1979 Guideline that the value of trademarks was a result of the joint work of the licensee and licensor:

> *"The legal creation of a new trademark (or one newly introduced to a given market) is usually not an expensive matter. In contrast, it will very often be an expensive business to make it valuable and to ensure that the value is maintained (or increased). Intensive and costly advertising campaigns and other marketing activities will ordinarily be necessary as will expenditure on the control of the quality of the trademarked product. The value and any changes will depend to an extent on how effectively the trademark is promoted in the markets in which it is used. Value will also depend on the reputation of the owner for quality in production and rendering of services and on how well this reputation is maintained. In certain cases, the value for the licensor may increase as the result of efforts and expenditure by the licensee. "*[68]

[67] The US has made this point clear through the "bright line" test that the distributor's remuneration is depend on the level of advertising, marketing and promotion (usually referred to as the AMP) expenditure it spent. See Section 5.4.2.

[68] The 2010 Report, above fn 8, para 6.9. This paragraph was a selective combination of paragraph 126, 127, 133 and 136 of the 1979 Report with only minor changes.

It was worth noting that this position only applied to trademarks. The OECD provided another list of indicators that applied to both kinds of marketing intangibles. It included marketing expenditures, quality control and more:

> *"… the reputation and credibility of the tradename or the trademark fostered by the quality of the goods and services provided under the name or the mark in the past, the degree of quality control and ongoing R & D, distribution and availability of the goods or services being marketed, the extent and success of the promotional expenditures incurred in order to familiarize potential customers with the goods or services (in particular advertising and marketing expenditures incurred in order to develop a network of supporting relationships with distributors, agents, or other facilitating agencies), the value of the market to which the marketing intangibles will provide access, and the nature of any right created in the intangible under the law."*[69]

The above paragraphs divided the indicators into three categories:

- The expenditures and efforts mainly provided by the licensor, such as the reputation of the trademark.
- The expenditures and efforts mainly provided by the licensee, such as the distribution and availability of the goods.
- The quality of the market, such as the value of the market.

It was surprising that the OECD included "the value of the market" as an influencing factor. The marketing intangible in this case might referred to either trademarks, which need to

[69] The 2010 Report, above fn 8, para 6.4.

be registered for entering into a new market, or tradeable "market access" that provide access to industries with entry barrier.[70] The higher quality the market has, the more the associated marketing intangibles worth. For instance, if Coca-Cola decided to sell its trademark in a couple of countries, the one registered in China will certainly be worth more than the one registered in Luxemburg. This is because the size and quality of the two marks are distinct. This position strengthened the links between the market and the trademark.

The next issue is the treatment of the outperforming distributors. The 2010 Guideline inherited the logic from the 1979 Guideline that when a licensee outperformed in marketing, both parties would benefit. The additional "efforts and expenditure" increase the value for the licensor. Consequently, they would most likely be compensated in comparability adjustments:

> *"For example, a distributor may have the ability to obtain benefits from its investments in developing the value of a trademark from its turnover and market share where it has a long-term contract of sole distribution rights for the trademarked product. In such cases, the distributor's share of benefits should be determined based on what an independent distributor would obtain in comparable circumstances. In some cases, a distributor may bear extraordinary marketing expenditures beyond what an independent distributor with similar rights might incur for the benefit of its own distribution activities. An independent distributor in such a case might obtain an additional return from*

[70] The tradable "market access" permissions are intangible assets because they are entity-specific advantages that can be owned or controlled. See the 2022 Report, above fn 1, para 6.6. The ones that are not tradable are a kind of location-specific advantage that should be considered in comparability adjustments. See Chapter 6.

> *the owner of the trademark, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate."*[71]

The example described a situation very similar to market penetration, in which the licensee enhanced the value of the trademark.[72] The OECD suggested the additional return allocated to the licensee could be realised through "a decrease in the purchase price of the product or a reduction in royalty rate".[73] The form of reward would be determined based on the specific circumstances of the controlled transaction and, more importantly, the presence of comparable uncontrolled transaction. When reliable comparable transactions were available, and the licensee performed better than the comparable party in those transactions, the OECD suggested marketing comparability adjustments. However, if reliable comparable transactions were not available, such as when the trademark is unique and valuable, and consequently, the enhancement of the trademark was also unique and valuable, the PSM would likely to be the most appropriate transfer pricing method.

In theory, the licensee would share a portion of residual profits through both comparability adjustments and a profit split. These two approaches should have similar results, but the market jurisdictions would prefer a profit split over comparability adjustments. This is because the PSM not only assesses contributions made by both parties of a controlled transaction, but also takes the group synergies into consideration

[71] The 2010 Report, above fn 8, para 6.38. It was reinforced by paragraph 1.62, but paragraph 1.62 did not preclude the triggering of the PSM. See Chapter 5.2 for details.
[72] Another example was the landmark case involving marketing intangible in India: *Maruti Suzuki India Ltd v. Additional Commissioner of Income Tax Transfer Pricing Officer of New Delhi* (2010). See above fn 38.
[73] The 2010 Report, above fn 8, para 6.38.

(see Chapter 6.2). Hence, the market jurisdictions would benefit the most from profit splits.

5.5.3 The 2017 Guideline and the 2022 Guideline

The pre-2017 Guidelines generally respected the legal ownership and were ambiguous about when the value of the licensing intangibles would increase.[74] The post-2017 Guidelines significantly reduced the importance of "ownership". It identified every little DEMPE contribution that might enhance the value of the intangibles and allocate profits accordingly:

> *"…the ultimate allocation of the returns derived by the MNE group from the exploitation of intangibles, and the ultimate allocation of costs and other burdens related to intangibles among members of the MNE group, is accomplished by compensating members of the MNE group for functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles."*[75]

A party would be compensated with "all or a substantial part of the return anticipated to be derived from the exploitation of the intangible" if it performed and controlled functions, provided assets, or assumed risks related to the DEMPE and created value for

[74] The tax professionals criticised that the post-BEPS OECD Guidelines were vague about when and under what circumstances a distributor can be said to contribute towards a unique and valuable marketing intangible, such as a trademark. See e.g., Rahul K. Mitra, 'Need to Revisit and Amend OECD Guidelines on Marketing Intangibles' (2023) 30 (1) *International Transfer Pricing Journal* 21; Alissa Fedi, 'Transfer Pricing Aspects of Transactions with Marketing Intangibles in a Post-BEPS World' (2019) 26 (6) *International Transfer Pricing Journal* 407.
[75] The 2022 Report, above fn 1, para 6.32.

the intangibles.[76] Legal ownership alone would not confer any right to retain the profits attributable to the intangible assets.[77] Also, like the 2010 Guideline, the ownership was not solely determined by contract. It started with the contractual term but landed on the economic substance. The parties' actual conduct needs to be consistent with the contractual arrangement. If not, "the actual transaction must be deduced from the facts as established, including the conduct of the parties".[78]

The 2022 Guideline used the same example from the 2010 Guideline discussed in Section 5.5.2, but the treatment was slightly different.[79] Where a distributor has a long-term contract providing sole distribution rights, it might be able to obtain benefits from its investment in developing the value of a trademark from its turnover and market share.[80] The more it sells, the more it earns.[81] The 2010 Guideline suggested that if a distributor spent more marketing expenses than the independent distributor in comparable circumstances, it would be compensated through "a decrease in the purchase price of the product or a reduction in royalty rate",[82] meaning the adjustments only made at the comparability level.

However, the 2017 and 2022 Guidelines clearly put the PSM on the table. They provided that if the distributor performed functions, used assets or assumed risks that exceed those of an independent distributor with similar rights, it might be compensated through,

[76] Ibid, para 6.71.
[77] Ibid, para 6.42.
[78] Ibid, para 6.36.
[79] Ibid, para 6.78; The 2010 Report, above fn 8, para 6.38.
[80] In the 2017 Report, instead of "investments", the term used was "functions performed, assets used, and risks assumed". See the 2017 Report, above fn 12, para 6.78.
[81] This was further illustrated in examples 8 and 9. The 2022 Report, above fn 1, at 473.
[82] The 2010 Report, above fn 8, para 6.38.

inter alia, "a share of the profits associated with the enhanced value of the trademark or other marketing intangibles".[83]

The post-2022 Guidelines also introduced the concept of "important functions" to highlight the functions that would be considered DEMPE.[84] Marketing could be an important function if it made a significant contribution to intangible value.[85] Ironically, the distributors or marketers might not be the parties that "perform" the marketing function. In the case of a self-developed platform for marketing purposes, the party strategically controlled and managed the platform would perform important functions to the intangible:

> *"For self-developed intangibles…serve as a platform for further development activities, these more important functions may include, among others, design and control of research and marketing programmes, direction of and establishing priorities for creative undertakings including determining the course of "blue-sky" research, control over strategic decisions regarding intangible development programmes, and management and control of budgets."*[86]

The MNEs often centrally manage the marketing campaigns by the headquarter, with the local teams further customising them to suit local needs. For example, the Coca-Cola

[83] The 2022 Report, above fn 1, para 6.78. it was also illustrated in example 10, at 474. The pre-2017 reports did not rule out the PSM for this situation, but because Chapter II and VI were reformed at different times, there were mismatches and ambiguous wordings, such as the present. Chapter II of 2010 Report, which was reformed and amended first, indicated that any method could be the most appropriate method, including the PSM, but Chapter VI did not include consistent wording reflecting this position. The post-2017 reports made it consistent throughout the reports that PSM was one of the choices for this situation.
[84] The 2022 Report, above fn 1, para 6.56 to 6.58.
[85] Ibid, para 6.56.
[86] Ibid, para 6.56.

company has a platform that collects marketing ideas from local marketing teams worldwide. Some of them may be chosen as global campaigns and promoted globally. Though the local service teams contribute the ideas, they are paid on a cost plus basis with renewable one-year contracts.[87] The platform as an intangible asset is managed by the headquarter.[88] In this way, the local teams scarcely provide any important marketing function to the intangibles (see Chapter 9).

5.5.4 Summary

The distributors, consequently, the market jurisdictions, are able to share residual profits by performing DEMPE functions, and they could be compensated through all kinds of ways, including the PSM. However, the OECD Guidelines did not provide enough details regarding when and what kind of activities performed by the distributors would consider DEMPE activities that enhance the value of the trademarks. Likewise, the concept of "control" of the marketing activities left a backdoor for the MNEs to allocate marketing functions and profits out of market jurisdictions artificially. Without marketing intangibles on hand, the distributors still suffer from being structured as risk-free distributors in one way or another. Hence, the market jurisdictions are not allocated an appropriate level of taxing rights over the profits arising from them.

[87] *Coca-Cola Co. v. Commissioner,* above fn 15, at 50.
[88] Ibid, at 31

5.6 The relationship between markets and marketing intangibles

It is observed that a distributor (subsidiary or PE in market jurisdiction) can create an intangible asset of its own, but the chances are minimal, and it is mostly out of its control. In other words, the trademarks and other marketing intangibles arising from a market are likely to be owned or controlled by offshore entities, just like the trade intangibles. Nevertheless, connections between a market and its marketing intangibles are real. A trade intangible may have similar value across markets, but most marketing intangibles only work well in a particular market. A well-established trademark in one market may worth nothing in another. Similarly, a second kind of marketing intangible, such as a customer list, can hardly be used in another market. These marketing intangibles are worthless once separated from the relevant markets.

The marketing intangibles are nothing but devices that help the MNEs to sell in a particular market. Hence, customers are essential in enhancing the value of the marketing intangibles. For instance, the value increase of the trademarks is a joint work of the licensee and the licensor.[89] All the work, regardless of who was the performer, needs to connect to the customers, meaning the value of a trademark generally depends on the customers' impression. The value of the markets may also influence the value of the marketing intangibles, such as trademarks. The China vis Luxemburg example discussed earlier reinforced the intrinsic link between the trademark and the market it trades in. Likewise, the value of a second kind of intangible, such as a customer list or customer data, comes from the study of customers. Hence, the marketing intangibles can't be separated from the relevant market.

[89] The 2010 Report, above fn 8, para 6.4.

This part discusses the developments of the OECD's opinion regarding the nexus between the markets and the marketing intangibles arising from them.[90]

5.6.1 The 1979 Guideline

The OECD did not deny the nexus between the market, the customers, and the marketing intangible. Figuring out how they connect seems to touch on the fundamental marketing principle in terms of how exactly does marketing work. However, what's important for transfer pricing purposes is whether the value of marketing intangibles, such as a trademark, deviates in different markets and whether the nature of markets contributes to the differences. The OECD admitted that, among other things, the value of the market was a factor that determines the value of the marketing intangibles:

> *"The value of the trademark in a particular country depends upon the nature of the legal right created under that country's law, upon the extent and success of the promotional expenditure incurred in order to implant the goods or services in the minds of potential customers … upon the value of the market to which it will provide access (emphasis added)."*[91]

The OECD also provided that the trademarks were mostly used at the consumer market level.[92] The value of the trademark changes as it "makes an impression on the market (or perhaps loses its impact)"[93] through promotional expenditure that "implant the goods or

[90] Many academics have explored this issue, see e.g., Xiaorong Li, 'A Potential Legal Rationale for Taxing Rights of Market Jurisdictions' (2021) 13(1) *Word Tax Journal* 21, at 56; Rohan Shah, Ajit Tolani and Ashish Bhatnagar, above fn 10; Michelle Markham, above fn 34.
[91] The 1979 Report, above fn 7, para 127.
[92] Ibid, para 129.
[93] Ibid, para 136.

services in the minds of potential customers".[94] The intrinsic link between the trademark and markets exists, regardless of who funds the marketing campaigns or who is the legal owner of the trademark.

5.6.2 The 1995 Guideline and the 2010 Guideline

The positions of these two Guidelines were incoherent.

On the one hand, it inherited the position from the 1979 Guideline regarding the connection between the markets and the marketing intangibles arising from it. It kept most of the lines quoted above with only minor changes. For example, the 1979 Guideline provided the value of marketing intangibles depends upon "…promotional expenditure incurred to implant the goods or services in the minds of potential customers",[95] while the 2010 Guideline used a different expression with similar meaning that "…the promotional expenditures incurred to familiarize potential customers with the goods or services".[96]

On the other hand, it allowed the marketing intangibles to be freely transferred to foreign entities.[97] The connection between a market and its marketing intangibles is undeniable. Yet not the market but the local entities own the intangibles and participate in the profit allocation. When the ownership lowers to the entity level, the connection is not as strong because foreign entities may perform functions, use assets, or assume risks to the

[94] Ibid, para 127.
[95] Ibid, para 127.
[96] The 2010 Report, above fn 8, para 6.4.
[97] Ibid, para 9.89, 9.90.

intangible assets (but other markets can't). So, it wasn't surprising that the 2010 Guideline allowed locally developed marketing intangibles to be transferred to associated foreign entities, just like the trade intangibles, and restructure the full-fledged local distributor into a limited-risk distributor. Once transferred, the market jurisdiction bred the marketing intangible lost the chance to share residual profits for good. However, considering their connections with the market, shall the transfers be limited in a way, for example, to local entities only?

5.6.3 The 2017 Guideline and the 2022 Guideline

In these two Guidelines, the OECD did not emphasize the specialties of the marketing intangibles and the connections they had to the relevant markets. Instead, the OECD tried to find a practice that fit all intangible assets. It pointed out that the approach for determining arm's length prices did not deviate in cases involving different kinds of intangibles, including trade intangibles and marketing intangibles.[98] It meant that the OECD emphasized "intangible" rather than "market" for "marketing intangible". Hence, the Guidelines still allowed locally developed marketing intangibles to be freely transferred to foreign entities.[99]

5.7 The marketing intangibles vs location specific advantages

[98] The 2022 Report, above fn 1, para 6.15, 6.16.
[99] Ibid, para 9.64, 9.65.

Marketing intangibles are unique. Unlike the trade intangibles that result from serious expensive research and development activities, the marketing intangibles are either free to create (trademarks) or derivatives of marketing activities (e.g., customer lists). The consequence of research and development is evident whether the activities have created a trade intangible, so the relevant expenditures and costs can be capitalized. However, the purpose of marketing activities is to sell. It is ambiguous whether a marketing intangible has arisen from marketing activities.

Marketing intangibles should bring tax revenue to market jurisdictions due to the unbreakable connection they have to the markets that bred them (see Section 5.6), but in practice, it can be challenging for the distributors to share a portion of residual profits (see Sections 5.4 and 5.5). The dilemma arises because a country or a market can't participate in the profit allocation. The entities do. When the analysis is lowered to the entity level, the market jurisdictions may not enjoy the profits attributable to marketing intangibles at all.

If marketing intangibles are entity-level market advantages, the location-specific advantages (hereinafter LSAs), such as market premium and household purchasing power, are market/jurisdictional-level advantages. Limited by the practice of the ALP, the LSAs are only reflected in the comparability analysis in limited cases.

The marketing intangibles (entity level market advantage) and the LSAs (jurisdictional level market advantages) should both bring benefit to market jurisdictions. However, under the current ALP, neither of them fulfilled their purposes.

5.7.1 The limited practice of the LSAs: market isolation

The ALP we use today has an important underlying assumption that the markets are isolated. Chapter 2 discussed an example that businesses can sell high-quality tuna at a premium price in Japan due to market preference.[100] The preference for high-quality tuna is a feature that most Japanese share, so any comparable local transactions tell the same story: the premium price is fair. The additional profits that arise in Japan shouldn't be allocated to Japanese market. Only when a non-local comparable is adopted in transfer pricing analysis, which the OECD doesn't recommend, the market preference will be considered in comparability adjustment, and the premium may be allocated to Japan. Likewise, cheap labour, strong purchasing power, and the other LSAs that are positively contributed by a market are ignored in many cases.

Following this assumption, transfer pricing analysis discusses the "market advantages" or "competitive advantages" that an intangible asset is expected to bring to the entity.[101] The ALP primarily awarded licensees when they performed better than the comparable parties in uncontrolled transactions, or in other words, had "market advantages" over their equivalents. These rules create ironic scenarios, such as an entity from a third country (other than the country that owns the trademark or the distributor's country) owns a marketing intangible that gives it "market advantages" over all local distributors, although the entity has never actually performed any marketing activities in that country.

[100] See Chapter 2 of this thesis, at fn 51.
[101] For example, paragraph 6.118 regarding the exclusivity of intangibles and paragraph 6.122 regarding the useful life of intangibles. The 2022 Report, above fn 1.

5.7.2 The failure of marketing intangibles: entities-specific market advantages

Another defect the current ALP has is undertaking transfer pricing analysis at the entity level. The criticize not only apply to the separate legal entity doctrine that ignores the group benefits but also the market advantages or intangibles that need to be owned by a specific entity. For example, in the 2017 Guideline, the OECD pointed out clearly that an intangible needs to be owned or controlled for use in commercial activities.[102]

It may work for the trade intangibles but not so much for the marketing intangibles.[103] The nexus between the markets and the marketing intangibles arising from it is prominent, but when it lowers down to the entity level, it fatigues. The nexus breaks when these intangibles are transferred overseas. The OECD needs to realize that the allocation of international taxation rights is a state play. The athletes competing in the international taxation area are not the entitles or the groups but the countries. Unfortunately, as long as the trademark, which is the origin for all marketing intangibles may be owned by foreign entities, there is no better way to solve this problem.

5.8 Potential strategies for maximizing the efficacy of marketing intangibles

[102] Ibid, para 6.6.
[103] The location-specific advantages are not intangibles because they are features of a particular market, not able to be owned or controlled by a specific entity. It will be addressed in Chapter 6. See ibid, paras 6.9 and 6.31.

Chapter 5

It is observed and discussed in the previous chapters that:

(1) Market jurisdictions are presently entitled to insufficient share of profits than they should be (Chapter 2).

(2) Formulary apportionment is currently impractical, leaving the ALP as the only viable approach (Chapter 3).

(3) Despite the inherent connection between marketing intangibles and markets under the ALP, market jurisdictions are not gaining sufficient benefits from these intangibles (Chapter 5).

This thesis argues that the ALP interpretation should treat the marketing intangibles in a way that is consistent with the observation, making them proxies o as to assist marketing countries to enjoy the equitable share of profits. This is preferable to treating marketing intangible in profit allocation in the same way as trade intangible.

There are several ways to “activate” marketing intangibles for the market countries to share residual profits under the ALP. One approach is to keep all the past year’s documents associated with a marketing intangible and work out the economic ownership percentage for everyone who has exploited it. In this way, the distributors will share residual profits attributable to the trademark it exploited in the long run. The thesis proposal is a minor change to the current OECD Guidelines, but it will significantly increase the compliance cost and overall administrative burden.

The second approach is to treat a full-fledged distributor as the economic owner of a foreign trademark. This approach is similar to the 1994 version US Section 482. Under Section 1.482-4(f)(3)(iv) Example 4[104], when a full-fledged distributor concludes a long-term exclusive right to distribute products under a tradename, its conducts indicate the existence in the substance of an agreement that all or part of the legal ownership has transferred to the distributor, the distributor is deemed to be the owner of the trademark under Section 1.482(f)(3)(ii)(A).[105] This position was revised in 2006,[106] but the market jurisdictions may borrow the idea in their domestic laws to prevent the profits from being shifted to the location of the trademarks or trade names.

However, none of the above approaches solves the problem when the MNE is highly digitalised and does not have a physical presence in the market jurisdiction. International tax policymakers may potentially improve these two strategies by adopting the suggestions made in Section 4.4 of this thesis, namely using "sales" to build nexus between income and markets or viewing the activities such as marketing and displaying that aim to sell in the same way or as a bundle with the sales activities.

The last approach is to view the trademarks and trade names deemed to have been created in the market jurisdiction. This approach is similar to the "marketing intangibles" proposal the OECD put up in 2019,[107] under which all marketing intangibles, rather than the trademarks only, are deemed to have been created in the market jurisdiction. The

[104] 26 CFR § 1.482-4(f)(3)(iv) Example 4 (T.D. 8552 1994-2 C.B. 93) Examples 2 to 4 were the well-known "cheese examples".
[105] 26 CFR § 1.482-4(f)(3)(ii)(A) (T.D. 8552 1994-2 C.B. 93)
[106] T.D. 9278, 71 FR 44484, Aug. 4, 2006. The regulations in 2009 (T.D. 9456, 74 FR 38842, Aug. 4, 2009) introduced the test of "control", providing that the ownership of an intangible asset not legally protected should be determined by "control". Also see Marc M. Levy and Brian P. Arthur, 'The High Court in India Relies on OECD Approach for Marketing Intangibles in the Maruti Suzuki Case" (2010) 12(38) *Intertax* 672, at 673 to 674.
[107] OECD, *Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy* (2019), part 2.2.2.

logic behind it was unarguable: the marketing intangibles have intrinsic links to the markets.[108] The trademarks' value generally depends on the impression of the customers (see Chapter 5.6), and the second kind of marketing intangibles is the result of studying the markets, such as a distribution channel, or the customers, such as a customer list. They are the joint works of the marketing team and the market.

However, offshore teams can undertake marketing functions in the digital age. Artificially reallocating all marketing intangibles to the market jurisdiction represented a different kind of unfairness: it disregarded the possible effort and expenditures made by the offshore group members. Artificially reallocating the trademarks and trade names to the market jurisdictions, rather than all marketing intangibles, will better reflect the economic reality. When an offshore team perform marketing functions to some extent, the existing practice regarding marketing intangibles will apply to them (See Sections 5.3 to 5.5). They will share a portion of residual profits in the short run, and the market jurisdictions, as the owner of trademarks and trade names, will always share a portion of residual profits in the long run.

The artificial reallocation of trademarks and trade names will benefit the market jurisdiction while not deviate from the ALP. The MNEs will benefit because they don't need to pay extra tax so long as an entity does not initially hold the trademarks in a low-tax country for tax avoidance purposes. The market jurisdictions get their appropriate share of profits arising from the trademarks. It will not influence the tax bases of the source countries because they will still share profits according to functional analysis. The best of all is that it is not primarily deviate from the current arm's length structure.

[108] Ibid, para 31.

Chapter 6

The Profit Split Methodology

6.1 Introduction

Let's assume that the market jurisdiction has successfully overcome previous hurdles by establishing a physical presence of the multinational enterprise (hereinafter MNE) within its borders (see Chapter 4), and has either participated in enhancing existing intangibles or created its own marketing intangible (see Sections 5.4 and 5.5), so as to gain eligibility to share the residual profits. Depending on the nature of the contributions and the availability of reliable comparable transactions, the distributor can share residual profits through comparability adjustments or a profit split. The profit split method (hereinafter PSM) is particularly advantageous for the market jurisdiction as it assesses the contributions of both parties, and it is the only method that applies the enterprise doctrine rather than the separate entity doctrine.

This chapter traces the changes of the PSM, aiming to: (1) investigate its historical application and evolution over time; (2) assess its role in facilitating market jurisdictions by claiming an appropriate share of taxing rights; and (3) examine the factors contributing to its transition from an "unspecified" method to one garnering increasing attention.

This chapter starts with a brief explanation for the preference of the PSM over comparability adjustments in Section 6.2. It then traces the historical development of the

PSM within the framework of US Section 482 and the OECD Transfer Pricing Guidelines in Section 6.3. Sections 6.4 and 6.5 provide insights into the application and implementation of the PSM. Concluding the chapter, Section 6.6 offers a summary of the discussed points.

6.2 Why a profit split is preferred over comparability adjustments

The arm's length principle (hereinafter ALP) operates on the premise that entities within the same MNE are distinct and independent entities.[1] It assumes that each entities prioritise their own profit maximisation rather than maximising overall group profits. Consequently, the ALP treats the group as merely a collection of individual members, a perspective often termed as the "separate entity approach".

However, the separate entity principle is based on a myth. Despite the fact that MNEs consist of numerous subsidiaries and branches, they operate as unified entities. According to the enterprise doctrine[2] (see Section 7.2.3), members of the group are organised to prioritise the collective interest of the group over their own member interests. This collective mindset allows the group to exploit efficiencies, cut costs,[3] and

[1] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), para 1.6.
[2] For an application of enterprise doctrine in tax, see Antony Ting, *The Taxation of Corporate Groups under Consolidation: An International Comparison* (Cambridge Tax Law, 1st ed, 2012).
[3] The reduced costs include research and development costs, transaction costs, information obtaining costs, managerial costs, and finance costs. See Reuven S. Avi-Yonah and Ilan Benshalom, 'Formulary Apportionment – Myths and Prospects' (2010) *Law and Economics Working Paper, Paper 28*, at 10.

benefit from economies of scope and scale.[4] The resulting additional profit generated from the corporate group functioning as a unified entity is termed "group synergies".

Formulary Apportionment (hereinafter FA) deals with the group synergies well. As an application of the enterprise doctrine, it makes the correct assumption that the MNEs are unitary enterprises and therefore apportioning group synergies along with the other profits.[5]

On contrary, the ALP heavily relies on comparable uncontrolled transactions. These transactions are undertaken by unrelated parties and lack the presence of group synergies found in controlled transactions. While the OECD has acknowledged the existence of economies of scale and group synergies, it has yet to devise an effective method for addressing these factors.[6] Under methods other than the PSM, group synergies are typically allocated to the party holding the intangibles, along with other non-routine profits. The OECD has suggested potential adjustments to comparability to allow non-intangible owners to share in group synergies,[7] but such adjustments cannot be guaranteed.[8]

[4] A wide range of papers discussing group synergies and whether they should be apportioned between group members. See e.g., Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation' (2007) *Law and Economics Working Paper;* Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation' (2002) 50(3) *Canadian Tax Journal* 823; Harlow N. Higinbotham and Marc M. Levy, 'When Arm's Length Isn't Really Arm's Length: Issues in Application of the Arm's Length Standard' (1998) 26 *Intertax* 235; David L. P. Francescucci, 'The Arm's Length Principle and Group Dynamics – Part 1: the Conceptual Shortcomings' (2004) 11 (2) *International Transfer Pricing Journal* 55; Georg Kofler, 'The BEPS Action Plan and Transfer Pricing: The Arm's Length Standard Under Pressure?' (2013) 5 *British Tax Review* 647; Mitchell A. Kane, '*Transfer Pricing, Integration and Synergy Intangibles: A Consensus Approach to the Arm's Length Standard*' (2014) 6(3) *World Tax Journal* 282.
[5] Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation' (2007) *Law and Economics Working Paper*, at 26.
[6] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995), para 1.9.
[7] The 2022 Report, above fn 1, para1.183.
[8] The synergies need to be material and they need to arise from "deliberate concerted group actions". Likewise, it is also necessary to determine the nature, the amount of the advantages. See ibid, paras 1.181 to 1.183.

The group structure generates group synergies, which should be distributed among all members, regardless of whether the contribution is in the form of intangible assets or not. Among all transfer pricing methods, the PSM is arguably the only one that accounts for group synergies. It can be described as a transactional-based FA, tailored to each MNE. As a two-sided transfer pricing method that does not heavily rely on comparable transactions, the PSM evaluates the contributions of both parties, ensuring that group synergies are apportioned based on the relative value of these contributions. Consequently, the PSM can assist market jurisdiction distributors in obtaining an appropriate share of taxing rights compared to comparability adjustments.

6.3 The rise of the PSM

6.3.1 The 1968 US tax reform and the OECD 1979 Guideline

The story of PSM started before it was introduced in the US in 1992.

The US reformed Section 482 in 1968, providing procedural rules of applying the ALP and introducing the three transfer pricing methods to deal with the international transfer between group members: comparable uncontrolled price (hereinafter CUP) method,[9] resale price method, and cost plus method.[10] The 1968 regulations discussed three types

[9] Treas. Reg. IRC § 482-2(d)(2)(ii) (1968) (T.D. 6952, 1968-1 C.B. 218). It provided that "In determining the amount of an arm' s length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances." It was quoted by The Department of the Treasury and Internal Revenue Service, 1988-2 *Internal Revenue Cumulative Bulletin* (1988), at 460.

[10] Treas. Reg. IRC § 482 (1968) (T.D. 6952, 1968-1 C.B. 218). 9 April 1968. The reform aimed to protect the US tax base from stopping US companies from shifting domestic income to their foreign subsidiaries, as the US corporate tax rate can potentially hit 48%. See IRS 1988-2, above fn 9, 460; Stanley S. Surrey, 'Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482' (1968) 28 *The Journal of Taxation* 75, at 75.

of transfers, i.e. services, intangibles and tangibles. The service and intangibles could only use the CUP method, but the regulations did not provide any specific guidance in detail.[11] The tangibles, on the other hand, will be priced under the traditional transfer pricing methods in a strict order.[12] If none of the above is suitable, "some appropriate method of pricing other than those described in subdivision (ii) can be used".[13] This is sometimes described as the "mysterious fourth method".[14]

It is worth noting that this tax reform rejected a FA method, which had been well-established in the 1960s in the US for profit allocation among states (see Section 3.2.1). The FA method was proposed as another option after the CUP in dealing with the cross-border tangible property transfer,[15] substituting the resale price method and cost plus method.

In the 1960s, intangibles have already become a headache in terms of valuation and determination of the appropriate charge for using them.[16] For this reason, the now problematic cost sharing agreement was proposed as "cost sharing arrangement" in 1966 to avoid the need for intangibles valuation,[17] and promulgated in 1968.[18] The OECD

[11] Treas. Reg. IRC § 482-2(d)(2)(ii) (1968) T.D. 6952, 1968-1 C.B. 218. It was quoted by IRS 1988-2, above fn 9, at 460.
[12] The order of hierarchy: CUP, Resale price, and cost plus. See IRS 1988-2, above fn 9, at 460.
[13] IRS 1988-2, above fn 9, at 460.
[14] Richard J. Vann, 'Reflections on Business Profits and the Arm's Length Principle' in Brian J Arnold, Jacques Sasseville and Eric M. Zolt (eds), *The Taxation of Business Profits Under Tax Treaties* (Canadian Tax Foundation, 2003) 13, at 135 and 136.
[15] "Taxable income shall be apportioned between the related parties under a formula based on their relative economic activities." See IRS 1988-2, above fn 9, at 460.
[16] Stanley S. Surrey, above fn 10, at 78.
[17] 31 Fed. Reg. 10394 (1966); Stanley S. Surrey, above fn 10, at 78.
[18] Treas. Reg. IRC § 482-2(d)(4) (1968) T.D. 6952, 1968-1 C.B. 218.

believed that they were considered harmless,[19] because unrelated enterprises also cooperated in research and development.[20]

The 1968 regulations became the basis for the OECD 1979 Guideline.[21] The OECD also adopted a hierarchical structure that prioritised the CUP method, followed by the resale price and cost plus methods.[22] When it was difficult to apply these, other reasonable approaches might be adopted.[23] In this case, the "other reasonable approaches" clearly imitate the "mysterious fourth method" in the US Section 482.[24] The OECD provided that a reasonable approach could be:

> *"…to attempt to allocate some proportion of combined net income arising from a sales transaction to the various associated enterprises concerned in it on the basis of their proportionate contribution to the final profits."*[25]

This approach referred to the FA.[26] The OECD didn't agree with this approach and described it as "disregard market conditions as well as the particular circumstances of the individual enterprises" and "ignore the management's own allocation of resources".[27] It merely served as a solution to the situations where traditional transactional methods

[19] The OECD provided that "Experience with such intra-group cost sharing arrangements is said to be positive and they do not appear to have opened up avenues for tax avoidance. No greater danger of tax avoidance is seen through cost sharing arrangements than through any other type of intra-group transaction." See the 1979 Report, above fn 14, para 109. The OECD included a chapter discussing the "cost contribution agreement" (CCA) in the 1995 Report, which became the OECD version of the cost sharing agreement. See OECD, *Transfer Pricing and Multinational Enterprises* (1979), Chapter VIII. It was one of the three agreements discussed under "The creation of marketing intangible" in Chapter 4.4.
[20] Ibid, para 107.
[21] Richard J. Vann, above fn 14, at 136.
[22] The 1979 Report, above fn 19, paras 46 and 70.
[23] The 1979 Report, above fn 19, para 70.
[24] Richard J. Vann, 'Reflections on Business Profits and the Arm's Length Principle' in Brian J Arnold, Jacques Sasseville and Eric M. Zolt (eds), *The Taxation of Business Profits Under Tax Treaties* (Canadian Tax Foundation, 2003) 13, at 135 and 136.
[25] The 1979 Report, above fn 19, para 72.
[26] Paragraph 72 directed the readers to paragraph 14, which outlined the problems of GFA. The 1979 Report, above fn 19, para 72.
[27] The 1979 Report, above fn 19, para 14.

found difficult and could only be used in a limited (case-by-case) situation when relevant countries agreed to prevent double taxation.[28]

However, this approach could also be viewed as the originate of the PSM. It revealed the truth that the PSM was similar to FA in treating the MNEs as a unitary business,[29] but was different in a critical aspect: instead of applying a pre-determined allocation formula for all MNEs, the PSM is tailored and applied on a transactional basis.

6.3.2 The 1986 US tax reform and the OECD 1995 Guideline

The US 1986 tax reform was a response to the increasingly problematic transfer of intangible properties. It was observed that the comparable transactions adopted under the CUP were not stringent enough. Industry norms for transfers of less profitable intangibles frequently are not realistic comparable transactions for transfers of high-profit intangibles.[30]

In 1988, the US issued a white paper: A Study of Intercompany Pricing, regarding the transfer pricing methods for intangibles,[31] which led to the US tax authority Internal Revenue Service (hereinafter IRS) issuing proposed regulations under Section 482 in 1992 (hereinafter 1992 Regulations) accepting the PSM, comparable profits method (hereinafter CPM) and comparable uncontrolled transaction method (hereinafter CUT) –

[28] The 1979 Report, above fn 19, para 14.
[29] Michael Kobetsky, 'Principles and Policy' in Michael Kobetsky (ed), International Taxation of Permanent Establishments (Cambridge University Press, 2011) 11, at 91.
[30] See H.R. Rep. 99-426, 99th Cong., 1st Sess. (1985), at 424, discussed in the Department of the Treasury and Internal Revenue Service, 'Intercompany Transfer Pricing Regulations Under Section 482' (1994) 59(130) *Federal Register*, at 2.
[31] The Department of the Treasury and Internal Revenue Service, "A Study of Intercompany Pricing," Notice 88-123, 1988-2 C.B. 458 (18 October 1988).

a transfer pricing method that is equivalent to the CUP but specially designed for transfer of intangible assets.[32] The regulations were amended in 1993 (hereinafter 1993 Regulations), opened for comments,[33] and finalised in 1994 (hereinafter 1994 Regulations).[34]

The 1994 Regulations showed a compromise the IRS made under pressure from the stakeholders, while the 1992 and 1993 Regulations revealed the true goals the IRS wanted to achieve through the tax reform. The original intention of the 1986 tax reform was to impose higher comparability standards for all other methods except for the CPM and encourage the use of CPM. It tightened up the comparability standards for the traditional methods, especially the CUP and CUT,[35] and it imposed elective and other procedural requirements on the PSM, which made it unavailable.[36] At the same time, the

[32] INTL-0372-88, INTL-0401-88, 57 FR 3571.
[33] For example, the OECD published a report criticising the US using CPM as a mandatory check-up of the other methods. See OECD, *Intercompany Transfer Pricing Regulations Under US Section 482 Temporary and Proposed Regulations* (1993). The OECD used "CPM" directly, but the correct method was comparable profit interval, which is similar to CPM in broad term. See IRS 1994, above fn 30, at 5.
[34] The 1993 regulations (T.D. 8470; INTL 401-88, 58 FR 5263) originally proposed four profit split methods. The 1994 final regulations reduced four methods to two, namely the comparable profit split and the residual profit split. For a detailed discussion of the difference between 1993 and the final regulations, see IRS 1994, above fn 30.
[35] For example, the 1992 Regulations only allowed the CUP method to be applied when there were at most minor differences between the controlled and uncontrolled transactions, which were much more restrictive than the ones under the 1968 Regulations. The 1994 Regulations (T.D. 8552 1994-2 C.B. 93) removed this restriction. It means that the 1994 Regulations were more stringent than the 1968 Regulations but not as much as the 1992 Regulations. With less stringent comparability requirements, the reliability would be reduced for the purpose of the best method rule. If the CUP was only used when there were no more than minor differences, it would make CPM the best method for a lot more transactions. See IRS 1994, above fn 30, at 4, 7 and 19.
Another example regarding high comparability standards of the CUT was that the 1993 Regulations required intangibles transferred to have substantially the same profit potential as the intangibles in uncontrolled transactions. They need to be the same class of intangibles that relate to the same class of products or services. The 1993 Regulations received comments expressing objection to the high comparability standards under the CUT, so the 1994 Regulations relaxed the standard from "same" to "similar", as long as it provided the most reliable measure under the best method rule. See IRS 1994, above fn 30, at 4, 7, 21 and 22.
[36] The 1992 and 1993 Regulations set a list of elective and procedural requirements for the PSM to be used. The 1993 Regulations received comments urging the restrictions to be removed. Therefore, the 1994 Regulations removed them. See IRS 1994, above fn 30, at 4, 7, 8.

CPM had a much lower comparability standard and was readily available to the IRS.[37] Given that only four methods can be adopted for transferring intangible assets: the CUT, CPM, PSM and the unspecified method. Restricting the rest would inevitably make CPM more easily to be the best method.

Why did the US IRS prefer the CPM and possibly still does? The CPM was intended to be applied to the simplest and easiest comparable operations.[38] In most cases, the tested party is the least complex of the controlled transaction and doesn't own valuable intangible property or unique assets.[39] As a net technology exporter, the application of the CPM is likely to allocate more or all of the residual value to the US.[40] It solved the long-standing concern the US government had regarding the US subsidiaries of non-US MNEs, those of Japanese parents in particular, paid less tax than is deemed fair.[41] Statistics showed that in 1987, the US sales by Japanese MNEs rose about 50% but the reported taxable income dropped by two-thirds. Similarly in 1990, Japanese auto transplants in the US produced 22 billion worth moto vehicles, but only paid 12 million in taxes.[42] It

[37] The CPM originated from the comparable profit interval in the 1992 Regulations, which served as a mandatory check for most other methods. Though the 1994 Regulations removed the mandatory check, it showed that the US was trying to broaden the scope of the CPM. See IRS 1994, above fn 30, at 5 and 7. The 1993 comments showed a wide range of concerns that stakeholders had regarding the CPM. They were worried that because the CPM had a lower standard of comparability than other methods, it might be readily available to the IRS, and they might apply it without regard to the evidence provided by other methods. They were also worried that the scope language indicating the CPM was preferred to the other methods. See IRS 1994, above fn 30, at 5 and 7.
[38] See IRS 1994, above fn 30, at 5.
[39] 26 CFR § 1.482-5(b)(2)(i).
[40] For a contrary view that the PSM would allocate more profits to the US, see e.g., David G. Noren, 'The US National Interest in International Tax Policy Commentary' (2001) 54(3) Tax Law Review 337, at 348. The author doesn't agree with it for two reasons. Firstly, the US intends to apply the PSM when both parties of the controlled transactions own valuable non-routine intangibles, which means the US entity is not the only one that owns intangibles. Consequently, it will not be allocated with all the residual profits. Secondly, the US was reluctant to apply the PSM, which shows that the PSM wasn't going to bring many benefits. For the US position, see IRS 1994, above fn 30, at 4 and 6. It has been an ongoing concern that the CPM would allocate more profits to the US than is reasonable. See e.g., Hubert Hamaekers, "Transfer pricing: history – state of the art – perspectives", Ad Hoc Group of Experts on International, Cooperation in Tax Matters, Tenth meeting (Geneva, 10 - 14 September 2001), UN Doc ST/SG/AC.8/2001/CRP.6, at 11.
[41] See Jamie Elliott, 'Developments in transfer pricing' (1995) 4 *British Tax Review* 348, at 352.
[42] Suk H. Kim, Eugene Swinnerton and Gregory Ulferts, '1994 Final Transfer Pricing Regulations of The United States' (1997) 5(1) Spring *Multinational Business Review* 17, at 18.

demonstrated that during the 1980s, the US not only experienced losses of prominent real estate properties through the "buying America" trend,[43] but also faced challenges as a market jurisdiction in receiving a fair portion of taxing rights over the profits arising from it.

The PSM, on the contrary, was the least preferred method by the US. Initially, it suffered the same treatment as the unspecified method: the 1992 Regulations required it to be applied with authorization by the regulations,[44] the 1993 Regulations required a pricing agreement prior to the select of the PSM and applied consistently year to year.[45] Although these restrictions were eventually removed with the application of the best method rule, the IRS still treated the PSM as the last resort:

> *"The final regulations contain an extensive discussion of comparability and reliability considerations under this method… Since the second step ordinarily will not be based on a market benchmark, the reliability of this [profit split] method will tend to be reduced for purposes of the best method rule as the amount of the residual profit allocated pursuant to the second step increases.*

[43] In the 1980s, Japan's domestic market could not meet the demands of the rapidly expanding Japanese MNEs. As a result, the well-capitalised Japanese MNEs began acquiring businesses overseas, including those in the United States. This phenomenon was commonly referred to as "buying America". Several notable Japanese MNEs made high-profile acquisitions in the US, such as Columbia Pictures, Universal Studios, CBS Records, and Rockefeller Center in New York. During that time, there was a widespread belief that the Japanese would eventually acquire the entire United States. See, e.g. Suk H. Kim, Eugene Swinnerton and Gregory Ulferts, '1994 Final Transfer Pricing Regulations of The United States' (1997) 5(1) Spring *Multinational Business Review* 17, at 18; John Yemma, 'Suddenly There's Concern as Japanese "Buy America"', 5 February 1988, *The Christian Science Monitor*, available at <https://www.csmonitor.com/1988/0205/fmark5.html> accessed on 16 June 2023; Rob Wile, 'The True Story of The 1980s, When Everyone Was Convinced Japan Would Buy America', 6 September 2014, Business Insider, available at <https://www.businessinsider.com/japans-eighties-america-buying-spree-2014-9> accessed on 16 June 2023.
[44] IRS 1994, above fn 30, at 4.
[45] IRS 1994, above fn 30, at 7.

> *Under the best method rule, methods that determine an arm's length result based on the results of transactions between uncontrolled taxpayers are generally considered to be more reliable than methods (such as the residual profit split) that only rely on such transactions in part. Therefore, the results of the methods based solely on results of transactions between uncontrolled taxpayers will be selected under the best method rule unless the data necessary to apply them is relatively incomplete or unreliable.* ***In this regard the residual profit split generally would be considered a method of last resort.****"*[46]

Apart from the reduced reliability, the proof that the US didn't like the PSM, and possibly still doesn't, was the scope of the PSM. Initially, the US intended to apply the PSM when both parties of the controlled transaction owned valuable non-routine intangibles.[47] The PSM was likely introduced along with the CPM as the other side of a coin: the CPM was used when only one party owned valuable non-routine intangibles, and the PSM was used when both parties owned such intangibles. Legislatively, the 1994 Regulations abandoned the "non-routine intangibles" ownership restrictions to ensure the consistency of the best method rule,[48] meaning the PSM could be in use as long as it was a better method than any other transfer pricing method. However, in practice, the PSM and CPM are used in ways as initially planned. Consequently, the OECD stated in its 1995 Guideline that "in most countries the application of transactional profit methods has been limited to the profit split method…".[49]

[46] IRS 1994, above fn 30, at 28.
[47] IRS 1994, above fn 30, at 6.
[48] IRS 1994, above fn 30, at 8.
[49] The 1995 Report, above fn 6, para 3.52.

In 1994, the OECD issued Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations: Discussion Draft of Part I, II, and III (the 1994 Draft), among other things, to "provide a clearer indication of which methods are acceptable and which are not".[50] In the 1994 Draft, the OECD prescribed two new transactional profit methods under the ALP: the PSM and the CPM,[51] which re-named to transactional net margin method (hereinafter TNMM) in the 1995 Guideline[52] Thus, the PSM was, for the first time, prescribed in the OECD Guidelines.

The 1995 Guideline expanded the original hierarchical structure of transfer pricing methods, adding the transactional profit methods as the last resort. The CUP method was the most preferred method for being direct and reliable.[53] Followed by the other traditional transactional methods, namely the resale price method and the cost plus method.[54] The newly introduced transactional profit methods, namely the PSM and the TNMM, are discouraged.[55] They might be used "when traditional transactional methods cannot be reliably applied alone or exceptionally cannot be applied at all".[56]

The OECD seemed reluctant to approve the transactional profits methods, in particularly, the TNMM was too readily available. The OECD was concerned that the taxpayers would

[50] Diane Hay, Frances Horner and Jeffrey Owens, 'Past and Present Work in the OECD on Transfer Pricing and Selected Issues' (1994) 22(10) *Intertax* 423. Quoted by Heather Self, 'OECD transfer pricing guidelines: Part II' (1995) 4 *British Tax Review* 358, at 358.
[51] See Jamie Elliott, above fn 41, at 351. Some academics think that the OECD changed the CPM to TNMM in its official 1995 Report "to emphasize that it does not involve a global profit allocation but rather allocation for particular transaction, since the forer is closer to FA (formular apportionment)". See Reuven S. Avi-Yonah, 'Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation' (2009) *University of Michigan Public Law Working Paper No. 152*, at 2.
[52] The OECD pointed out that it only accepted the PSM and the TNMM. The so-called CPM (as opposed to the TNMM, but not defined) was only acceptable when it was consistent with the OECD guidelines. The 1995 Report, above fn 6, para 3.1.
[53] The 1995 Report, above fn 6, para 2.7.
[54] The OECD provided that "traditional transaction methods are preferable to other methods". See The 1995 Report, above fn 6, para 2.49.
[55] The 1995 Report, above fn 6, para 3.50.
[56] The 1995 Report, above fn 6, para 3.1.

apply it automatically without first considering the traditional transactional methods,[57] or the differences between controlled and uncontrolled transactions.[58] These concerns were consistent with the comments the US received for the 1993 Regulations.

The PSM was much more acceptable compared to the TNMM. The OECD didn't allow the TNMM to be used without appropriate comparable transactions,[59] but it provided that:

> *"One strength of the profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified."*[60]

On the contrary, when comparable transactions were not available, the US would use the CPM rather than the PSM to break the tie.[61]

The respective preference of the OECD and the US was so evident that the OECD could have adopted the PSM by itself in the 1995 Guideline instead of accepting the whole package of PSM and CPM from the US. Some academics suspected that the US had a deal with the OECD for it to approve the two new profit methods. In exchange, it has de-emphasised the role of CPM and allowed greater flexibility in using comparable transactions.[62]

[57] The 1995 Report, above fn 6, para 3.50.
[58] The 1995 Report, above fn 6, para 3.53.
[59] The 1995 Report, above fn 6, para 3.30. The use of a multiyear average might mitigate this concern, but it was a general rule that applies to all methods, not a privilege enjoyed only by the TNMM. Also, the MNEs in question might not have such data. The tax administrators might have, but they are not allowed to use them unless the data were disclosed. See The 1995 Report, above fn 4, para 1.49 to 1.51 and 3.30.
[60] The 1995 Report, above fn 6, para 3.6.
[61] See Jamie Elliott, above fn 41, at 356.
[62] See Jamie Elliott, above fn 41, at 356.

6.3.3 The 2010 Guideline

The 2010 Guideline removed the hierarchical structure half-hearted. On the one hand, all the relevant terms, such as "last resort", were deleted and substituted with "the most appropriate method" in choosing the transfer pricing method.[63] No single method takes priority over the others. On the other hand, the OECD put a word of caution:

> *"As a result, where, taking account of the criteria described at paragraph 2.2, a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where, taking account of the criteria described at paragraph 2.2, the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred."*[64]

Some tax practitioners believed that it did not mean the traditional transactional methods were preferred over the transactional profit methods.[65] The OECD was merely softening their approach towards the profit methods without losing the grip. The same lines were inherited by the 2017 and 2022 Guidelines.

The "most appropriate method" is an OECD version of the US "best method rule".[66] It took the OECD some 15 years to adopt the "best method rule" shows how unsure it was about the profit methods, the TNMM in particular. The tax practitioners found that the

[63] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010), Chapter II, Part I, A Selection of the most appropriate transfer pricing method to the circumstances of the case.
[64] The 2010 Report, above fn63, para 2.3.
[65] Jamil Ahmadov, 'The "Most Appropriate Method" as the New OECD Transfer Pricing Standard: Has the Hierarchy of Methods Been Completely Eliminated?' (2011) 18(3) *International Transfer Pricing Journal,* at 191.
[66] 26 CFR § 1.482-1(c).

TNMM/CPM was overused because they were too readily available to the MNEs.[67] The MNEs bought the external comparable services from the database providers and used them straight away without undergoing the analysis of the internal comparable.[68] The hierarchical structure did not stop the MNEs from abusing the CPM/TNMM in transfer pricing. MNEs were long for international consensus between the US and the rest of the world, which put a lot of stress on the OECD. In addition, some OECD member countries (and non-members) such as India, New Zealand, Australia, and South Africa had introduced similar concepts of the "most appropriate method" and pushed away the hierarchical structure. It means that they had been deviating from the OECD's approach for some time, which enlarged the gap between the different approaches.[69]

The OECD recognised that modern MNEs operate in an increasingly integrated manner across jurisdictions, and the ownership of intangibles was becoming a critically important issue in transfer pricing.[70] This change exposed the limitations of the traditional transaction methods, which were misplaced where they were not the most appropriate methods by the hierarchical structure.[71] The OECD started to realise the critical importance of the PSM in solving these increasingly controversial transfer pricing issues.[72]

[67] Robert Feinschreiber and Margaret Kent, 'How the OECD Narrows the Application of the Transactional Net Margin Method' (2011) 6(12) *Corporate Business Taxation Monthly* 23.
[68] The internal comparable was prefered by the OECD to be used as comparable. See the 2010 Repot, above fn 63, para 2.58.
[69] Jamil Ahmadov, above fn 65, at 185 and 201.
[70] Pim Fris and Graham Poole, 'Transfer Pricing More Demanding', *Tax Journal* 1019 (2010), at 14. The OECD also recognised this situation in the 2010 Repot, above fn 59, para 2.4.
[71] Jamil Ahmadov, above fn 65, at 190.
[72] The 2010 Report, above fn 63, para 2.4.

Another change worth noting was that the OECD placed a greater emphasis on the comparability analysis.[73] It included a typical process that can be followed when performing comparability analysis,[74] which made none of the transfer pricing method too readily available. The OECD made it clear that it "does not require the application of more than one method for a given transaction",[75] and it does not require all the methods to be analysed in depth to reach the conclusion of the most appropriate method.[76] In the meantime, the OECD also does not preclude various methods to be used in conjunction:

> *"However, for difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the [ALP] that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration."*[77]

When the MNEs could not find reliable comparable transactions, the OECD hoped they not to use a method that barely suit but try different ways to enhance the comparability, such as combining more than one method, using statistical tools like the interquartile range, or even start with the overlapping ranges of different methods.[78]

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[73] For a critical analysis of the OECD comparability analysis, see Robert Feinschreiber and Margaret Kent, 'How the OECD Applies Comparability Analysis' (2012) 5(13) *Corporate Business Taxation Monthly* 27. Likewise, Mura, Emmanuel and Vallascas statistically challenged the OECD comparability analysis by proving the foreign controlled entities are generally more profitable than third party, see Alessandro Mura, Clive Emmanuel and Francesco Vallascas, 'Challenging the Reliability of Comparables under Profit-Based Transfer Pricing Methods' (2013) 5(43) *Accounting and Business Research* 483.
[74] The 2010 Report, above fn 63, para 3.4. The same process was included in the subsequent reports.
[75] The 2010 Report, above fn 63, para 2.11.
[76] The 2010 Report, above fn 63, para 2.8.
[77] The 2010 Report, above fn 63, para 2.11.
[78] The 2010 Report, above fn 63, para 3.57 to 3.59.

6.3.4 The 2017 Guideline and the 2022 Guideline

Since the adoption of the "most appropriate method" rule, the TNMM gradually became the most used transfer pricing method in member and non-member countries, such as China,[79] Italy,[80] Indonesia,[81] Mexico,[82] Thailand[83]. For example, Baker & McKenzie observed that, in China, as of 2013, the TNMM is used in over 95% of all transfer pricing documentation prepared.[84] This trend was slightly tuned down to an average of 80.89% in 2005 to 2020,[85] as China developed a preference for the PSM.[86]

Likewise, The TNMM/CPM also accounted for the most used method in Advance Pricing Agreements (hereinafter APAs). For example, the CPM has been the dominant transfer pricing method ever since the IRS was required to report annually on APAs and the Advance Pricing and Mutual Agreement (hereinafter APMA) Program in 1999.[87] For

[79] IFA 67th Congress in Copenhagen - Seminar E: Profit methods and the arm's length principle (27 August 2013), *IBFD*. This seminar report mentioned that the TNMM is the most used transfer pricing method in China, however, Chinese tax authority prefers PSM. See Section 7.4.
[80] Agenzia delle Entrate (Italian Revenue Agency), Central Directorate for Tax Assessment: International Division, International Ruling Office, *International Standard Ruling Report*, second edition (19 March 2013). Quoted in P. Valente, Italy - Transfer Pricing, Country Tax Guides, *IBFD,* accessed on 1 October 2022, at 4.7 Transactional net margin method.
[81] F. Karyadi & Darussalam, Indonesia - Transfer Pricing, Country Tax Guides, *IBFD*, accessed on 1 October 2022, at 4.7 Transactional net margin method.
[82] O. López Salazar, Mexico - Transfer Pricing, Country Tax Guides, *IBFD*, accessed on 1 Ocober. 2022, at 4.7 Transactional net margin method.
[83] P. Poshyanonda, Thailand - Transfer Pricing, Country Tax Guides, *IBFD*, accessed on 1 October 2022, at 4.7 Transactional net margin method.
[84] Baker & McKenzie, *Newsletter — Transfer Pricing (People's Republic of China)* (2013), at 5.
[85] SAT, *China Advance Pricing Agreement Annual Report* (2020).
[86] F. (Frank) Wu, China (People's Rep.) - Transfer Pricing & Customs Valuation, Country Tax Guides, *IBFD,* accessed on 1 October 2022, at 1.2.1. National transfer pricing.
[87] For all IRS APA reports, see <https://www.irs.gov/businesses/corporations/annual-apa-statutory-reportspercent of transfers of tangible and intangible property> accessed on 1 October 2022.

example, the CPM/TNMM was used 85% for the sale of tangible property and the use of intangible property in 2021.[88]

Globalization has provided the MNEs with significant tax planning and avoidance opportunities. It is particularly true for technology companies whose main assets are vast intellectual properties, which are highly mobile and very difficult to value. Having an international taxation system benefits the intangible owners for too long, the MNEs have developed means of transferring profits to low-tax countries with the help of intangibles. For example, the MNEs transfer intangibles to the subsidiaries in tax heavens on the book to avoid taxes. The CPM/TNMM makes the situation even worse by allocating all residual profits to intangible owners without testing them.

The intense profit shifting triggered the Base Erosion and Profit Shifting (hereinafter BEPS) Project in 2013.[89] Among other things, Action 8-10 is about transfer pricing, under which the OECD and its broader Inclusive Framework of jurisdictions published revised drafts and guidance on profit split methods three times, namely in 2016, 2017 and 2018.[90] Being the only transfer pricing method that was revised in the BEPS, the PSM drew a lot of attention. A US official asserted that the 2018 revised guideline ensures that the use of the PSM will remain infrequent,[91] but the OECD was clearly trying to broaden

[88] IRS, *Announcement and Report Concerning Advance Pricing Agreements* (22 March 2022), available at <https://www.irs.gov/pub/irs-apa/po41010-announcement-2021-6-apa-report.pdf> accessed on 1 October 2022, at 9.
[89] See <https://www.oecd-ilibrary.org/taxation/oecd-g20-base-erosion-and-profit-shifting-project_23132612> accessed on 6 October 2022.
[90] They are OECD, *Public Discussion Draft - BEPS Action 8-10 Revised Guidance on Profit Splits* (2016); OECD, *Public Discussion Draft: BEPS Action 10 Revised Guidance on Profit Splits* (2017); OECD, *Revised Guidance on the Application of the Transactional Profit Split Method* (2018).
[91] Christopher Bello, branch 6 chief, IRS Office of Associate Chief Counsel (International), referred to in Ryan Finley, 'Narrower OECD Profit Split Guidance Is a Result of U.S. Efforts' (2018) 91(4) *Tax Notes International* 404. Also discussed in Michael Kobetsky, 'The Transfer-Pricing Profit-Split Method After BEPS: Back to the Future' (2019) 67(4) *Canadian Tax Journal* 1077, at 1080.

the scope of the PSM. The OECD realised that the current international taxation system was outdated, and the PSM could better reflect the economic reality with the profit earned:

> *"The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created."*[92]

The 2017 and the 2022 Guidelines are both post-BEST reports that, to some extent, reflected the BEPS work. Among other things, the 2017 Guideline introduced DEMPE to better allocate returns attributable to intangibles (see Section5.5.3)[93] and the 2022 Guideline incorporated the 2018 revised guidance of the PSM (See Sections 6.4.4 and 6.5.3).[94] Additionally, BEPS Action 13 Country-by-Country Reporting (hereinafter CBC Reporting)[95] improved international tax transparency, which overcome of the PSM's weakness that the tax authorities had difficulties accessing information from foreign affiliates.[96] With the reform of these three parts, the PSM is likely to be applied in a wider scope.

[92] OECD Revised Guidance 2018, above fn 90, at 3.
[93] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017), Chapter VI, Section B.
[94] The 2022 Report, above fn 1, Part III, Section C.
[95] See <https://www.oecd.org/tax/beps/beps-actions/action13/> accessed on 10 October 2022.
[96] The 1995 Report, above fn 6, para 3.9.

6.4 When should the PSM be applied?

6.4.1 The 1995 Guideline

In the 1995 Guideline, arguably, there were five situations that the PSM might be applied:

One situation arose when the transactions were so interrelated that they could not be separately evaluated.[97] When the independent parties have similar needs, they might as well set up a partnership or company to do the business. However, entities from the same MNE do not need to do so. The development of technology makes MNE members more and more integrated in doing business, which makes this indicator increasingly important. Against this background, Jinyan Li proposed a global PSM in 2002 hoping to find a "superior" way to split MNE's global profits that is consistent with the ALP.[98]

The Second situation was when the profit or residual profit could not be readily assigned to one party, such as the profit arising from "high-value, sometimes unique intangibles".[99] The report did not require each party of the controlled transaction to contribute a separate intangible but made it rather ambiguous on the number of the intangible. It was not wrong to argue that the PSM could be applied to transactions where both parties of the controlled transaction contributed to the creation, development, or exploitation of the same intangible, in which the profits could not be assigned accordingly. If it was interpreted this way, the treatment was the same as the subsequent reports.[100]

[97] The 1995 Report, above fn 6, para 3.5.
[98] Jinyan Li, above fn 4, at 824.
[99] The 1995 Report, above fn 6, para 3.5.
[100] This position was most clear after the 2017 Report introduced the DEMPE functions to the intangibles. The 2017 Report, above fn 93, Chapter VI, Section B.

The 1995 Guideline did not require the intangibles to be unique but valuable, meaning as long as both parties contribute valuable intangibles (unique or not) and the comparable could not be found, the PSM would be used. This was understandable as the uniqueness of the intangibles was not yet an outstanding issue worldwide. Back then, valuableness of the intangible was emphasised.

The third situation was when no or less close comparable transactions could be found, which was often the case when intangible presented.[101] The OECD provided that:

> *"One strength of the profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified."*[102]

The PSM was the last resort, so it would be considered where the traditional transactional methods could not be reliably applied. In these cases, the relative value of each party's contribution would be valued by either internal or market data, profits would be split accordingly.[103]

The fourth situation was interesting: the PSM might also be used to "achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations."[104] It could be interpreted as that the OECD did not

[101] Brian J. Arnold and Thomas E. McDonnell, 'The Allocation of Income and Expenses among Countries: Report on the Invitational Conference on Transfer Pricing' (1993) 10(4) *Australian Tax Forum* 545, at 554 and 555.
[102] The 1995 Report, above fn 6, para 3.6. This position was different from the US version PSM, which has comparability requirement (see Section 6.3.2). for a practical comparative analysis of the US version and Australia (an OECD member country) version PSM, see Tony Cooper, 'A Comparison of the Profit Methodologies under the Transfer Pricing Rules of Australia and the United States: Are They a Voluntary Compliance Option for the Taxpayer' (1995) 12(1) *Australian Tax Forum* 91.
[103] The 1995 Report, above fn 6, para 3.16.
[104] The 1995 Report, above fn 6, para 3.7.

want to leave an extreme result to one of the intangible owners,[105] so the PSM was the most appropriate transfer pricing method that would comfort everyone.

The last situation was where the reliable comparable transactions indicated a PSM. However, the OECD recognised that it was unlikely:

> *"In most cases where traditional transaction methods would not be used, it will be difficult to find independent enterprises engaged in transactions that are sufficiently comparable to use this approach as the primary method."*[106]

Even where such transactions existed, the MNEs and tax administrations were unlikely to have access to relevant information from foreign affiliates.[107] This was one of the weaknesses of the PSM and likely the biggest one. With the improved tax transparency and Country-by-Country reporting today, this weakness has been significantly reduced.

The last situation seemed to contradict the third situation, which provided that the PSM could be used when no comparable transaction existed. In fact, it was coherent. The PSM could be adopted where it was much more reliable than the other methods. Otherwise, it would be used as the magic fix-up, where no comparable transaction could be found at all.

Shortly after the PSM was prescribed in the 1995 Guideline, the OECD and the tax authorities worldwide started to acknowledge the need for the PSM in the case of global trading of financial instruments and deepened the doubts for using the TNMM.[108]

[105] The 1995 Report, above fn 6 para 3.7.
[106] The 1995 Report, above fn 6, para 3.25.
[107] The 1995 Report, above fn 6, para 3.9.
[108] OECD, *The Taxation of Global Trading of Financial Instruments* (1998), at 3.

Likewise, the OECD also argued that the PSM might have wider application to the transfer pricing issues in the context of electronic commerce, which was very visionary.[109]

6.4.2 The 2010 Guideline

In the 2010 Guideline, the OECD introduced the most appropriate method rule, meaning that the PSM wasn't the last resort anymore.[110] The 2010 Guideline provided a typical process of comparability analysis for the first time, in which "selection of the most appropriate transfer pricing method" (step 6) was applied before "identification of potential comparable" (step 7).[111] It meant that the absent of reliable comparable transaction per se (the third situation that the PSM would be used in the 1995 Guideline), would no longer be the reason for using the PSM. However, the 2010 Guideline provided four indicators that justified the use of the PSM as the most appropriate method, covering the most cases where reliable comparable transactions were not available.

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[109] OECD, *Electronic Commerce: The Challenge to Tax Authorities and Taxpayers* (1997), at Part E, paragraphs a and e. Also quoted in Paul McNab, 'International Reaction to Electronic Commerce Developments' (1998) 27(4) *Australian Tax Review* 219, at 223.

[110] Subsequent to the publication of the 2010 Report, it was commonly recognized that the PSM would generate increasing importance, so a variety of journal articles was published exploring the PSM, for example, Kroppen, Dawid and Schmidtke compared the PSM and the Formulary Apportionment (hereinafter FA) and argued that they looked similar but were crucially different. See Heinz-Klaus Kroppen, Roman Dawid and Richard Schmidtke, 'Profit Split, the Future of Transfer Pricing? Arm's Length Principle and Formulary Apportionment Revisited from a Theoretical and a Practical Perspective' in Wolfgang Schön, and Kai A Konrad (eds), *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Berlin, Heidelberg, 1st ed, 2012) 267. Alternatively, Morse suggested that the residual PSM was a lot like the FA, and proposed to apply it in a wider scope, see Susan C. Morse, 'Revisiting Global Formulary Apportionment' (2010) 29(4) *Virginia Tax Review* 593, at 600 and 639. The tax attorneys Feinschreiber and Kent thoroughly compared different approaches of the PSM with examples. Rober Feinschreiber and Margaret Kent, 'Reviewing the OECD's Illustration of Different Transactional Profit Split Profit Measures' (2011) 12(9) *Corporate Business Taxation Monthly* 35.

[111] The 2010 Report, above fn 63, para 3.4. The OECD didn't mean to blindly choosing a method. Step 1 to 5 would help in choosing the most appropriate method. For instance, step 2 "broad-based analysis of the taxpayer's circumstances", and step 3 "…functional analysis" would indicate the most appropriate method.

Firstly, the PSM "offered a solution to highly integrated operations."[112] It was very similar to the 1995 Guideline where the PSM was the most appropriate method "where transactions are very interrelated". [113] They both referred to the situation where unrelated entities would have set up a partnership or joint venture to do business.

Secondly, the PSM was the most appropriate method "where both parties to a transaction make unique and valuable contributions".[114] "Uniqueness" became an essential character the contributions must have to make the PSM the most appropriate method.[115] It was also worth noting that the 2010 Guideline reformed Chapter II Transfer Pricing Method, the relevant chapters of choosing and applying the transfer pricing, but not Chapter VI Special Considerations for Intangible Property, which kept using the term "highly valuable" rather than "unique and valuable".[116] The inconsistencies made it ambiguous whether valuableness of the intangibles was emphasized over uniqueness in the 2010 Guideline.

In a market penetration strategy, the licensor provided, and the licensee exploited the trademark. The PSM would be the most appropriate method when contributions made by both parties, namely the trademark and its exploitation, were unique and valuable. If not, the additional expenditure and effort would be rewarded in comparability

[112] The 2010 Report, above fn 63, para 2.109.
[113] The 1995 Report, above fn 6, para 3.5.
[114] The 2010 Report, above fn 63, para 2.109. In this case, a residual PSM would be suitable to price out the routine function first, and the residual profits would be shared by the parties that made unique and valuable contributions.
[115] The concept of "unique and valuable" was criticised to be ambiguous. Some academics proposed to use the classic three-factor formula to split the profits in the residual PSM. See, e.g., Avi-Yonah, Reuven S., above fn 51, at 13; Jinyan Li, 'Soft Law, Hard realities and Pragmatic Suggestions: Critiquing the OECD Transfer Pricing Guidelines' in Wolfgang Schön, and Kai A Konrad (eds), *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Berlin, Heidelberg, 1st ed, 2012) 71, at 87.
[116] The 2010 Report, above fn 63, para 6.26.

adjustments.[117] Additionally, marketing expenses could be the appropriate allocation key to allocate profits:

> *"An allocation key based on expenses may be appropriate ... For example, marketing expenses may be an appropriate key for distributors-marketers if advertising generates material marketing intangibles, e.g. in consumer goods where the value of marketing intangibles is affected by advertising."*[118]

It was unclear whether this position only applied to the "creation of marketing intangible" or also applied to "enhancing the value of existing marketing intangible", but likely only to be applied to the former case, because the DEMPE was not introduced yet and the exploitation of intangible was still remunerated by comparability adjustments.

Thirdly, the OECD kept the position that the PSM might also be used to achieve a division of the profits from the economics of scale or other joint efficiencies that satisfies both the taxpayers and the tax administrations.[119] This position was the same in the 1995 Guideline.

Fourthly, the PSM was the most appropriate method where comparable data indicated its suitability.[120] However, when a traditional method can be applied in equally reliable manner, the traditional method was preferred.[121] The 2010 Guideline put the PSM at the same footage as the traditional transactional methods, but the OECD simply could not believe that the PSM would have higher comparability than the traditional transactional

[117] The 2010 Report, above fn 63, para 6.38.
[118] The 2010 Report, above fn 63, para 2.138.
[119] The 2010 Report, above fn 63, para 2.113.
[120] The 2010 Report, above fn 63, para 2.110.
[121] The 2010 Report, above fn 63, para 2.3.

methods by warning the MNEs and tax administrations about the difficulties of accessing information from foreign affiliates.[122]

6.4.3 The 2017 Guideline

The relevant paragraphs regarding choosing the most appropriate method and applying PSM were the same in the 2010 and 2017 Guidelines. However, the 2017 Guideline reformed Chapter VI Intangibles, which broadened the scope of the PSM with the introduction of the DEMPE functions.

The OECD showed an apparent intention to extend the scope of the PSM.[123] It suggested in many places that the two-sided methods (the CUP and PSM) were more reliable in cases such as the transfer of intangibles or rights in intangibles[124] or when a party performed significant portions of the important functions,[125] which would include market jurisdiction licensee made contributions exploited the trademark. Thus, the PSM would be more suitable than comparability adjustments if the licensee performed a significant part of marketing which exploited the unique and valuable trademark.[126]

[122] The 2010 Report, above fn 63, para 2.114.
[123] Practitioners argued that the new Chapter VI over promoted the PSM, see Rick Mitchelle, 'OECD Intangibles Draft Oversells Profit Split Method, Practitioners Say' (2012) 21(15) *Tax Management Transfer Pricing Report* 742.
[124] The 2017 Report, above fn 93, paras 6.141m 6.145.
[125] The OECD provided that "the reliability of a one-sided transfer pricing method will be substantially reduced if the party or parties performing significant portions of the important functions are treated as the tested party or parties." The 2017 Report, above fn 93, para 6.58.
[126] When the the licensee made contributions to enhance the value of the trademark, OECD allowed "a decrease in purchase price of the product", "a reduction in royalty rate", or "a share of the profits associated with the enhanced value of the trademark or other marketing intangibles". See, the 2017 Report, above fn 93, para 6.78.

Also, the OECD clarified that uniqueness was a mandatory requirement for the contributions to trigger the PSM by aligning the terms "unique and valuable contribution" with Chapter II.

6.4.4 The 2022 Guideline

The 2022 Guideline incorporated the BEPS Guidelines regarding the PSM. One of the most significant changes was the introduction of the "accurate delineation of a transaction",[127] which requires:

> *"…a two-sided analysis (or a multi-sided analysis of the contributions of more than two associated enterprises, where necessary) irrespective of which transfer pricing method is ultimately found to be the most appropriate."*[128]

The application of accurate delineation would broaden the scope of the PSM. Previously, the one-sided transfer pricing methods only tested the party that made relatively simple contributions. In a marketing intangible licensing relationship, the tested party usually was the licensee in the market jurisdiction. Sometimes, the contributions made by the licensee might have significantly greater value when considered in combination with the contributions made by the licensor.[129] Example 9 in Annex II to Chapter II exhibited that one party of the controlled transaction produced only one product component. Still, it was the key component specially tailored for the product and largely contributed to its

[127] For a critical view of the "accurate delineation of transactions", see Jens Wittendorff, 'OECD Misinterprets Controlled Transactions' (2015) 78(5) *Tax Notes International* 461.
[128] The 2022 Report, above fn 1, para 2.125.
[129] The 2022 Report, above fn 1, para 2.138.

success. The 2022 Guideline provided that the PSM would be the most appropriate method.[130] In contrast, previous Guidelines might not consider such a contribution as "unique and valuable" if one of the one-sided methods was used.

Another significant change was the more explicit indicators of the method. The 2022 Guideline outlined three indicators that made the PSM the most appropriate method:

1) highly integrated operations where the one-sided methods were not suitable;[131]
2) both parties made "unique and valuable" contributions, such as unique and valuable intangibles;[132]
3) all parties share assumption of economically significant risks.[133]

The first two indicators were not new, but compared to the previous Guidelines, the 2022 Guideline provided more details and examples, e.g., it defined "unique and valuable contributions" as:

> *"(i) they are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) they represent a key source of actual or potential economic benefits in the business operations."*[134]

Based on the definition, the LSAs are not "unique and valuable" contributions, even if they result in a significant part of the profits, because they are not "in the business operations".

[130] The 2022 Report, above fn 1, para Example 9 in Annex II to Chapter II.
[131] The 2022 Report, above fn 1, para 2.120.
[132] The 2022 Report, above fn 1, para 2.119.
[133] The 2022 Report, above fn 1, para 2.121.
[134] The 2022 Report, above fn 1, para 2.130. The "key source of economic benefits" referred to the resources which made the product successful or have advantages over the competitors. See the 2022 Report, above fn 1, para Example 3 and 4 in Annex II to Chapter II.

The third indicator was new to the Guideline and arguably the most important one. It should always be considered even if PSM has been triggered by the other two indicators.[135] This is because it will influence the types of profits (actual or anticipated) to be split.[136] The parties of the controlled transactions can jointly assume one type of risk or different types of risks, but the risks need to be interdependent.[137]

The OECD indeed broadened the scope of the PSM,[138] but it does not want the MNEs to blindly use the PSM, just like what they did to the TNMM. The presence of the above three indicators would highly likely lead to a result of missing reliable comparable transactions.[139] However, a lack of close comparable should not per se led to the PSM:

> *"Depending on the facts of the case, an appropriate method using uncontrolled transactions that are sufficiently comparable, but not identical to the controlled transaction is likely to be more reliable than an inappropriate use of the transactional profit split method."*[140]

It proves the view stated earlier in this thesis (discussed in Section 6.4.2) that it was the indicators that trigger the PSM, not the absent of reliable comparable transactions.

6.5 How should the PSM be applied?

[135] The 2022 Report, above fn 1, para 2.131.
[136] The 2022 Report, above fn 1, para 2.159 and 2.142.
[137] The 2022 Report, above fn 1, para 2.140 and Examples 10 and 13 in Annex II to Chapter II.
[138] For a critical view that the OECD was blinding encouraging the use of the PSM by "bastardizing the arm's-length principle", see Mike Gaffney, 'BEPS-Basically, Everyone on a Profit Split?' (2015) 147(5) *Tax Notes* 543.
[139] The 2022 Report, above fn 1, para 2.143.
[140] The 2022 Report, above fn 1, para 2.128.

6.5.1 The 1995 Guideline

The 1995 Guideline allowed different types of profits to be split by the parties of the controlled transactions. Since the PSM was the last resort, it had to be flexible to swallow the hard bones that the traditional transactional methods couldn't deal with. For example, the ex-ante transactions usually use projected profit because it hasn't happened yet,[141] and the ex-post transactions need to use the actual profit.[142] Operational profits were typically relevant,[143] but in some cases, gross profits were more appropriate.[144]

The profit split could be based on either contribution or residual analysis.[145]

Contribution analysis determines the relative value of the contributions made by both parties of the controlled transactions, including functions performed, assets used, and risks assumed.[146] The combined profits would be allocated among parties of the controlled transactions based on the relative value of their contributions. The OECD preferred the MNEs to measure the relative value of the contributions directly, presumably by internal data and supplemented as much as possible by the external market data that indicated how independent parties would have split the profits in

[141] The 1995 Report, above fn 6, para 3.11 to 3.13. The US did not allow anticipated or projected profit to be used, see Mitchell Greenhill and Charles W. Bee Jr, 'Transfer Pricing Guidelines Issued by the OECD' (1996) 27(5) *The Tax Adviser* 265, at 266.
[142] The 1995 Report, above fn 6, para 3.14.
[143] The 1995 Report, above fn 6, para 3.7.
[144] The OECD provided an example where an MNE engaged in highly integrated trading. See the 1995 Report, above fn 6, para 3.17. In comparison, the US only allowed operating profits. See, Sec. 1.482-6(a), *Income Tax Regs.*
[145] In comparison, the US also provides two types of PSM, namely the comparable profit split (Sec. 1.482-6(c)(2), *Income Tax Regs*) and residual profit split (Sec. 1.482-6(c)(3), *Income Tax Regs*).
[146] The 1995 Report, above fn 6, para 3.5. and 3.16. While the US comparable profit split is much more stringent than the OECD contribution analysis. The former relies exclusively on external market benchmarks (Sec. 1.482-6(c)(2)(ii)(D), *Income Tax Regs*), but the later allows, or even encourages, the use of internal comparable. The OECD once questioned the use of internal data, but eventually decided to adopt it, see 'OECD Draft Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations - December 2, 1994' (1995) 47(1) *Tax Executive* 40, at 41.

similar cases,[147] The OECD also pointed out that the external market data should be used primarily to assess the value of the contributions, not to determine the division of profits directly,[148] meaning they were not suitable to be used directly as splitting factors or allocation keys.

The residual analysis first allocates "basic return" to account for returns not generated by unique and valuable intangibles by reference to the market rate of return.[149] The residual profits would then be apportioned between parties who made unique and valuable contributions. The level of routine profits was typically determined by traditional transactional methods. Hence the PSM could be used in conjunction with other methods.[150]

6.5.2 The 2010 Guideline and the 2017 Guideline

The relevant paragraphs regarding choosing the most appropriate method and applying PSM were the same in the 2010 and 2017 Guidelines. Apart from raising the "most appropriate method rule", these two Guidelines did not deviate much from the 1995

[147] The 1995 Report, above fn 6, para 3.16.
[148] The 1995 Report, above fn 6, para 3.6. The OECD worried that the MNEs would blindly use external market data in the PSM. It had the same worry for the TNMM (see Chapter 5.1.2). However, it turns out the PSM wasn't overused, but the TNMM was.
[149] The 1995 Report, above fn 6, para 3.19. The routine profits could also be determined by the bargaining position of the two parties. See the 1995 Report, above fn 6, para 3.21. In comparison, the US allows the residual profit split to apply its second step not rely so directly on market data. However, if internal data is used, the US will consider it as a reduction of the comparability (Sec. 1.482-6(c)(3)(ii)(B), *Income Tax Regs*). In extreme cases, the IRS would accuse the foreign tax authorities that allowed a profit split based on internal data as adopting a FA, see e.g., Richard Clark and William Dodge, 'Hybrid Methods – Bridging the Gap' (April 1997) *International Tax Review* 129, at 130.
[150] The 1995 Report, above fn 6, para 3.20.

Guideline regarding the application of the PSM, except that they have inserted a lot more details helping the taxpayers and the tax administrators better apply the PSM.

Firstly, the OECD brought the application of the PSM to align slightly more with the US application. It provided that the determination of the combined profits to be split and the splitting factors [151] should generally be used consistently over the lifetime of the arrangement, [152] and financial accounting could be a starting point in the absence of harmonized tax accounting standards.[153] The MNEs or tax administrations need to put accounts on a common basis, including accounting, currencies, etc.[154] The OECD further clarified that it was especially true for the ex-ante transactions, in which the criteria and allocation keys should be agreed upon in advance.[155] This position differed from the US version of profit split because the US only allows actual operating profits to be split.[156]

Moreover, like the US version of residual profit split,[157] the OECD allowed the TNMM (or CPM in the US context) to be used in the same footage as the traditional transactional methods for pricing the "non-unique contributions", [158] which was not previously mentioned in earlier OECD Guidelines.

Last but not least, the 2010 and 2017 Guidelines provided many more details regarding the allocation keys, while the US section 482 generally requires the profits to be split

[151] in OECD Guidelines, splitting factors and allocation keys are used interchangeably.
[152] The 2010 Report, above fn 63, para 2.117. The US requires "accounting consistency among the participants …operating profit are measured on a consistent basis", see Sec. 1.482-6(c)(2)(ii)(c)(2), *Income Tax Regs.*
[153] The 2010 Report, above fn 63, para 2.126.
[154] The 2010 Report, above fn 63, para 2.125.
[155] The 2010 Report, above fn 63, para 2.117.
[156] Sec. 1.482-6(a), *Income Tax Regs.*
[157] Sec. 1.482-6(c)(3)(ii)(A), *Income Tax Regs.*
[158] The 2010 Report, above fn 63, para 2.121.

based on the comparative value of the contributions.[159] For example, the OECD required that the allocation keys be based on objective data rather than controlled transactions.[160] It could be a figure, variable, or other possible keys.[161] More than one allocation key could be used simultaneously, with them being properly weighted.[162] The asset/capital-based and cost-based allocation keys are commonly used.[163]

6.5.3 The 2022 Guideline

The 2022 Guideline removed a few paragraphs, such as the paragraphs about the PSM would achieve a division of the profits from the economics of scales or other joint efficiencies[164] and the paragraphs about bargain theory.[165] At the same time, it added positions reflecting the work of the BEPS Project. However, these works increased the likelihood of the PSM being the most appropriate method (see Section 6.4.4) rather than how it was applied or implemented.

The BEPS Project had a clear intention to rely more heavily on the PSM to solve the problems such as the rising digital economy and increasing integration of the MNEs.[166]

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[159] The comparable profit split relies exclusively on external market benchmarks to determine the relative value of non-routine contributions. See Sec. 1.482-6(c)(2)(ii)(D), *Income Tax Regs.* While the residual profit split allows multiple ways to value the non-routine contributions. Ideally the external market benchmarks would be used. In absence of the external data, internal data would be allowed, and in some cases, the actual intangible development expenditures would be allowed. See, Internal Revenue Service, LB&I Internal Practice Service Process Unit – Overview, at 29 – 34, available at <https://www.irs.gov/pub/int_practice_units/ISIPUOP_6_9_04.pdf> accessed on 2 July 2023.
[160] The 2010 Report, above fn 63, para 2.132.
[161] The 2010 Report, above fn 63, para 2.134.
[162] The 2010 Report, above fn 63, para 2.134.
[163] The 2010 Report, above fn 63, para 2.135.
[164] The 2010 Report, above fn 63, para 2.113.
[165] The 2010 Report, above fn 63, para 2.122.
[166] This is a worldwide trend that not limited to the OECD approaches. See, e.g., Michael P. Devereus and Joh Vella, 'Taxing the Digitalised Economy: Targeted or System-Wide Reform?' (2018) 4 *British Tax Review* 387, at 392.

However, ALP supporters criticized this trend as "moving away from the arm's length standard".[167] Some were particularly concerned that the PSM could be used when comparable transactions were unavailable.[168]

6.6 Summary

This chapter shows the OECD's strong intention to broaden the scope of the PSM (Section 6.4). The PSM is increasingly likely to be employed in scenarios such as the market penetration strategy, where the trademark licensee performs functions, uses assets and assumes risks that enhance the trademark's value. In such case, market jurisdictions are likely to benefit more utilising a PSM (see Section 6.4.4).

Conversely, the US IRS consistently prefers the CPM/TNMM (See Section 6.3). This poses a significant challenge in situations where the controlled transaction occurs between a US entity and an entity in a country supportive of profit split methodologies, such as China (see Chapter 7). MNEs may suffer double taxation if the Chinese tax authority requires the controlled transaction to be priced by the PSM while the US IRS insists on using the CPM. This scenario could potentially arise in cases like the Coca-Cola case, if it involved the US headquarters and Chinese ServCos, as discussed in Chapter 9.

[167] See, e.g., Joachim Englisch, 'BEPS Action 1: Digital Economy – EU Law Implications' (2015) 3 *British Tax Review* 280, at 284.
[168] See, e.g., George Kofler, 'The BEPS Action Plan and Transfer Pricing: The Arm's Length Standard Under Pressue?' (2013) 5 *British Tax Review* 646, at 661.

In future Guidelines, the OECD may consider addressing the LSAs in context of the PSM (see Section 7.5.3). LSAs are not intangibles or "market advantages" that can be owned or controlled by an entity, but they can give rise to profits.

Chapter 7

A Comparison of the Pre-Two-Pillars Positions between OECD and China

7.1 Introduction

Some academics believe that the emerging power is shifting from the US to China.[1] Just as the US has been using the OECD Transfer Pricing Guidelines (hereinafter OECD Guidelines)[2] to export its Section 482, emerging markets, particularly China and India, are willing to export the Chinese and Indian domestic laws on the UN Transfer Pricing Manual.[3] With the increasing large differences, the OECD model and international consensus is under threat.

The OECD introduced the Base Erosion and Profit Shifting (hereinafter BEPS) Project in 2013. The BEPS reports can be seen as an attempt to bring the emerging markets back to the OECD's tent.[4] It includes a few positions that are consistent with China's interests,

[1] See e.g., Eduardo Baistrocchi, 'The International Tax Regime and Global Power Shifts' (2021) 40(2) *Virginia Tax Review* 219.
[2] They are OECD, *Transfer Pricing and Multinational Enterprises* (1979) (hereinafter The 1979 Report); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) (hereinafter The 1995 Report); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) (hereinafter The 2010 Report); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2017) (hereinafter The 2017 Report); OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022) (hereinafter The 2022 Report).
[3] UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries*, Part D.2 China Country Practice (2021); Eduardo Baistrocchi, above fn 1, at 250.
[4] Eduardo Baistrocchi, above fn 1, at 251. Baistrocchi argued that the US had lost control of the international tax rule evolution since 2015, which was correlated with the gradual rise of China and the publication of the BEPS report. See Ibid, at 257.

such as the development, enhancement, maintenance, protection and exploitation (hereinafter DEMPE) functions to the intangibles and the recognition of the location-specific advantages (hereinafter LSAs).[5] The Two-Pillars Approach, in the beginning, was also consistent with China's interest in the short term by ringing-fence the digital giants. Yet, the Chinese transfer pricing rules are still distinguished to the OECD model in many places, particularly in the treatment of the LSAs, comparability analysis and marketing intangibles, as well as a wider application of the PSM.[6]

This chapter presents a comparative study that highlights the difference between the OECD model and the Chinese approach. The Chinese model was selected as the research focus among all emerging markets for three reasons. Firstly, as discussed earlier, the emerging power is gradually shifted from the US to China. China demonstrates a strong willingness to participate in marketing the international taxation rule, and its model will serve as a basis for export. Secondly, China has grown from a large market jurisdiction into a powerful and influential economy.[7] As of 26 June 2023, its "Belt and Road Initiative", a global infrastructure development strategy, has invested in 152 countries and 32 global organizations.[8] This strategy helps China maintain friendly relations and influence with fellow developing countries. Thirdly, due to the aforementioned factors, it is highly likely

[5] China is likely the first major country that recognizes LSAs in its transfer pricing regulations. For an overview of Chinese transfer pricing regime and LSAs, *see* Jinyan Li and Stephen Ji, *Location-Specific Advantages: A Rising Disruptive Factor in Transfer Pricing*, (2017) 71(5) *Bulletin for International Taxation* 259.
[6] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, paras 2.1.2, 2.9.1 and 2.19.1.
[7] European Commission, *China's Economic Power on Uncertain speed*, 5 October 2022, available at <https://knowledge4policy.ec.europa.eu/foresight/chinas-economic-power-uncertain-speed_en> accessed on 4 July 2023.
[8] Belt And Road Portal, *List of Countries that joined the "Belt and Road Initiative"* (in Chinese), 26 June 2023, available at <https://www.yidaiyilu.gov.cn/xwzx/roll/77298.htm#:~:text=%E6%88%AA%E8%87%B32023%E5%B9%B46%E6%9C%88,%E2%80%9C%E4%B8%80%E5%B8%A6%E4%B8%80%E8%B7%AF%E2%80%9D%E5%90%88%E4%BD%9C%E6%96%87%E4%BB%B6%E3%80%82> accessed on 4 July 2023.

that China will serve as a model or benchmark for other developing countries, making the Chinese international tax approach influential.

Chapters 4 to 6 outlined the obstacles a market jurisdiction shall pass to share residual profits under the OECD model. However, the taxing rights of the market jurisdictions largely depend on how they domesticate the model. This chapter adopts the same theoretical framework as Chapters 4 to 6, investigating the Chinese transfer pricing rules. It first outlines in Section 7.2 the core principles of the Chinese transfer pricing model that deviate from the OECD's. As the Chinese PE concept is the same as the OECD's, Section 7.3 will discuss the Chinese rules of creating marketing intangibles and treatment of enhancing the value of the existing intangibles. Afterwards, it scrutinizes the Chinese approach of the PSM, including when and how it is applied in Section 7.4. It follows an analysis of the LSAs in Section 7.5. As Amount B of the Two-Pillars Approach will influence the application of the Chinese model, especially in terms of the LSAs, Section 7.6 will be a brief discussion of Amount B. Lastly, Section 7.7 will be a summary.

This chapter does not examine Chinese academic literature in detail because they are underdeveloped regarding the main issues addressed in this chapter. For instance, the term "comparative advantage" repeatedly appeared in official publications such as China's chapter in the UN Transfer Pricing Manual,[9] but the Chinese State Taxation Administration (hereinafter STA)[10] developed the concept of LSA from this economic theory without any adequate explanation. The Chinese academic literature took it for

[9] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3.
[10] The Chinese tax authority used to call "State Administration of Taxation", short for "SAT". In the recent UN Transfer Pricing Manual, as well as the tax authority's official website, the name has changed to "State Taxation Administration", short for "STA". see <http://www.chinatax.gov.cn/chinatax/index.html>, accessed on 14 November 2022; UN 2021 Transfer Pricing Manual, above fn 3. Both names refer to the Chinese tax authority.

granted and only mentioned this concept in passing.[11] They provide little critical analysis of the essential Chinese international tax policy. Also, in the author's opinion, China's position will only be reflected in either the official publications or the semi-official publications, such as the journal articles written by Tizhong Liao,[12] the director of the International Tax Department of The STA of China. The Chinese academic literature tends to engage in uninformed speculation concerning how the government's tax policy, which is explicable because its deliberate ambiguity.

Though this chapter is not built on a large number of journal articles, it bases its argument mainly on the official publications of the Chinese STA, such as the relevant chapters of the UN Transfer Pricing Manual, Chinese tax regulations, announcements and memorandum of the Chinese STA. These are primary sources of Chinese international tax law, which reflects the position of the Chinese STA and government.

7.2 Core principles

China declares that the core of its transfer pricing regime is the ALP, while it also claims that it has "made great efforts to uphold the ALP despite many challenges encountered in

[11] See, e.g., Zhixuan Wang and Liping Deng, '20 Years in WTO: The Review and Prospect of China's International Taxation System' (in Chinese) (2021) (11) *Taxation Research* 18, at 19; Lin Han and Ruyu Deng, 'A Century of Internaional Tax Reform under Umtiple Games — Interview with Ping Lian, Chief Economist and Director of Zhixin Investment Research Institute' (in Chinese) (2021) (12) Taxation Research 3, at 5; Handan Hong, 'The Status Quo of the Global Tax Governance Structure' (in Chinese) (2022)(2) *Taxation and Economy* 34, at 37.

[12] See, e.g., Tizhong Liao, 'Century Choice and Future of The International Taxation Policy' (2021) (2) *International Taxation in China* 3; Tizhong Liao, 'Globalization and International Tax Reform' (2021) (08) *International Taxation in China* 3. Apart from the position in Chinese STA, Dr. Tizhong Liao is also a Senior Advisor in the OECD Committee on Fiscal Affairs. In his articles, he often articulated that "the views of the article do not represent the OECD", but he never made the same statement for the Chinese STA.

the process".[13] This is a perfect note explaining the status quo of the Chinese international tax rules. On the one hand, the Chinese approach is still primarily based on the OECD model. On the other hand, it has been bred and premised on several principles fundamentally different from the ALP.

7.2.1 Comparative advantage theory

China does not specify the economic theory underlying its transfer pricing practice, but its emphasis on LSAs is most closely aligned with comparative advantage theory.[14] The simplest model of this theory consists of two countries, such as China and the US, and two types of resources or products, such as labour and research and development. Assume that China has a comparative advantage in low-cost labour and the US in research and development. The two countries perform their functions at relatively low cost and use fewer resources than if they carried out both functions. In this case, the two countries will choose to spend all their resources, performing the function they are good at, and trade for what they need. According to the bargain theory, the cost saving will eventually be split between the two parties.

The initial intention of this theory was to explain the benefit of international trading, but it also justified the concept of LSAs for transfer pricing purposes. An MNE will choose to perform functions in a country with lower costs to benefit from the comparative advantages of each country and maximize its profits. For example, MNEs usually choose

[13] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, paras 2.11.1.
[14] Comparative advantage theory was built on the absolute advantage concept alluded to by Adam Smith in his well-known *The Wealth of Nations* (1776). The theory was developed by Robert Torrens, and refined by David Ricardo in David Ricardo, *On the Principles of Political Economy, and Taxation* (1st Am. ed., J. Milligan 1819).

to develop intangible assets in the US to save on developing costs and manufacture products in China or countries with lower manufacturing-related costs. The MNEs enjoy the benefits of all sorts of comparative advantages as single enterprises. Hence, it is unfair to allocate all or most of the residual profits to one particular state only because its comparative advantages give rise to trade intangibles. All relevant jurisdictions should share the benefits of the cost savings.

China repeatedly uses the term 'comparative advantages' in its Country Practice chapter of the UN Manual to explain the concept of LSAs. For instance:

> *"In a globalizing economy, MNEs usually set up operations in developing countries to take advantage of comparative advantages that these countries offer. For example, they set up manufacturing operations to take advantage of the abundant cheap labour or natural resources to supply products for overseas markets, R&D to take advantage of local talent for overseas principals, and distribution of imported products to the local market. These operations often take the form of contract or toll manufacturing, contract R&D, and limited risk distribution to leave little profit to the local country, despite the fact that many such comparative advantages contribute significant profits to the MNE group."*[15]

Chinese local tax authorities also use the concept of "comparative advantages". For example, Shenzhen local tax authority specifies in its Explanatory Memorandum of Public Notice [2014] No. 42 that:

[15] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.22.1.

> *"Location-specific advantages are the factors in a specific geographic area that the body of economies can obtain to get comparative advantages…"*[16]

These positions indicate that the Chinese STA views the transfer pricing analysis more as a state play than something undertaken at the entity level. The STA is not caught up in the details, such as functions performed, assets used, and risks assumed by a single entity but views the MNE in its entirety.[17] The jurisdictions in the value chain of an MNE actively contribute to value creation through LSAs. Hence, in the Chinese model, like intangibles, the significant LSAs will trigger the PSM regardless of if they are owned or controlled by an entity.[18] The LSAs arising in China are real benefits the MNE captures as a single enterprise, so the relevant entities or jurisdictions will share the additional profits.

7.2.2 The critical importance of market in value realization

The Chinese transfer pricing practice places significant importance on the market. The STA believes that the MNEs require fast-growing markets like China and the contributions of market jurisdiction subsidiaries to realise the value of their trade

[16] Shenzhen Local Tax Bureau, *Explanatory Memorandum of SAT Public Notice [2014] No. 42 "Public Notice on Matters Regarding Refining the Fiing of Related Party Transactions and Administration of Contermporaneous Transfer Pricing Documentation*", Article 71. Shenzhen is one of the pilot locations for Chinese international taxation reform. The other pilot locations include Liaoning Province, Shanghai, Jiangsu Province, Henan Province, Chongqing, Guangdong Province, and it arguably include Beijing, Shanxi Province, Hubei Province. See SAT, *Reform Pilots Lead The Innovation and Development of Taxation*, Available at <http://www.chinatax.gov.cn/n810341/n810780/c2667843/content.html> (in Chinese) accessed on 16 November 2022. Also, China has a highly centralized transfer pricing investigation system, only the STA headquarters have the right to open and close a transfer pricing case. It ensures the consistency of the enforcement of transfer pricing rules among the local tax authorities. For the aforementioned reasons, it is reasonable to assume that the publications and public notices of local tax authorities generally reflect the position of the STA. See UN 2021 Transfer Pricing Manual, above fn 3, para 2.4.1.

[17] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.22.2.

[18] Ibid, para 2.22.9.

intangibles.[19] Emerging markets create value for the MNEs, which results in profits.[20] Therefore, it is unfair to allocate most or all residual profits of an MNE to the jurisdictions where intangibles are located. The market jurisdictions should share some of the residual profits for being markets.

This importance of the market in the Chinese approach also likely makes the second reason for introducing the concept of LSAs to the transfer pricing analysis. In the Chinese approach, the LSAs include location savings and market premiums.[21] The comparative advantage theory outlined in Section 7.2.1 explained the application of location savings. The market jurisdiction shall share residual profits for being markets, and the better markets are eligible for more profits than others because they create more value in the value chain, which are reflected as market premiums. A great example of premium tuna was illustrated in Chapters 2 and 5:

> *"…due to higher demand in Japan for high quality tuna, businesses can sell such tuna at a higher price in Japan than anywhere else. This higher consumer demand clearly is a factor that generates value for the supplier, but this notion is absent from the usual understanding of the principle of value creation."*[22]

The preference for high-quality tuna is a market feature the Japanese have in common. Any comparable domestic transactions will prove that the premium price charged in Japan is fair, so the premium profits arising from this market feature will be shifted to foreign affiliates. It will be a different case if a comparable foreign transaction is used and

[19] Ibid, para 2.21.1.
[20] Jinyan Li and Stephen Ji, above fn 5, at 260.
[21] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.17.2.
[22] Michael P. Devereux and John Vella, 'Taxing the Digitalised Economy: Targeted or System- Wide Reform?' (2018) 4 *British Tax Review* 387, at 394.

the market premium is recognised, in which Japan will be allocated more profits for being a "good market" for premium tuna.

7.2.3 Enterprise doctrine

China has a stronger application of the enterprise approach in its transfer pricing regime.[23] Under the enterprise approach, a group is, in general, treated as one single enterprise instead of as separate entities. The STA takes a holistic view of the functions and risks performed in China, meaning it views the functions performed by different entities of the same MNE in their entirety rather than assessing them separately.[24] This position is consistent and beyond the "accurate delineation of the controlled transaction", which was just incorporated in the OECD 2022 Guideline.[25]

China is a supporter of the PSM,[26] which is a method that applies enterprise doctrine more extensively than any other transfer pricing methodologies. The STA has also observed that "comparable transactions are often hard to find in real life",[27] and "it is nearly impossible to take out one piece of a value chain of an MNE group and try to match it to comparable transactions/companies".[28] Therefore, a more approachable way to achieve an appropriate allocation of profit is to analyse the global value chain and allocate profits based on a varies of factors, such as the contributions of intangibles and tangible

[23] For a discussion of the difference between enterprise approach and separate entity approach, see Section 6.2 of this thesis.
[24] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.22.2.
[25] OECD 2022 Report, above fn 2, para 1.36.
[26] Jinyan Li, 'Soft Law, Hard realities and Pragmatic Suggestions: Critiquing the OECD Transfer Pricing Guidelines' in Wolfgang Schön, and Kai A Konrad (eds), *Fundamentals of International Transfer Pricing in Law and Economics* (Springer Berlin, Heidelberg, 1st ed, 2012) 71, at 88.
[27] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, paras 2.20.1.
[28] Ibid, paras 2.20.2.

assets used, functions performed and risks assumed, as well as the LSAs and group synergies.[29]

The Chinese approach does not rule out Formulary Apportionment (hereinafter FA). The FA method falls in Article 22 of Bulletin 6 that "other methods" apart from the CUP, resale price, cost plus, TNMM and PSM that satisfy the arm's length principle and "reflect the basic principle that profit attribution aligns with the economic substance and value creation".[30]

In some cases, the STA even recommends the FA approach, which fundamentally deviates from the ALP.[31] For instance, in the context of contract manufacturing, related parties often structure the arrangement in a way that minimizes the profits attributed to the Chinese manufacturer, citing its supposedly low-risk profile.[32] This practice results in the extraction of profits from the Chinese entity. Furthermore, in the electronic manufacturing services (EMS) sector, China effectively applies the enterprise approach and argues for a "global formulary approach" with more weighting for assets and employee headcounts in the allocation of profits:

> *"China takes the view that a risk based approach may place insufficient regard for the fact that there are sizeable assets located in China (i.e. the work force and factory plants). In many cases, the majority of the headcount of the EMS group*

[29] SAT, *Consultation Draft Circular: Implementation Measures for Special Tax Adjustments* (2015), published on 17 September 2015, in Chinese "特别纳税调整实施 办法(征求意见稿)", Article 73. Hereinafter "2015 Draft Circular". In comparison, the OECD approach does not always consider LSAs in profit allocation.
[30] SAT, Public Notice [2017] No.6, *Public Notice of the State Administration of Taxation on Issuing the "Administrative Measures of Special Tax Investigation and Adjustment and Mutual Agreement Procedure",* in Chinese "特别纳税调查调整及相互协商程序管理办法", Article 22. Hereinafter "Bulletin 6".
[31] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.23.3.
[32] Ibid, para 2.23.2.

> *are based in China… remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits should stay, and* ***a global formulary approach should be a realistic and appropriate option****… Alternatively, the Chinese tax administration may determine the proper return for the headquarters, with the Chinese manufacturer earning the residual profits."*[33]

Tizhong Liao, the director of the International Tax Department of The STA of China argued that due to digitalization, the international taxation community would eventually agree upon global FA which would give rise to a "fairer international taxation system".[34] Therefore, it is likely that China will move away from the OECE approach and increasingly align itself with the global FA method.

7.3 Creation of marketing intangibles and enhancing value of existing intangibles

China has a PE concept similar to the OECD Model Tax Convention, e.g., the double tax convention between China and the US has the same Article 5 as the OECD Model Tax Convention 1977.[35] Hence, this part discusses the Chinese approach regarding the

[33] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.23.3.
[34] Tizhong Liao, 'Globalization and International Tax Reform' (2021) (08) *International Taxation in China* 3, at 3.
[35] See United States – The People's Republic of China Income Tax Convention, signed 30 April 1984 (entered into force 1 January 1987); OECD, *Model Double Taxation Convention on Income and on Capital* (1977), Article 5.

creation of marketing intangibles and enhancing the value of the existing licensing intangibles.

As discussed in Chapter 5, under the OECD approach, both marketing intangible and the DEMPE activities that enhance the value of the intangibles help the market jurisdiction distributors share a portion of residual profits. Between these two options, creating a marketing intangible is more beneficial to the market jurisdiction because it will bring long-term benefits even after the termination of the licensing contract. On the contrary, during the agreement, the DEMPE activities only benefit the licensee in the short term. Consequently, it is reasonable to assume that emerging markets like China will be willing to make tax policies encouraging MNEs to create local marketing intangibles.

However, China seems to be happy with the short-term benefits. The Chinese transfer pricing rules intentionally make the "marketing intangibles" concept ambiguous. Prior to the most current transfer pricing regulation Bulletin 6,[36] China published a draft circular published in 2015,[37] which defined the concept of "marketing intangible" as "intangibles that related to marketing activities, such as trademarks, trade names, customer lists, customer channels, results of market research, franchises, and government licences".[38] In an earlier transfer pricing regulation, Circular 2, which was published in 2009, China has included trademarks, customer lists and marketing channels as examples of marketing intangibles. [39] However, Bulletin 6 included neither the definition of marketing

[36] SAT, Bulletin 6, above fn 30.
[37] SAT, 2015 Draft Circular, above fn 29.
[38] SAT, 2015 Draft Circular, above fn 29, Article 69.
[39] SAT, Guo Shui Fa [2009] No. 2, *Implementation Measures for Special Tax Adjustment (trial)*, Article 10(2). Hereinafter "Circular 2".

intangibles nor the examples, which made the concept of "marketing intangibles" ambiguous. Not to mention clear instructions for creating marketing intangibles.

Moreover, compared to creating marketing intangibles, the Chinese transfer pricing rules focus more on the activities that enhance the value of the existing intangibles.[40] Further to the DEMPE functions, China adds "promotion" to be the sixth factor that contributes value to the intangibles (hereinafter DEMPEP, in comparison to the OECD DEMPE) to highlight the contributions made by distributors or marketers.[41]

Nevertheless, China has an opposite position towards trade intangibles. All Chinese entities undertaking research development activities for themselves or as service providers will be eligible for a lower tax rate of 15%[42] compared to a standard corporate income tax rate of 25%.[43] However, the entities that provide contract research have much more restrictions and requirements to be eligible to enjoy the lower tax rate. For instance, their staff education deduction is limited to 8% of total salary expense;[44] at least 50% of the employees should have Bachelor Diplomas; [45] income sourced from contract researching should constitute at least 50% of the total income. [46] While the entities

[40] See, e.g. UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.21.2.
[41] SAT 2017 Bulletin 6, above fn 30, Article 31(4).
[42] For entities providing contract research services to other entities, see Ministry of Finance, SAT and Ministry of Commerce, Caishui [2017] No. 79, *Public Notice of the Ministry of Finance, the State Administration of Taxation, and the Ministry of Commerce on Nationally Promoting the Income Tax Policies for Advanced Technology Service Enterprises*, in Chinese "关于将技术先进型服务企业所得税政策推广至全国实施的通知", Article 1(1). For entities obtained "high and new technology status" meaning they are supposed to perform research and keep the resulting intangible assets, see STA, Public Notice [2017] No.24, *Public Notice of the State Administration of Taxation on the Issues Concerning Implementation of the Tax Cut for Hi-Tech Enterprises*, in Chinese "关于实施高新技术企业所得税优惠政策有关问题的公告", Article 1.
[43] *Law of the People's Republic of China on Enterprise Income Tax*, in Chinese "中华人民共和国企业所得税法" (2018), Article 4.
[44] Minstry of Finance, SAT and Ministry of Commerce, Caishui [2017] No. 79, *Public Notice of the Ministry of Finance, the State Administration of Taxation, and the Ministry of Commerce on Nationally Promoting the Income Tax Policies for Advanced Technology Service Enterprises*, Article 1(2).
[45] Ibid, Article 2(3).
[46] Ibid, Article 2(4).

obtained "high and new technology status", meaning they are supposed to perform research functions and keep the resulting intangible assets in China, do not have such restrictions.[47] The different positions show that China encourages the MNEs to leave the legal and economic ownership of the locally developed trade intangibles in China.

The Chinese STA observed that some MNEs established Chinese subsidiaries obtained the "high and new technology status" but only undertook contract research for the groups and did not keep the legal and economic ownership of the resulting intangibles.[48] In this case, the tax concessions for these entities will be denied.[49]

7.4 China's profit split methodology

China, in general, follows the OECD model with respect to the application of the PSM. In particular, it applies the PSM in a three-step approach:

(1) determine whether the PSM is the most appropriate transfer pricing method;

(2) calculate the relevant profit to be split; and

(3) split the profit to the parties of the controlled transaction.[50]

Section 7.4.1 analyses the first step, and Section 7.4.2 the other two steps.

[47] Guokefahuo [2016] No. 32 *Public Notice of the* Ministry of Science and Technology, Ministry of Finance and State Administration of Taxation of revising the Administrative Measures for Recognition of *High-Tech Enterprises*, in Chinese "科技部 财政部 税务总局关于修订印发《高新技术企业认定管理办法》的通知", and STA, Public Notice [2017] No.24, *Public Notice of the State Administration of Taxation on the Issues Concerning Implementation of the Tax Cut for Hi-Tech Enterprises*.
[48] See UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.22.3.
[49] Caishui [2017] No. 79, above fn 44.
[50] SAT 2017 Bulletin 6, above fn 30, Articles 15, 16 and 21.

7.4.1 When should the PSM be applied?

7.4.1.1 The most appropriate method

The OECD stipulates the following general rule for choosing the most appropriate transfer pricing method:

> *"…the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case, taking into account the respective strengths and weaknesses of each method, its appropriateness in view of the nature of the accurately delineated controlled transaction, the availability of reliable information (in particular on uncontrolled comparables) needed for application, and the degree of comparability between the controlled and uncontrolled transactions."*[51]

To determine whether the PSM is the most appropriate method, the OECD states that the presence of any of the following indicators is relevant:

- both party makes unique and valuable contributions;
- the business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other;
- the parties share the assumption of economically significant risks or separately assume closely related risks.[52]

[51] OECD 2022 Report, above fn 2, para 2.116.
[52] OECD 2022 Report, above fn 2, paras 2.119, 2.120 and 2.121.

China currently recognizes only the first two indicator:

- both the enterprise and its related party make unique contribution to profit creation;
- engage in highly integrated operations and thus difficult to separately assess each party.[53]

The absence of the third indicator is possibly because China released its most recent transfer pricing regulations in early April 2017, which was before the OECD introduced the third indicator in its Revised Guidance on the PSM in June 2017.[54]

While the two first indicators identified by the OECD and China may appear similar, the application of these indicators in practice is quite different. In particular, the OECD emphasizes the importance of the first indicator to determine when the PSM is the most appropriate method: "the existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate."[55] Following this logic, the OECD indicates that, in general, the PSM is unlikely to be appropriate to a case where one party to the controlled transaction performs only simple functions,[56] such as a typical limited-risk distributor structure.

In contrast, China argues that the contributions from marketing and distribution functions in developing countries are often underestimated, even for the typical limited-

[53] SAT 2017 Bulletin 6, above fn 30, Article 21.
[54] OECD, *Revised Guidance on the Application of the Transactional Profit Split Method, Inclusive Framework on BEPS Action 10*, (2018).
[55] OECD 2022 Report, above fn 2, para 2.126. The OECD defines unique and valuable contributions to be those that "(i) … are not comparable to contributions made by uncontrolled parties in comparable circumstances, and (ii) … represent a key source of actual or potential economic benefits in the business operations, see para 2.130.
[56] OECD 2022 Report, above fn 2, para 2.127.

risk distributor structure:

> *"The Chinese experience shows that many MNEs treat their Chinese distribution entities as limited risk distributors, and use a set of simple distributors performing limited functions in a mature market such as Japan as the comparable… There are a couple of obvious deficiencies … First, there is often a mismatch in terms of functional profile, as the Chinese entity may perform significantly more functions… which is evident if it incurs significantly more operating expenses relative to sales. Second, it does not account for market differences, with China being a fast growing economy with strong demand and requiring relatively less selling effort, which can therefore achieve higher efficiency and profitability.* ***Other LSAs such as country premium and any marketing intangibles that are created by the Chinese entity are also commonly ignored.****"*[57]

To rectify these deficiencies, China may apply the PSM as a "more appropriate transfer pricing method … in cases where there are significant local marketing intangibles or LSAs".[58] This case passes on the message that in the case of the low-risk distributor, foreign comparables may be questioned by the STA as not accounting for the geographic difference. Such differences may give rise to the LSAs for the Chinese entities, which triggers the PSM. While the OECD emphasizes the LSAs are not intangibles because they are not owned or controlled by the entities,[59] China treat them as quasi-intangibles and unique contributions made by China through the Chinese entity.

[57] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.22.8.
[58] Ibid, para 2.22.9.
[59] The 2022 Report, above fn 2, para 6.9.

More importantly, China does not require the relevant contributions to be "valuable" but only unique to trigger the PSM. China has constantly claimed that it is nearly impossible to find reliable comparable transactions globally and domestically (see Section 7.4.1.2).[60] Many reasons cause it, and one of them is the increasing uniqueness of the intangibles. This is distinct from the OECD's approach, where "valuable" was emphasized over "uniqueness" before 2010, and this position arguably stretched to 2017 when Chapter VI was reformed by the BEPS Project (see Section 6.3.4).

7.4.1.2 Do reliable comparable transactions exist?

China has consistently argued that it is difficult to find reliable comparables in practice. In the Chinese STA's opinion, it is a global problem due to the increasing number of MNEs and the increasingly uniqueness of the intangibles:

> *"…the application of the [ALP] has become more challenging as the number of MNEs grew. The statistics shows that over 2/3 of the world trade involves MNEs. More than 50% of the world trade involves related party transactions…Take a pharmaceutical group as an example… The [ALP] can hardly be applied here as there are no comparable transactions on the market to be found because the parent company would not give the formulation to a third-party company to manufacture."*[61]

[60] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, paras 2.20.2, 2.20.4 and 2.20.5.
[61] Ibid, para 2.20.2.

Though it's a common problem all countries face, it is more severe in developing countries:

> *"One of the key challenges for developing countries is the lack of reliable, public information on comparables…Up till the end of 2019, there are about 4000 listed companies in China whereas the private companies are not bound by law to disclose financial information to the public. It is unrealistic to expect that reliable comparables to the tested companies can be found in 4000 listed companies."*[62]

By claiming that no reliable comparable can be found, China benefits in two ways. One is that a lack of comparable leads to a wider application of the PSM, under which the group synergies will be shared by both parties.[63] The other is the missing local comparable transactions enable the STA to apply a foreign reliable comparable, under which significant comparability adjustments, including LSAs, can be made.[64]

The OECD provided that a lack of close comparable should not per se make the PSM the most appropriate method.[65] However, China specifically points out that the PSM should be applied when it is difficult to obtain the information of comparable transactions, while the combined profit of the controlled transaction and the relevant value-adding factors can be reasonably decided.[66] The Chinese version PSM value creation factors such as

[62] Ibid, para 2.20.4.
[63] Ibid, para 2.20.5. Also see SAT 2017 Bulletin 6, above fn 30, Article 21: "Where it is difficult to obtain information on comparable transactions … to analyze value contribution made by each party and allocate profits accordingly."
[64] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.5. The STA has stipulated this policy in the latest transfer pricing regulations: SAT 2017 Bulletin 6, above fn 28, Article 27 that "…environments, tax authorities should analyze location-specific factors, such as cost savings, market premium, etc., and select an appropriate transfer pricing method to determine the contribution to profits derived from the location specific factors."
[65] OECD 2022 Report, above fn 2, para 2.128.
[66] SAT 2017 Bulletin 6, above fn 30, Article 21.

income, cost, expenses, assets and employee headcount as the allocation keys. This particular method is often labelled as "Value Contribution Allocation Method" as appose to a common OECD PSM.[67]

In summary, while China does not actively implement tax policies to encourage Chinese entities to develop their own marketing intangibles, it often relies on the concept of LSAs to justify the use of PSM when foreign comparable transactions are used. Given the lack of local comparable transactions, it likely makes the PSM to be employed more often than under the OECD model. Due to the limited availability of local comparable transactions, the PSM is likely employed more frequently in China compared to the OECD model.

7.4.2 How should the PSM be applied?

Once the PSM is the most appropriate method, the next step is to decide the relevant profit or loss to be split and the allocation keys. The OECD admits that the PSM is difficult to apply in practice, and it is necessary to rely heavily on "judgement" (see Section 6.5.3).[68]

As such, the OECD allows substantial flexibility in the application of the PSM,[69] For instance, the OECD allows choices of different types of profits (for example, actual profit or anticipated profit) and different measures of profits (for example, gross profit or operating profit) that are consistent with the accurate delineation of the transaction.[70] Also, the OECD allows flexibility on the choices of splitting factors (sometimes called

[67] Giammarco Cottani, 'Formulary Apportionment: A Revamp in the Post-Base Erosion and Profit Shifting Era?' (2016) 44(10) *Intertax* 755, at 759.
[68] OECD 2022 Report, above fn 2, at 2.123, 2.151 and 2.181.
[69] Ibid, at 2.146.
[70] Ibid, at 2.158 and 2.162.

allocation keys), including a weighted combination of asset-, capital-, or cost-based splitting factors.[71]

Though the Chinese approach is mainly consistent with the OECD model, it is distinct regarding applying the PSM in several ways. First, while the Chinese STA allows the PSM to use actual or anticipated profits as the "combined profits"— total profits to be split, it does not seem to allow a split of gross profits. The Bulletin 6 used the word "profit" under the PSM rules Article 21 as opposed to "gross profit" in Articles 19 and 20,[72] indicating these two were different concepts. It is possible that the Chinese approach only allows the use of operating profits under the PSM, like the US Section 482.

Second, China tends to use the splitting factors more appropriate to low-cost or low-income jurisdictions. For example, the OECD allows "employee compensation" as a cost-based allocation key, while China directly uses the "employee headcount",[73] a common allocation factor in FA. With the same number and quality of employees, the salary cost in China is expected to be lower than in developed countries. Hence, using "employee headcount" directly will benefit China more.

Further, as discussed in Sections 7.2.3 and 7.4.1, the Chinese STA allows a potential application of the PSM when significant LSAs are present, meaning the LSA not only triggers the PSM but also splits between controlled parties in a way. The OECD does not explicitly exclude LSAs from the PSM analysis. While the OECD takes the position that the LSAs should be considered in the comparability analysis if needed, they are not unique and valuable contributions like the intangible assets that trigger the PSM. However, in the

[71] Ibid, paras. 2.171 and 2.172.
[72] SAT 2017 Bulletin 6, above fn 30, Articles 19 to 21.
[73] Ibid, Article 21.

most recent 2022 Guideline, the OECD opened the door to the split of LSA benefits when they are significant contributors to profits:

> *"In identifying and applying appropriate cost-based profit splitting factors a number of issues may need to be considered…marketing costs may be incurred and recorded across several product lines, whereas only one product line is the subject of the profit split transaction. Where location savings retained by member(s) of the MNE group are a significant contributor to profits, and such costs are included in the profits to be split, then the manner in which independent parties would allocate retained location savings would need to be reflected in the profit split, taking into account the guidance in Section D.6 of Chapter I."*[74]

This change of position made the OECD model slightly more aligned with the Chinese approach that the LSAs would trigger the PSM, and the LSA benefits should be allocated according to one of the transfer pricing methods, such as PSM.[75] However, the split of benefits still needs to reflect the third-party comparable transaction, which could be hard to find.

7.5 Location-specific advantages

China defines LSAs as "advantages for production arising from assets, resource endowments, government industry policies and incentives, etc., which exist in specific

[74] The 2010 Report, above fn 2, para 2.182.
[75] Georg Kofler, 'The BEPS Action Plan and Transfer Pricing: The Arm's Length Standard Under Pressure?' (2013) 5 *British Tax Review* 647, at 654.

localities".[76] The concept was first introduced by China in its Country chapter in the 2012 UN *Transfer Pricing Manual*.[77] Since then, the concept of LSAs has become a focus of the STA for transfer pricing audit and APA negotiations.[78] Identifying LSA leads to allocation of more profits to the LSA host country.[79]

By contrast, the concept of LSAs was not formally recognized by the OECD until the revision of its 2017 Guideline after the BEPS project. The 2017 Guideline and subsequent 2022 Guidelines did not formally define LSAs but instead refer to the concept in terms of "location savings" and "other local market features".[80] They are relevant factors in comparability analysis if the difference is material.[81] China believes that LSAs arise more frequently in developing countries and are comprised of two main categories: location savings and market premium.[82]

The Chinese STA defined the location savings as "the net cost savings derived by an MNE when it sets up its operations in a low cost jurisdiction".[83] They represent the net savings due to lower costs for labour, rent, raw materials and infrastructure, etc., after offsetting against additional expenses due to the relocation, such as increased training costs.[84]

[76] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.8.
[77] Deloitte, *Location-Specific Advantages* in *The New Transfer Pricing Landscape: A Practical Guide to the BEPS Changes* (November 2015), <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-beps-changes-transfer-pricing-location-specific-advantages.pdf> accessed on 11 June 2019.
[78] For instance, LSAs are specifically mentioned as relevant factors in comparability analysis of a transfer pricing investigation: SAT 2017 Bulletin 6, above fn 30, Article 15.
[79] For a worked example showing the effect of LSAs from the perspective of China, see UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.15.
[80] OECD 2022 Report, above fn 2, Ch. 1, D.6.
[81] Ibid, Part D.6.
[82] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.8.
[83] Ibid, para 1.139.
[84] Ibid, para 2.4.4.3.

On the other hand, market premiums are defined to be "additional profit derived by an MNE by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product".[85] The relevant market conditions that may give rise to premiums are market size or scale, market access, government incentives for certain industries, substitution of products or services in a market, and inelasticity of demand for certain products or services.[86] They are often seen in the luxury goods, pharmaceutical and automotive industries in China.[87]

This section intends to undertake a thoroughly comparison between the OECD model and the Chinese approach regarding the LSAs. Section 7.5.1 discusses the different treatment of the LSAs between the OECD and the Chinese approach. Section 7.5.2 contains a comprehensive comparison of the LSA items, where the positions of the OECD, the UN, and the Chinese approach are contrasted. The detailed analysis outlines the differences and similarities among these organisations' stances on the LSA items.

7.5.1 The treatment of LSAs

The Chinese treatment of LSAs deviates from the ALP but is consistent with the BEPS value creation principle. During its involvement in the BEPS project, China consistently advocated including LSAs in profit split calculations.[88] The effort proved unsuccessful at

[85] Ibid, para 2.20.9.
[86] STA, *Public Notice [2016] No.42: Public Notice of the State Administration of Taxation on Issuing the 'Public Notice on Matters Regarding Refining the Fiing of Related Party Transactions and Administration of Contermporaneous Transfer Pricing Documentation'*, Article 14(iii)(a)(4); Sophie Ashley, above fn 61, question 5.
[87] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.16.
[88] Diheng Xu, 'The Convergence and Divergence between China's Implementation and OECD/G20 BEPS Minimum Standards' (2018) 10(3) *World Tax Journal* 471, at 485.

first. Shortly after it unilaterally incorporated LSAs into its own transfer pricing rules, the OECD approved the LSAs in the 2017 Guideline.

However, under the OECD model, it is difficult for a jurisdiction even to confirm the existence of the LSA benefits. The OECD stipulates the following broader approach to determine whether and how the LSAs should be allocated:[89]

- determine the amount of LSAs;
- determine the extent to which LSAs are passed on to independent customers or suppliers;
- where LSAs are not fully passed on to independent customers or suppliers, determine the manner in which independent enterprises operating under similar circumstances would allocate any retained LSAs.

The OECD illustrates this approach with an example in which an MNE reallocates its clothing manufacturing activities – which are basic and can be readily performed by a third party – to Country B for a lower cost, while the group member (Co.A) in Country A retains the brand name and continues performing the design function. The company in Country B (Co.B) manufactures the clothes under a contract manufacturing arrangement and sells the products to Co.A, which in turn sells to third-party customers. In this case, the OECD's position is that the LSA benefits arising from the low cost should not be allocated to Country B because:

> *"[G]iven that the relocated activity is a highly competitive one, it is likely that the enterprise in Country A has the option realistically available to it to use*

[89] OECD 2022 Report, above fn 2, para. 1.141. A similar approach is set out for 'other local market features': para. 1.146.

> *either the affiliate in Country B or a third party manufacturer. As a consequence, it should be possible to find comparables data to determine the conditions in which a third party would be willing at arm's length to manufacture the clothes for the enterprise. In such a situation, a contract manufacturer at arm's length would generally be attributed very little, if any, part of the location savings."*[90]

The OECD provides another example to illustrate when and how LSAs may lead to a greater allocation of profits.[91] This example is similar to the one above, except that the MNE is in the business of providing highly specialized engineering services, and Co.B is the only entity in a lower-cost country that can provide the same quality services for substantially lower wages. In this case, the OECD agrees that Co.B should enjoy the benefits arising from the LSAs, and the PSM may be the appropriate method to provide for this:

> *"[Co.A] does not have many other options available to it than to use this service provider. The remuneration payable by [Co.A] to [Co.B] should take into account the location savings created by [Co.B] … In some instances, the nature of the contributions made by the [two companies] may meet the criteria for the use of a [PSM]."*[92]

These two examples highlight that the OECD does not view a feature, such as offering a low-cost function, as a "contribution" that would increase tax revenue for a jurisdiction. Instead, the OECD requires the feature to be "entity-owned" or accessible exclusively to a particular entity for the jurisdiction to have the authority to claim more taxing rights.

[90] Ibid, para. 9.129.
[91] Ibid, para. 9.130.
[92] Ibid, para. 9.131.

This approach by the OECD contradicts the concept of LSAs being a shared feature of jurisdiction rather than being tied to a single entity.

The OECD undertakes the transfer pricing analysis at the entity level and assumes that the markets are isolated, the entities competing with competitors in the same market, so the differences between markets are not of critical importance (see Section 5.7). The transfer pricing analysis focuses on the "market advantage" of a particular entity, which often refers to intangibles, while the countries are passive in this algorithm, and they will share the tax base to the extent of what the local entities have contributed to the value creation.

Based on this guiding principle, the OECD ignores LSAs when local comparable transactions are available because they are not intangibles that are owned or controlled by a specific entity. When foreign comparable transactions are used in transfer pricing analysis, the LSAs may be adjusted in comparability adjustments.[93] It means that the LSAs are often neglected in the transfer pricing analysis even though MNEs benefit from the comparative advantages of a jurisdiction. For example, Vietnam has a comparative advantage of low-cost labour, and all Vietnam entities share this advantage in common. Any domestic comparable transaction adopted in the transfer pricing analysis will tell the same lie that the labour contribution by the Vietnam entity is lower than a US equivalent entity, so Vietnam should collect tax on a profit lower than the US. Hence, the cost-saving by Vietnam's comparative advantage will be stripped by jurisdictions where the intangibles are located.

[93] Ibid, para 6.31. It was reinforced in para 6.9.

The Chinese approach towards the LSAs, while broadly consistent with the OECD Guidelines, was modified by China primarily in response to key problems identified by the STA in the application of the traditional transfer pricing methods, including the lack of comparable local transactions and the desirability of identification, valuation and allocation of LSAs in the determination of the share of income attributable to a jurisdiction.[94] Comparing to the OECD model, China has a different focus with respect to the allocation of LSAs:

- determine *whether the LSA generates additional profit*;
- quantify and measure the additional profits arising from the LSA; and
- determine the transfer pricing method to allocate the profits arising from the LSA.[95]

This approach focuses on whether the LSAs generate additional profits for an MNE instead of whether they are passed on to independent customers or suppliers. China applies LSAs mainly in two ways: comparable analysis[96] and the PSM. It likely depends on the availability of the comparable transactions to determine which way will be adopted, but for MNEs that need to prepare a local file in China,[97] "whether the LSA has contributed to the value created in China" is mandatory check-up in preparing local file:

[94] Sophie Ashley, *STA's Liao Tizhong Discusses China's Transfer Pricing Position: Part One*, question 2, TP Week (10 Apr. 2013), <https://www.tpweek.com/articles/STAs-liao-tizhong-discusses-chinas-transfer-pricing-position-part-one/araejlcu> accessed on 11 June 2019.
[95] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.10.
[96] SAT 2017 Bulletin 6, above fn 30, Articles 15 and 27.
[97] BEPS Action 13 Country-by-Country Reporting (hereinafter CBC Reporting) includes a master file and local files. Participating jurisdictions are allowed to tailor-made the thresholds and requirements when domesticating the OECD CBC report templates. These reporting documents provide information about revenue, profits, income tax paid and main business activities in each geographic location where reporting MNEs operate. See OECD, *Transfer Pricing Documentation and Country-by-Country Reporting Action 13: 2015 Final Report* (2015).

> *"Any enterprise that meets one of the following criteria during the fiscal year shall prepare a local file… In addition to what is required in the Action 13 report, taxpayers need to provide (1) value chain analysis that notes the measurement and attribution of value creation contributed by location specific factors…"*[98]

While the comparability adjustments of the LSAs are almost "warranted",[99] the LSAs are involved in many ways under the PSM. They may be adjusted in the comparable analysis,[100] as an indicator that triggers the PSM[101] or as an allocation factor for the allocation of profits under the PSM (see Section 7.4.2).

7.5.2 LSA factors

As the concept of LSAs plays a critical role in China's PSM approach, the following section provides an overview of the LSA factors in China's transfer pricing regime.

- Labour costs

Labour cost is a classic example of location savings. China does not provide details to guide the recognition and allocation of the LSAs arising from labour costs, but the Jiangsu Provincial Office of the STA, one of China's leading local tax offices in international tax avoidance campaigns against BEPS, specifies that:

[98] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.14.2.
[99] Ibid, para 2.20.7.
[100] SAT 2017 Bulletin 6, above fn 30, Article 21.
[101] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.22.9.

> *"China has a large growing number of technicians of high value-added labour force in R&D, and software design. … Many Chinese subsidiaries of MNEs have undertaken R&D activities for the group but paid comparatively low salaries compared to the technicians in developed countries. MNEs should consider the cost savings of this factor…"*[102]

In contrast, the OECD has a more restrictive position and argues that the LSA arising from low labour costs will not lead to greater profit allocation to the market jurisdiction if the MNE can find a third party to perform the same functions for the same low price.[103]

- Market size

The OECD includes market size as a potential item for comparability adjustment but does not mention it in the discussion of LSAs.[104]

In contrast, China specifically identifies "huge … demand in China due to the large population and growing wealth of the population" as one of the LSAs "that ha[s] led to extraordinarily high profits that are rightly earned by Chinese taxpayers".[105] This LSA factor may arise due to the fact that China is an expanding market, so that MNEs spend less effort to sell.[106] It may also arise due to a large number of high-quality, low-cost suppliers, which give rise to location savings.[107]

[102] Jiangsu Provincial Office, *2016 - 2018 Compliance Plan on International Tax Administration, Su Guoshuifa [2016] No. 125* (2016), at Part 2(3).
[103] OECD 2022 Report, above fn 2, paras. 9.128 and 9.129.
[104] Ibid, para 1.110.
[105] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.12.
[106] Ibid, para 2.22.8.
[107] Ibid, para 2.20.12.

- Consumer purchasing power

The OECD recognizes "purchasing power and product preferences of households in that market" as one of the factors in "other local market features".[108]

China believes that Chinese customers have a general preference for foreign brands and imported goods.[109] It is not a firm-specific advantage, such as being loyal to a specific brand, but a general trend attributable to many social factors. Consequently, those foreign brands and imported goods that have the same quality as the local ones can charge a premium. This position was illustrated with an example of automotive products sold in China in the UN Country Practice discussion.[110]

- Degree of competition in the market

From an economic perspective, the stronger the competition in a market, the more likely that value will be passed on to customers. The OECD in general views it as a negative factor that tends to deny profit share to Chinese subsidiaries, unless the MNE has gained firm-specific advantages through competition, such as dominant market share.[111]

China follows the OECD's logic to a large extent but also argues that the degree of competition in the country can often give rise to LSAs. This is due to the fact that the degree of competition in the Chinese market is relatively low in many sectors, such as

[108] OECD 2022 Report, above fn 2, para. 1.144.
[109] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.12.
[110] Ibid, para 2.20.12.
[111] OECD 2022 Report, above fn 2, para. 1.144.

automotive and luxury goods.[112] For instance, the "market-for-technology" industry policy requires foreign automotive manufacturers to form joint ventures before they can assemble automobiles in China, thus significantly limiting market access opportunities for other foreign car manufacturers.[113]

- Availability of substitutes for goods/services

The OECD includes the availability of substitute goods and services as an item to be adjusted for in comparability analysis but does not refer in particular to it as an LSA factor.[114]

China specifically identifies this item as an LSA factor. For instance, the automotive industry in the country has been benefiting from "many LSAs that have led to extraordinarily high profits … [including] a large supply of high-quality, low-cost parts manufactured by suppliers in China".[115]

- Government regulations

The OECD, again, includes "the nature and extent of government regulation of the market" as an item to be adjusted for in comparability analysis, but does not in clued it specifically as an LSA factor.[116]

[112] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.8.
[113] Ibid, para 2.20.12.
[114] OECD 2022 Report, above fn 2, para. 1.110.
[115] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.12.
[116] OECD 2022 Report, above fn 2, para. 1.110.

As mentioned above, China argues that government regulations can have the effect of limiting competition for MNEs in the country, and thus should be regarded as an LSA factor. Furthermore, some local governments in China provide special concessions and financial incentives to attract foreign investments and reduce MNEs' manufacturing costs, which will also be considered to give rise to LSAs. For example, Guangdong province offers up to CNY 100 million in financial incentives to eligible overseas investments.[117]

- Duty savings

While the OECD is silent on this item, China regards the duty saving of MNEs in China as an LSA factor, and illustrates this view with an example from the automotive industry:

> *"[D]uty savings from the lower duty rates on automotive parts (e.g. 10%) compared to imported vehicles (e.g. 25%) … [mean that] when MNEs manufacture products in China as opposed to importing the products from outside of China, they are able to generate overall savings from the lower duty rates, even if the MNEs incur manufacturing costs and sell their domestically-manufactured products at a lower sales price compared to a foreign-manufactured vehicle …"*[118]

[117] Guangdong Provincial Government, *Notice Issued by Guangdong Provincial Government Regarding Reduce the Cost for Manufacturing Sector and Support the Development of Real Economy* (2017).
[118] UN 2021 Transfer Pricing Manual Part D.2 China Country Practice, above fn 3, para 2.20.12.

7.6 The OECD proposal likely limit creative interpretation of ALP: the Amount B

Sections 7.2 to 7.5 demonstrated that the Chinese approach places a significant emphasis on the concept of LSAs with the aim of maximising taxing rights. However, it is important to note that LSAs will only come into play when no comparable local transactions are available. In other words, the Chinese approach's effectiveness diminishes when most controlled transactions have local comparable transactions. This result will likely be achieved by Amount B under the Two-Pillars Approach.

Amount B is a reaffirming of the ALP. According to the OECD Pillar One Blueprint published in 2020, Amount B is expected to reduce compliance costs and enhance tax certainty.[119] It aims to simplify the transfer pricing by standardising the remuneration for "baseline marketing and distribution activities",[120] which many stakeholders have a negative overlook at the very beginning and describe it as "a continuation of past, largely unsuccessful, OECD and other multilateral development organizations' efforts to simplify transfer pricing".[121]

In the initial design, Amount B would be applied in a narrow scope with a two-fold process combining qualitative and quantitative methods in determining such activities.[122] There would be a defined "positive list" that measured the profit of typical routine distributors and a "negative list" of typical functions not to be performed, assets

[119] OECD, *Pillar One Blueprint*, above fn 93, para 651.
[120] Ibid, para 650.
[121] Alistiar Pepper, Thomas D. Bettge and Jessie Coleman, 'Amount B: The Forgotten Piece of the Pillar 1 Jigsaw' (2022) 107 (2) *Tax Notes International* 143, at 144.
[122] OECD, *Pillar One Blueprint*, above fn 93, para 653.

not to be owned, and risks not to be assumed by routine distributors.[123] The activities that fell on the "positive list" would then be verified by quantitative indicators based on third-part comparable transactions. [124] If the activities exceeded the quantitative indicators, they would fall back to the negative list and be denied being "baseline".[125]

In pricing the in-scope transactions, the OECD would provide artificial comparable local transactions for each region, called "reference benchmarking set", [126] reflecting the potential differentiated return accounting for the different geographic locations. It meant local comparable transactions would nearly always be available for the in-scope marketing and distribution functions. Furthermore, once the activities were in the scope of Amount B, the tax authority would lose the position to challenge it as being "non-routine".[127]

There would be two distinct results. The LSA would inevitably be ignored if the OECD used local third-party comparable transactions to construct the quantitative reference benchmarking set.[128] Alternatively, the OECD might enhance the quantitative threshold for certain jurisdictions, such as China and India, reflecting the LSAs they often claim to have. The determination of quantitative thresholds is likely determined by the country's negotiation power and political influence.

[123] Ibid, para 664.
[124] Ibid, para 654, 664.
[125] Ibid, para 675.
[126] Ibid, para 694.
[127] Ibid, para 654.
[128] The geographic location differences listed in the Blueprint are mostly LSAs. See ibid, para 689.

The IRS officials criticised this approach as being too complex and the scope too narrow at the National Association for Business Economics' annual transfer pricing symposium in Washington on July 19.[129]

In 2023, the OECD published a consultation document on Amount B, suggesting that the in-scope baseline marketing and distribution activities should capture the distributors that exhibit economically relevant characteristics that their transactions can be reliably priced by a one-sided method.[130] The net profit indicators are usually the most relevant comparison, which makes the Transactional Net Margin Method (hereinafter TNMM) the most appropriate method. Hence, the OECD developed a pricing matrix based on a "global dataset of companies"[131] involved in baseline marketing and distribution activities:[132]

[129] Alexander F. Peter, 'OECD and IRS Address Criticism of Amount B' (2023) 111(4) *Tax Notes International* 447, at 447.
[130] OECD, *Public Consultation Document Pillar One – Amount B* (2023), para 12.
[131] The global dataset contains financial information about almost 2,500 companies. The OECD hoped to use this decent-sized dataset to deal with geographic-specific issues. See Alexander F. Peter, above fn 129, at 447.
[132] 2023 Public Consultation Document of Amount B, above fn 130, at 5.

Industry Grouping Factor intensity	Industry Grouping 1	Industry Grouping 2	Industry Grouping 3
[A] *High OAS / any OES >45%/any level*	3.50% +/- 0.5%	5.25% +/- 0.5%	5.50% +/- 0.5%
[B] *Med/high OAS / any OES 30%-44.99%/any level*	3.25% +/- 0.5%	3.50% +/- 0.5%	4.50% +/- 0.5%
[C] *Med low OAS/any OES 15%-29.99%/any level*	2.75% +/- 0.5%	3.25% +/- 0.5%	4.25% +/- 0.5%
[D] *Low OAS / non-low OES <15%/10% or higher*	2.00% +/- 0.5%	2.25% +/- 0.5%	3.00% +/- 0.5%
[E] *Low OAS/low OES <15% OAS/<10% OES*	1.50% +/- 0.5%	1.75% +/- 0.5%	2.25% +/- 0.5%

Figure 4 – Pricing Matrix (return on sales %) derived from the global dataset[133]

Where-[134]

- OAS (Net operating asset intensity) refers to the ratio of net operating assets to net revenue

- OES (Operating expenses intensity) refers to the ratio of operating expenses to net revenue

The concept of "net revenue" was slightly confusing as in another place of the public consultation document, it may refer to "sales".[135] The taxpayer needs to determine the relevant industry grouping and the factor intensity classification of the distributor to locate the exact net profit indicator to be applied in the TNMM. This pricing matrix applies

[133] 2023 Public Consultation Document of Amount B, above fn 130, para 55.
[134] Ibid, at 5.
[135] Ibid, para 54.

to nearly all in-scope baseline distribution activities.[136] An OECD official explained that the goal of Amount B is simplification, so it must employ a new approach using non-industry-and-non-geographic-specific comparable transactions.[137]

Geographic differences have been observed in a small number of jurisdictions for which relevant data is available in the global dataset,[138] although the consultation document did not list which jurisdictions they are. A modified pricing matrix would apply to these qualifying jurisdictions to account for the geographic difference, adjusting +/-0.5% of the net profit indicator, which applies to the TNMM.[139]

It is uncertain whether China was one of the jurisdictions where geographic differences were observed. Even if it was, the modified pricing matrix only allows for a minimal 0.5% adjustment, which would not be sufficient to grant appropriate taxing rights to a market jurisdiction. Using a non-geographic specific dataset means that China's argument of LSAs will not work over the in-scope baseline marketing and distribution activities. The Amount B could potentially reduce or even diminish the benefits that LSAs bring to a market jurisdiction like China.

So much as the OECD wants to broaden the scope of Amount B and make the design simple, it also hopes to include as many inclusive framework members as possible, especially emerging markets like China and India. Consequently, the OECD did not completely close the door for market jurisdictions to account for geographic differences,

[136] There are two exceptions to this pricing matrix. First, geographic differences have been observed in a few jurisdictions, so a "modified pricing matrix" will be applied to account for observed geographic differences based on available data. Second, for distributors that operate in jurisdictions with insufficient data in the global dataset, and it is certain that the jurisdictions have higher country risk, the "data availability mechanism" will give these distributors higher returns. See ibid, paras 60 to 67.
[137] Alexander F. Peter, above fn 129, at 447.
[138] 2023 Public Consultation Document of Amount B, above fn 130, para 60.
[139] 2023 Public Consultation Document of Amount B, above fn 130, para 63.

such as LSAs. Jurisdictions can submit their own datasets with better coverage and ask the OECD to build a parallel pricing matrix based on that information.[140] Jurisdictions could potentially address the geographic difference in selecting the "appropriate" datasets that are submitted to the OECD.

Apart from the potential failure of the LSA, implementing Amount B will also restrict the application of enterprise doctrine in the Chinese approach. The STA typically takes a holistic view of the activities within its borders, making the distributors less likely to be considered limited-risk distributors. However, Amount B specifies that the qualifying distribution activities must be priced separately from non-distribution activities unless they cannot be.[141]

As a result, the consultation document revealed an unsolved divide among jurisdictions regarding the scoping of the baseline marketing and distribution activities, in particular, the need for a qualitative catchall. Two options have emerged with support from different groups of jurisdictions: Alternative A and Alternative B.

Alternative A captures qualifying baseline marketing and distribution activities performed by distributors that incur annual operating expenses between 3% to 30% of their net sales,[142] and an accurate delineation of the transaction shows that it can be reliably priced using a one-sided method.[143]

This approach will seize many Chinese distributors because the Chinese rules do not encourage local distributors to create marketing intangibles of their own (see Section7.3).

[140] Ibid, paras 68 to 71. Also see Alexander F. Peter, above fn 129, at 447
[141] 2023 Public Consultation Document of Amount B, above fn 130, para 9(c).
[142] Ibid, para 8(b).
[143] Ibid, para 8(a).

Instead, China imposes rules restricting the deduction of promotion and advertising expenses of specific industries. For instance, promotion and advertising expenses for cosmetics manufacturing or sales, pharmaceutical manufacturing and non-alcohol beverage manufacturing industry are limited to 30% of the sales,[144] and tobacco businesses cannot claim any promotion and advertising deductions.[145] These restrictions may help to ensure the profitability of Chinese distributors in the past, but they will be "in-scope" for Amount B under Alternative A, meaning it will be much harder for the Chinese STA to challenge these distributors using LSAs.

While Alternative B has a border in-scope "operating expenses to net sales" scale, ranging from 3% to 50%, it also includes a qualitative exclusion criterion protecting the integrity of the Amount B from undeserving beneficiaries. The qualitative text excludes non-baseline contributions, which the taxpayers and tax administrations should "exercise judgement" to identify.[146] Examples include "non-baseline contributions of the nature of technical or specialised support activities, including customisation or modification of the products distributed" [147] and "non-baseline contributions specific to highly regulated industries"[148] Supporters of Alternative B believe that:

> *"…the absence of an explicit requirement for qualitative considerations to identify "non-baseline" distributors creates risks of base erosion and profit shifting, and may increase instances where tax administrations assert that*

[144] SAT, Caishui [2017] No.41, *Notice on Policies Regarding the Pre-Tax Deduction of Advertising and Business Promotion Expenses,* in Chinese '关于广告费和业务宣传费支出税前扣除政策的通知', Article 1. Before 2009, the rate of deductible promoting and advertising expenses to sales was 15%. See SAT, Caishui [2009] No. 72, *Notice on Policies Regarding the Pre-Tax Deduction of Advertising and Business Promotion Expenses for Selected Industries*, in Chinse '关于部分行业广告费和业务宣传费税前扣除政策的通知', Article 1.
[145] SAT, Caishui [2017] No.41, above fn 144, Article 3.
[146] 2023 Public Consultation Document of Amount B, above fn 130, para 23.
[147] Ibid, paras 24-26.
[148] Ibid, paras 28-30.

> *distributors which make non- baseline contributions could meet the conditions to apply a two-sided transfer pricing method, potentially increasing disputes."*[149]

Compared to Alternative A, Alternative B will significantly reduce the application of Amount B. For example, the ServeCos in the Coca-Cola case (see Chapter 9) would likely be captured by Alternative A but not Alternative B because they have "significant and specialised capabilities that are not routine services easily obtainable from independent suppliers" and they are "an integral part of ongoing customer relationships".[150]

The debate of the two alternatives is still going on. The US suggested that qualitative test is not necessary.[151] The OECD potentially prefers the same, but it also indicated that the range of operating expense to sales ratio is negotiable.[152] If the implementation of Amount B is a done deal, China may need to consider broadening its creative interpretation of the OECD model by encouraging the Chinese entities to create marketing intangibles of their own.

[149] Ibid, at 10.
[150] Ibid, para 24.
[151] Alexander F. Peter, 'Countries' Disagreement Over Amount B Scoping Persists' (2023) 111(4) *Tax Notes International* 448, at 449.
[152] Ibid, at 449.

PART THREE: REDESIGN THE ARM'S LENGTH SYSTEM THAT RECOGNISING SALES AS A SOURCE OF PROFIT

Chapter 8

Coca-Cola Case Study

8.1 Introduction

In this thesis, Chapters 4 to 6 look into the challenges market jurisdictions face in obtaining suitable taxing rights over profits generated within their borders under the current arm's length system. Chapter 3 explores the historical and theoretical reasons underlying this issue, while Chapter 2 introduces and dismisses the potential solution of formulary apportionment (FA).

Furthermore, Chapter 7 analyses the Chinese approach of creatively interpreting the arm's length principle (ALP), demonstrating that market jurisdictions can increase their taxing rights by employing transfer pricing toolkits in innovative ways.

This chapter is a case study of Coca-Cola. Unlike the above purely theoretical chapters, it is a real-life example testing the preliminary findings from the previous chapters. Section 8.2 outlines the essential facts of the case and the arguments put up by the petitioner, respondent, and the court. Section 8.3 points out how this structured tax planning shifts

profits from market jurisdictions to countries with lower tax rates. Section 8.4 applies the Chinese approach to the Coca-Cola case, revealing that the market jurisdictions should challenge similar tax plannings and they are likely to obtain more taxing rights applying the ALP creatively.

8.2 Coca-Cola case in a nutshell

On 18 November 2020, the Internal Revenue Service (hereinafter IRS) of the US had a grand victory over Coca-Cola in 155 T.C. No. 10, in which the court upheld more than 9 million adjustments under Section 482 that increased the petitioner's (Coca-Cola) aggregated taxable income for 2007 to 2009.[1] This decision contrasted in many aspects with Tax Court's recent transfer pricing decisions, such as Amazon[2] and Medtronic,[3] and was described as "the first decisive IRS victory in a major transfer pricing case since 1979".[4]

The dispute was about the royalty paid in a licensing agreement. The petitioner, Coca-Cola, licensed its intangible properties, including trademarks, product names, logos, patents, secret formulas, and proprietary manufacturing processes, to its foreign subsidiaries, namely "supply points" to produce concentrates that sell to unrelated bottlers. The supply points, including the 7 in dispute, were licensees with limited rights

[1] Sec. 1.482-5, *Income Tax Regs*.
[2] *Amazon.com v. Commissioner* (2017) 148 T.C. No. 8.
[3] *Medtronic, Inc. v. Commissioner* (2016) T.C. Memo No. 2016-112.
[4] Reuven S. Avi-Yonah and Gianluca Mazzoni, 'Coca-Cola: A Decisive IRS Transfer Pricing Victory, at Last' (2020) 100 (11) *Tax Notes International* 1419, at 1419.

to use the intangibles properties and paid royalties in exchange.[5]

The petitioner had a closing agreement with the IRS in 1996, covering 1987 to 1995. The agreement specified a "10-50-50" method for royalty compensation, under which the supply points retain 10% of their gross sales as a routine return, and the residual operating profits would be split 50-50 between the petitioner and the supply points.[6] The agreement expired on 31 December 1995, but the petitioner relied upon it until the IRS issued a notice of deficiency.[7]

The IRS contended that the "10-50-50" formula did not reflect the ALP. During 2007-2009 the supply points remitted $1.8 billion in dividends to satisfy their royalty obligations,[8] which were too low according to the IRS. It adjusted Coca-Cola's aggregated taxable income for 9 billion U.S. dollars. The court agreed with the IRS saying the formula was a temporary solution. Though the petitioner wanted to apply it infinitely, no evidence showed that IRS agreed.[9]

The main dispute of this case was "whether the supply points own valuable marketing intangibles?" If it does, the best method is undoubtedly not comparable profit method (hereinafter CPM) but comparable uncontrolled transaction (hereinafter CUT, see Glossy

[5] *Coca -Cola Co. v. Commissioner* (2020) 155 T.C. No. 10, at 1. The supply points in disputes were in Mexico, Brazil, Chile, Costa Rica, Egypt, Ireland and Swaziland. See Ibid, at 7.
[6] *Coca-Cola Company v. Commissioner* (2017) 149 T.C. No. 21, at 5.
[7] IRS issued a notice of deficiency to Coca-Cola in 2011. The case first had a partial summary judgement in 2017, in which the IRS did not directly challenge whether the royalty paid by Mexican supply points reflected ALP but whether the foreign tax was compulsory under sec. 1. 901-2(a)(2)(i) *Income Tax Regs*. The court held that they were compulsory, thus creditable under *I.R.C.* sec. 901(a). See *Coca-Cola Company v. Commissioner* (2017) 149 T.C. No. 21, at 2 and 18 fn.
[8] The "10-50-50" method allowed the supply points to satisfy their royalty obligations by a combination of actual royalties, dividends, and pro-rata payments, which was an allocation of headquarters fees. From 2007 to 2009, The Brazilian supply point remitted 887 million, the Chilean supply point remitted 233 million and Costa Rican, Egyptian, Irish, and Swazi supply points jointly remitted 682 million. See *Coca -Cola case*, above fn 5, at 78.
[9] *Coca -Cola case*, above fn 5, at 94 and 95.

of terms) method or profit split method (hereinafter PSM) depending on the availability of the comparable transactions. The IRS argued, and the court agreed that the supply points did not own marketing intangibles, so the most appropriate method was CPM.[10] The comparable accepted in this case is Coca-Cola's independent bottlers, in particular, their average return on operating assets (hereinafter ROA).[11] Coca-Cola argued that the supply points in disputes owned valuable marketing intangibles. Thus, the best method should be CUT or PSM.[12] If CPM had to be used, the value of marketing intangibles should be considered.[13]

This case is a great example demonstrating the problem faced by the market jurisdictions: the local entities perform most of the marketing functions, but the profits are shifted to low-taxed countries. Ironically, the failure of the petitioner was not because any of the market jurisdictions challenged it but because the shifted profits did not land properly on the destination, contractually or by economic substance. Hence, the residence country of the MNE successfully challenged the taxpayer.

8.2.1 Background

The Coca-Cola group was a multinational manufacturing and selling non-alcoholic beverages in more than 200 countries and areas.[14] The ultimate parent was in Atlanta, Georgia, the United States (hereinafter TCCC).[15] TCCC had a wholly owned domestic

[10] *Coca -Cola case*, above fn 5, at 10 and 79.
[11] *Coca -Cola case*, above fn 5, at 10, 80 and 115.
[12] *Coca -Cola case*, above fn 5, at 11 and 150.
[13] *Coca -Cola case*, above fn 5, at 11 and 150.
[14] *Coca -Cola case*, above fn 5, at 5.
[15] *Coca -Cola case*, above fn 5, at 5.

subsidiary Coca-Cola Export Corp (hereinafter Export).[16] These two companies jointly performed headquarter functions and owned almost all existing intangibles, such as trademarks and patent, as well as the potential intangibles arising from R&D or marketing functions performed by other group members.[17] Export wholly owned Atlantic Industries (hereinafter Atlantic), a controlled foreign corporate (hereinafter CFC) in the Cayman Islands.[18] These three companies, in total, owned more than 60 foreign service corporates (hereinafter ServCos)[19] and 18 supply points.[20]

The headquarter in Atlantic strategically managed and provided guidelines for many critical issues. It set guidelines for brand identity, visual identity of products, quality assurance, business goals, and marketing strategies.[21] It delegated authority to regional units, including continental-level operating groups (hereinafter OGs), which supervise multiple national-level business units (hereinafter BUs).[22] These regional units were not separate legal entities. They were identified lines of managerial reporting from smaller to larger geographical territories and ultimately to HQ in Atlanta.[23] The regional units adopted the rules set by the headquarter to the cultural, religious, linguistic, and culinary traditions of their particular foreign markets.[24]

[16] *Coca -Cola case*, above fn 5, at 13.
[17] *Coca -Cola case*, above fn 5, at 68.
[18] *Coca -Cola case*, above fn 5, at 15.
[19] ServCos are service companies that mainly perform functions other than manufacturing. See *Coca -Cola case*, above fn 5, at 15.
[20] *Coca -Cola case*, above fn 5, at 28.
[21] *Coca -Cola case*, above fn 5, at 18.
[22] *Coca -Cola case*, above fn 5, at 19.
[23] *Coca -Cola case*, above fn 5, at 19.
[24] *Coca -Cola case*, above fn 5, at 18.

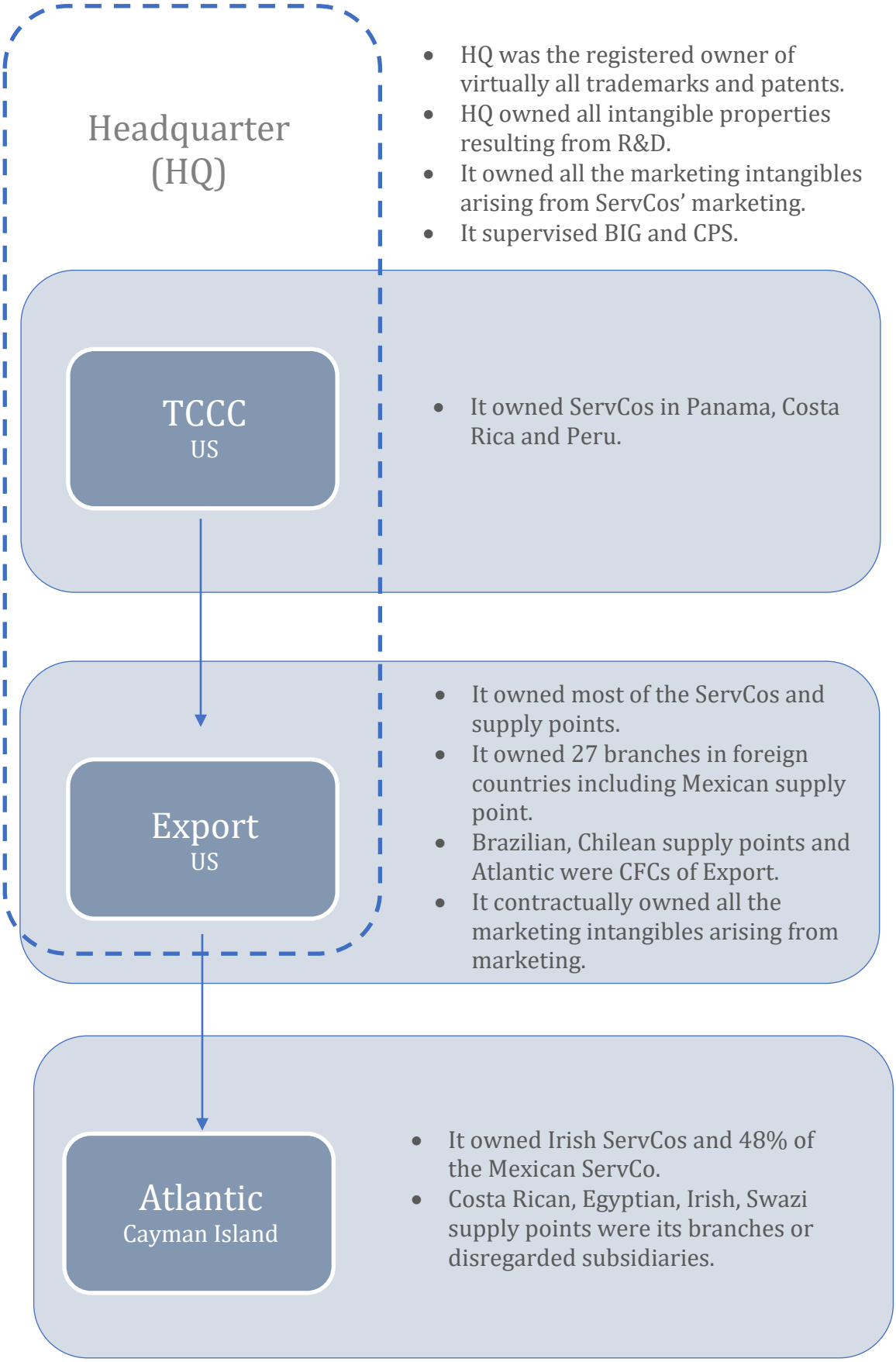

Figure 5 Corporate structure of Coca-Cola

The group's major value-added activities could be roughly divided into two parts: manufacturing and marketing.[25]

8.2.1.1 Marketing

In the beverage industry, two kinds of marketing were usually undertaken: consumer marketing and trade marketing.[26] Consumer marketing "coupled with past consumption experience, creates in minds of consumers favorable associations with products",[27] for instance, Commercial advertising on TV. Trade marketing aimed to increase demand with the partners by efficiently distributing and placing products in stores, making the product readily available to consumers.[28]

Coca-Cola pushed through many global consumer marketing campaigns.[29] TCCC usually designed them with input from ServCo personnel in various markets. For example, when Coca-Cola needed to sponsor major sports events, TCCC was responsible for negotiating financial terms and creating a package of promotional and advertising material that could be used globally in association with these events.[30] The package gave local marketers "70%

[25] There were other value-added activities, such as R&D, but they were not material. For instance, the annual budget for R&D was about 1% of the group's worldwide revenue from 2007 to 2009, undertaken by TCCC's central R&D laboratory in Atlanta and six regional R&D centres. Two of the regional centres were in the United States. The other four were located in Belgium, Brazil, China, and
and were operated by ServCos. See *Coca -Cola case*, above fn 5, at 20 and 21.
[26] *Coca -Cola case*, above fn 5, at 30.
[27] *Coca -Cola case*, above fn 5, at 31.
[28] *Coca -Cola case*, above fn 5, at 31. Trade marketing needs joint effort by both suppliers and retailers to achieve mutual economies of scale for mutual benefits. See Marc Dupuis and Elisabeth Tissier-Desbordes, 'Trade marketing and retailing: a European approach' (1996) 3(1) *Journal of Retailing and Consumer Services* 43, at 44.
[29] TCCC uploaded all permissible designs and model photographs to an online database called the "Design Machine". Major deviates needed to be approved by TCCC. See *Coca -Cola case*, above fn 5, at 7, 31 and 32.
[30] *Coca -Cola case*, above fn 5, at 33.

to 80% of the solution" but allowed customizing to meet local conditions.[31]

ServCos often played a leading role in regional marketing.[32] Each of them typically served one or more national markets providing various services to the headquarter as well as the supply points and the bottlers.[33] They employed all local marketing staff and all management staff in BU.[34]

ServCos might initial a marketing campaign focused on particular aspects. For example, a campaign focused on Latin American teens might be generated by the Brazilian ServCo.[35] In such cases, the TCCC would appoint a charter team to develop the campaign and communicate with stakeholders. Once it was developed, the other business units could choose to adopt and tailor the campaign to local needs.[36] TCCC provided various tools to help and train local marketers to achieve better results.[37]

Bottlers pushed trade marketing, which generally included: acquiring and retaining retailers through loyalty programs, promotions, and discounts;[38] managing the store marketing with the tools supplied by TCCC through the ServCos; encouraging impulse purchasing by means of, for example, invested in coolers to be placed in retailers' stores.[39] In general, the petitioner made sure the total marketing cost was shared 50-50 between

[31] *Coca -Cola case*, above fn 5, at 34.
[32] *Coca -Cola case*, above fn 5, at 34.
[33] *Coca -Cola case*, above fn 5, at 15 and 20.
[34] *Coca -Cola case*, above fn 5, at 34 and 101.
[35] *Coca -Cola case*, above fn 5, at 34.
[36] *Coca -Cola case*, above fn 5, at 34.
[37] *Coca -Cola case*, above fn 5, at 36.
[38] Price promotion decisions need to be made jointly by ServCos and bottlers. Marketing personnel from ServCos negotiated prices with large retailers, and bottlers managed the smaller ones. See *Coca -Cola case*, above fn 5, at 37 and 40.
[39] Coca-Cola assisted bottlers financially in purchasing the coolers through the "Jump Start" program. The Company covered a certain percentage of the cost. The bottlers viewed this expense as a type of marketing expense. See *Coca -Cola case*, above fn 5, at 39 and 40.

the bottlers and TCCC.[40]

Responsibility for managing relationships with retail customers was divided among TCCC, the ServCos, and the bottlers, where TCCC managed the top 51 customers, such as McDonald's and WalMart; the ServCos and the bottlers jointly managed smaller multinationals; and the bottlers solely managed smaller non-multinational customers at the national level.[41]

8.2.1.2 Manufacturing

Manufacturing started with supply points. TCCC or ServCos bulk purchased ingredients from company-owned flavour plants or other suppliers.[42] The 18 supply points worldwide, mostly located in countries with low tax rates or favourable tariff regimes,[43] used these ingredients to produce concentrates sold to bottlers.[44] The bottlers, most of them independent companies, used the concentrates to make ready-to-drink beverages and sold them directly or indirectly to the 20 million retailers.[45] Both supply points and bottlers were licensees to the petitioner's intangible assets in connection to the production and sales activities.[46] Both were responsible for quality assurance for their own products to meet the company's expectations and standards.[47]

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[40] *Coca -Cola case*, above fn 5, at 38.
[41] *Coca -Cola case*, above fn 5, at 39.
[42] *Coca -Cola case*, above fn 5, at 24.
[43] *Coca -Cola case*, above fn 5, at 27. The seven supply points in question enjoyed a weighted average income tax rate of 6.3%, at 76.
[44] Concentrates included syrups, flavourings, powder, and other ingredients used to produce petitioner's branded soft drinks. See *Coca -Cola case*, above fn 5, at 7.
[45] Bottlers produced, packaged, warehoused, and delivered products to retailers. See *Coca -Cola case*, above fn 5, at 16 and 17.
[46] *Coca -Cola case*, above fn 5, at 45 and 59.
[47] *Coca -Cola case*, above fn 5, at 23.

The manufacturing activity of supply points was a mutually agreed routine activity.[48] Though the supply points had the right to purchase secret ingredients and manufacture concentrates, they did not seem to have choices in many aspects. First, the supply points had limited procurement choices. "Many ingredients could be obtained only through Company-owned flavour plants, and other ingredient purchases were negotiated by bulk procurement specialists employed by TCCC or the ServCos."[49] Second, the manufacturing must be undertaken according to TCCC's instructions and standards.[50] The supply points "employed TCCC's secret formulas, confidential ingredients, and proprietary mixing specifications."[51] All these steps were managed by TCCC's protocol. Third, concentrates were only allowed to sell to approved bottlers.[52] The agreements between TCCC and the supply points were flexible. Any party could terminate them freely with 30- or 60-day notice.[53] The company shifted production significantly from 1980 to 2011. For example, it shifted a significant amount of Mexican supply point's manufacturing operations to Ireland between 2001 to 2006. As a result, the Mexico supply point's sales decreased from $889.6 million in 2002 to $395.5 million in 2004.[54] The supply points that lost production were not compensated in any way.[55]

Though bottlers were independent parties, TCCC maintained very stable relationships and had a certain level of control over them. For example, they were very similar to supply

[48] *Coca -Cola case*, above fn 5, at 172.
[49] *Coca -Cola case*, above fn 5, at 24.
[50] *Coca -Cola case*, above fn 5, at 43.
[51] *Coca -Cola case*, above fn 5, at 24.
[52] The contracts with the Mexican, Chilean, and Costa Rican supply points permitted them to sell concentrate only as "requested by the Company and at prices set and/or revised by the Company." See *Coca -Cola case*, above fn 5, at 44.
[53] *Coca -Cola case*, above fn 5, at 46.
[54] *Coca-Cola Company v. Commissioner* (2017) 149 T.C. No. 21, at 18.
[55] *Coca -Cola case*, above fn 5, at 47. The Commercial Product Supply Group, centrally managed by the headquarter, was responsible for production allocation. It could easily shift production from one supply point to another without cost. See *Coca -Cola case*, above fn 5, at 27 to 29.

points regarding production: standard production processes, always ready for TCCC's inspection, did not have many choices for procurement.[56] Also, bottler agreements were almost always renewed. If not, most likely, the bottlers were in financial difficulties. In that case, they would be acquired by the company and supervised by Atlanta until they recovered.[57] Today, these bottlers were gathered under Bottling Investments Group (thereafter BIG), which is also called "bottler hospital".[58]

The bottlers were long-term licensees that enjoyed more privileges and protections than supply points. For instance, they had long-term exclusive rights to produce and sell TCCC's products to retailers and wholesalers in their territories.[59] TCCC did not have the right to shift their production to another bottler.[60] The bottlers and TCCC aimed to share 50% of the system profit each.[61] To achieve the goal, they negotiated concentrate price once every few years. Between the negotiations, they employed tools to make sure the unexpected fluctuations like consumer demand, local inflation rates, or currency exchange rates would not influence the actual profit split rate too much.[62]

[56] *Coca -Cola case*, above fn 5, at 58.
[57] *Coca -Cola case*, above fn 5, at 60.
[58] These bottlers locate in Africa and South Asia. See <https://investors.coca-colacompany.com/about/segments/bottling-investments-group-big> accessed on 3 February 2021.
[59] The bottlers in European Union do not have geographic exclusivity due to the "free movement of goods" clause in the Treaty of Rome, but European bottlers generally respect it as an implied rule. See *Coca -Cola case*, above fn 5, at 57, 61, 124 and 187.
[60] *Coca -Cola case*, above fn 5, at 57, 61.
[61] In practice, they achieved a 45% to 55% split in favour of one party or the other. See *Coca -Cola case*, above fn 5, at 62.
[62] There were two tools to maintain the 50% rate. In areas that faced more unexpected fluctuations, concentrates were priced with a fixed amount plus a "trued up" to reflect actual sales. The other way was by adjusting the marketing expense the Company and bottlers would make. The Company might increase customer marketing expenses they made in the bottler's territory if the system profit split moved unexpectedly in their direction. Vice versa. See *Coca -Cola case*, above fn 5, at 62-63.

8.2.2 Did supply points own marketing intangibles?

Whether the supply points owned marketing intangibles was the most critical factor influencing the choice of best method rule and comparable parties. The previous chapters outlined that under the OECD model, it was extremely difficult for licensees to create marketing intangibles of their own unless the licencing agreements specified so. When such a clause was absent, it was more likely for a licensee to create marketing intangibles when firstly, it had a long-term agreement to explore the existing intangibles; secondly, it incurred more marketing expenditure and effort than the comparable party, which was not properly remunerated; and lastly, the expenditure must have a long-term impact (see Section 4.4).

In the Coca-Cola case, the supply points had nothing to do with marketing activities but artificially bore the marketing expenditure. The TCCC, the ServCos and the bottler performed marketing functions. The service contracts of ServCos showed that the service recipient was not any of the supply points but Export, who owned all potential resulting marketing intangibles.[63] The ServCos were supposed to invoice Export in local currency using a cost plus method.[64] However, The petitioner made the supply points book the marketing costs incurred by the ServCos,[65] with no evidence or record showing the supply points explicitly agreed to bear these charges.[66] The petitioner explained that the expense was booked according to "the matching principle". In particular, the marketing expense and allocated fees should match the revenue the supply point made in the

[63] *Coca -Cola case*, above fn 5, at 53.
[64] *Coca -Cola case*, above fn 5, at 55.
[65] The supply points reported on their books most of the marketing and related costs that the ServCos incurred and invoiced to TCCC or Export. See *Coca -Cola case*, above fn 5, at 70 and 102.
[66] *Coca -Cola case*, above fn 5, at 55.

markets for which the ServCos were responsible.[67] Yet, the accounting numbers showed no apparent relationship, and the petitioner offered no clear explanation for how and why this allocation worked.[68]

The petitioner argued that the supply points had created marketing intangibles, or "IP associated with trademarks", as the petitioner called them,[69] because of the above-mentioned marketing expenditure booked in their accounts. The petitioner contended that:

> *"Petitioner acknowledges that TCCC was the registered legal owner of virtually all of the trademarks and other intangible assets… But petitioner contends that these were in effect "wasting assets." What kept TCCC's products fresh in consumers' minds, petitioner says, were the billions of dollars spent annually on television advertisements, social media, and other forms of consumer marketing. Without ongoing consumer advertising, the trademarks, secret formulas, and proprietary manufacturing processes owned by TCCC would allegedly have suffered over time a hollowing out of value."*[70]

What the petitioner really tried to argue was that the marketing expenditure enhanced or maintained the value of the trademarks rather than they "created" marketing intangibles. It was not true in either case. The supply points did not perform consumer marketing. They neither contractually owned the potential marketing intangibles from in-country marketing performed by the ServCos, nor owned or created them by economic

[67] *Coca -Cola case*, above fn 5, at 56.
[68] *Coca -Cola case*, above fn 5, at 152 and 167.
[69] *Coca -Cola case*, above fn 5, at 11.
[70] *Coca -Cola case*, above fn 5, [at] 151. Also see *Nestlé Holdings, Inc. v. Commissioner* (1995) T.C. Memo. 1995-441, 70 T.C.M. (CCH) 682, at 696: "Trademarks lose substantial value without adequate investment, management, marketing, advertising, and sales organization."

substance. The court added that the supply points were passive recipients of the charges. They had no voice, bore no risks, but passively accepted what was put on their books.[71] The court found no support for the petitioner's argument in law, fact, economic theory, or common sense.[72]

The petitioner tried to set aside the contractual terms by arguing they were inconsistent with the economic substance.[73] The court held that only the Commissioner, and not the taxpayer, could do this.[74] The petitioner had complete control over the contracts when they were drafted, but once done, he had to accept the tax consequence of his choice.[75] This was also one of the common misunderstandings of the Coca-Cola case that news, even tax ones, mistakenly reported that the problem of Coca-Cola's supply points was that their marketing intangibles were lack of contractual, legal, or accounting recognition.[76] The truth was they did not own any marketing intangibles, even in economic substance. If any group member other than the headquarter owned marketing intangibles, it should be the ServCos.

The petitioner also tried to obscure the tested parties. It urged the court to focus more broadly on the activities of its BUs, which vague the boundary between the supply points and the ServCos, or more vaguely to "the Field", which referred to all the foreign group members.[77] It attempted to persuade the court to accept a profit split between US headquarters and "the Field" by marketing expenditure.[78] In other words, the petitioner

[71] *Coca -Cola case*, above fn 5, at 129 and 152.
[72] *Coca -Cola case*, above fn 5, at 152.
[73] *Coca -Cola case*, above fn 5, at 160 to 166.
[74] *Coca -Cola case*, above fn 5, at 160.
[75] *Coca -Cola case*, above fn 5, at 166.
[76] See e.g., Ryan Finley, 'U.S. Tax Court's Coca-Cola Ruling: Early Sign of a New Approach?' (2020) 100 (10) *Tax Notes International* 1279, at 1280 to 1281; Ryan Finley, 'Medtronic II and the U.S. Tax Court's Mixed Signals Regarding the CPM' (2022) 108 (1) *Tax Notes International* 7, at 7 and 11.
[77] *Coca -Cola case*, above fn 5, at 100.
[78] *Coca -Cola case*, above fn 5, at 100.

contended that the IRS should mind their own business: no matter where and by whom the consumer marketing was performed, it was not in the US, so the IRS should not collect tax on it.

The court certainly did not agree. In the U.S., or anywhere in the world, legal entities are generally respected.[79] The IRS and the court viewed the supply points and ServCos as distinct sets of "controlled taxpayers" because they were separate legal entities. The BUs were not legal entities. To support this argument, Coca-Cola should provide comparable or alternative transfer pricing analysis, but they did not.[80]

8.2.3 The best method

The best method was comparatively easier to be determined, given that the supply points created no marketing intangibles.

The IRS rejected CUT for lack of uncontrolled transactions that accurately capture the value of licensing the Company's unique brands.[81] It rejected PSM, finding it unreliable where TCCC owned valuable intangible assets and the supply points owned none.[82] Instead, the IRS found a CPM using independent bottlers as comparable suited the best.[83]

The petitioner disagreed that CPM was the best method. It relies chiefly on a statement in the preamble to the 1994 final regulations, where the Treasury referred to the CPM as

[79] A "controlled taxpayer" is defined as "any one of two or more taxpayers owned or controlled directly or indirectly by the same interests and includes the taxpayer that owns or controls the other taxpayers." See sec. 1.482-1(b)(1)(i)(5), Income Tax Regs.
[80] S. 1.482-1(b)(1), Income Tax Regs.
[81] *Coca -Cola case*, above fn 5, at 79.
[82] *Coca -Cola case*, above fn 5, at 79.
[83] *Coca -Cola case*, above fn 5, at 79.

"a method of last resort."[84] However, the court asked the petitioner to put the statement in the context. CPM was the last resort on the assumption that adequate data were available for CUT:

> *"Given adequate data, methods that determine an arm's length price (e.g., the CUP method) or gross margin (e.g., the resale price method) generally achieve a higher degree of comparability than the CPM. Because the degree of comparability, including the extent and reliability of adjustments, determines the relative reliability of the result under the best method rule, the results of these methods will be selected unless the data necessary to apply them is relatively incomplete or unreliable. In this regard the CPM generally would be considered a method of last resort."*[85]

In uncontrolled transactions involving intangibles, CUT is much harder to be the best method post-1994. The 1968 regulations only required the involved intangible asset to be "same or similar intangible".[86] The 1994 regulations, however, changed to "the same intangible" with "minor differences".[87] In this regard, CUT was not the best method, as Coca-Cola was the best-known brand in the world.[88] The IRS or the court could not find the "same intangible" as comparable.[89] Hence the court agreed with the IRS that CPM was the best method.[90]

[84] The Department of the Treasury and Internal Revenue Service, 'Intercompany Transfer Pricing Regulations Under Section 482' (1994) 59(130) *Federal Register*, at 25.
[85] *IRS 1994*, above fn 84, at 25.
[86] 26 C.F.R. sec. 1.482-2(d)(2)(ii) (1969).
[87] *IRS 1994*, above fn 84, at 21.
[88] *Coca -Cola case*, above fn 5, at 7.
[89] *Coca -Cola case*, above fn 5, at 107.
[90] *Coca -Cola case*, above fn 5, at 2.

8.2.4 Were bottlers acceptable comparables?

The IRS made a thoroughly comparability analysis of the supply points and third-party bottlers, including "(i) functions performed, (ii) contractual terms, (iii) risks, (iv) economic conditions, and (v) property employed or transferred", concluding that they were comparable.[91]

Bottlers performed similar functions to supply points but on a bigger scale.[92] Both sets of companies engaged in the same line of business, producing similar products consisting of mixing ingredients following the petitioner's detailed protocols. They also both engaged in quality control that was prescribed and inspections conducted by the petitioner.[93]

Both sets of companies had similar contracts with the petitioner. They were licensees with limited rights to use the intangible assets owned by the petitioner, and the contracts could be terminated with a few months' notice. However, the bottlers' contracts had more privileges. They enjoyed longer terms — usually 5-10 years, and always renewed.[94] They had exclusive rights to respectively territorial,[95] while the supply points did not have any exclusive territorial rights.[96] Their productions could be shifted,[97] contracts were

[91] *Coca -Cola case*, above fn 5, at 120.
[92] *Coca -Cola case*, above fn 5, at 122.
[93] *Coca -Cola case*, above fn 5, at 122.
[94] *Coca -Cola case*, above fn 5, at 60.
[95] *Coca -Cola case*, above fn 5, at 57, 124 and 187.
[96] *Coca -Cola case*, above fn 5, at 172.
[97] *Coca -Cola case*, above fn 5, at 118.

terminable by the petitioner at will with no compensation,[98] and they also had less bargaining power than the bottler.[99]

The IRS also argued that the two sets of companies were highly comparable in risks assumed. They faced the same risks to capital employed, and their profitability depended on the same products.[100] The bottlers bore more significant risks than the supply points because the latter guaranteed customers and the former did not.[101] The petitioner contended that the supply points bore "marketing risks" because they funded consumer marketing in foreign markets. The court held that the argument was unrealistic, as the revenue exceeded the marketing expenses by an extensive margin.[102] The petitioner also contended that the two sets of companies operated at different "levels of the market", but it failed to demonstrate the distinctions affect the comparability of the functions they discharged.[103]

The two sets of companies faced comparable economic conditions. They operated in the same industry, faced similar risks, economic cycles and flow of consumer demand.[104] he supply points were easily replaceable and regularly were replaced, at low costs to the petitioner, because most of them had unused production capacity.[105]

Also, the petitioner argued that the bottlers were unsuitable because they were "marketing-light businesses", whereas the supply points were "marketing-intensive".[106] The court disagreed because the bottlers paid more marketing expenditures than the

[98] *Coca -Cola case*, above fn 5, at 118.
[99] *Coca -Cola case*, above fn 5, at 80.
[100] *Coca -Cola case*, above fn 5, at 127 and 128.
[101] *Coca -Cola case*, above fn 5, at 128.
[102] *Coca -Cola case*, above fn 5, at 129.
[103] *Coca -Cola case*, above fn 5, at 130.
[104] *Coca -Cola case*, above fn 5, at 125.
[105] *Coca -Cola case*, above fn 5, at 126 and 173.
[106] *Coca -Cola case*, above fn 5, at 130.

supply points.[107] If the supply points had marketing intangibles because they funded marketing activities, the bottlers should also have.[108] In fact, the bottlers owned and controlled marketing intangibles, at least more than the supply points did, including retail distribution networks, sales forces, and customer lists.[109]

Hence, the court supported the IRS on choosing the bottlers as comparables:

> *The bottlers are comparable to the supply points because they operated in the same industry, faced similar economic risks, had similar (but more favorable) contractual and economic relationships with petitioner, employed in the same manner many of the same intangible assets (petitioner's brand names, trademarks, and logos), and ultimately shared the same income stream from sales of petitioner's beverages."*[110]

The court further held that given the privileges of the bottlers, this choice was conservative.[111] The IRS proposed CPM would likely overcompensate rather than undercompensate the supply points.

To determine the royalty, the IRS chose 18 bottlers with qualified auditor's opinions as samples, calculating their average ROA as the base comparable.[112] The ROA rate was then applied to each supply point to determine their routine income.[113] The rest of the total

[107] *Coca -Cola case*, above fn 5, at 130.
[108] *Coca -Cola case*, above fn 5, at 178 to 179.
[109] *Coca -Cola case*, above fn 5, at 186.
[110] *Coca -Cola case*, above fn 5, at 121.
[111] *Coca -Cola case*, above fn 5, at 121.
[112] The number of bottlers expanded from 18 in the initial report to 24 in the expert witness report. See *Coca -Cola case*, above fn 5, at 114.
[113] The IRS found that the Latin American bottlers' ROAs were significantly higher, so it adjusted the income of the Brazilian, Chilean, Costa Rican, and Mexican supply points downward to reflect the difference. The income of the Irish and Swazi supply points was adjusted downward, and the income of the Egyptian supply point was adjusted upward using the bottlers' general ROA. See *Coca -Cola case*, above fn 5, at 82.

profit was relocated to the petitioner as royalty.

The petitioner had been trying to argue that the supply points had performed routine manufacturing and consumer marketing, and the latter created marketing intangibles. Since the court held that manufacturing was the only meaningful function the supply points performed, manufacturing was a mutually agreed routine function. The petitioner priced an 8.5% markup on the costs in its report.[114] Compared to that, the IRS's adjustments were conservative and generous.

The petitioner contended that if the bottler's ROA had to be used as a benchmark, the operating assets for the supply points needed to be increased to include the marketing intangibles.[115] The court did not agree since no such assets were found.

It was worth noting that the IRS and the US tax court seemed to completely ignore that the supply points' biggest function was to keep Coca-Cola's formula safe. Coca-Cola's formula was and still is a world-class secret. The supply points and the bottlers were performing very similar manufacturing functions. Coca-Cola was willing to delegate bottling instead of the entire manufacturing process to third parties mainly because it needed to make the concentrate plants absolutely under control (they were CFCs or branches, as a matter of fact) to keep commercial secrets. The bottlers' manufacturing started with concentrates, so most were third parties.[116] Some did not even exclusively produce products for Coca-Cola.[117]

The court also seemed to misunderstand bargaining power. The supply points had very

[114] *Coca -Cola case*, above fn 5, at 110.
[115] *Coca -Cola case*, above fn 5, at 150.
[116] *Coca -Cola case*, above fn 5, at 60.
[117] *Coca -Cola case*, above fn 5, at 16.

high risks of losing production and terminating contracts without notice, and they had to pay all kinds of fees on their accounts. The IRS and the court held that it showed the supply points had very limited bargaining power, thus, should be paid at a lower rate.[118] However, a third party would not accept such mean conditions with such low remuneration. They accepted the mean conditions of the contracts only because they were a part of the group that was willing to contribute their benefits for a more significant overall group benefit. The real bargaining power of the supply points, if they were third parties, was the obligation to keep the formula safe. It would cost Coca-Cola a fortune to get third parties to sign the confidential clause. From this perspective, the court might consider increasing the return to the supply points from the current benchmarks.

8.3 A tax planning that shifts profits out of the market jurisdictions

8.3.1 Key designs of the planning

Coca-Cola's case was a typical aggressive tax planning that shifted profits from market jurisdictions to low-taxed countries where the supply points were located. The MNE is in the beverage industry, in which the profitability relies heavily on marketing. It must have local offices — ServCos, located in the market and staffed with locals who know the customers well. In comparison, concentrate manufacturing can be performed anywhere convenient for shipping. Therefore, after the 1980s, Coca-Cola shifted the supply points to jurisdictions with low tax rates and favourable tariff regimes.[119] For example, the Irish

[118] *Coca -Cola case*, above fn 5, at 126.
[119] *Coca -Cola case*, above fn 5, at 27.

supply point, which reported an income tax rate of 1.4%, took 50% of the Mexican supply's production for Coke Red in 2001 and sold the concentrates back to Mexican bottlers.[120] Another example was the more recently built Singapore supply point. The local authorities asked the supply points to meet certain production volumes for tax and tariff incentives.[121] On average, the seven supply points in question enjoyed a weighted average income tax rate of 6.3%.[122] The planning included the following two aspects:

First, it structured an artificial "entity" that undertook in-country management—the BUs. The BU and ServCo were suspected to be one operation with two names or one operation consisting of two teams. BUs were the management team focused on management and coordination between all stakeholders:

> *"The ServCo leadership teams acted as the liaison between the Company and local bottlers. These teams acted in a day-to-day advisory role to bottlers, facilitating bottlers' access to the Company's statistical data, consumer insights, advertising plans, and marketing strategies."*[123]

ServCos were the marketing team focused on providing in-country marketing services. Sometimes ServCos and BUs were used interchangeably.[124] These two teams, plus the supply points and the third-party bottlers representing the manufacturing stream,

[120] There were numerous other shifts of production to the Irish supply points after 1984. The Irish supply points had become the largest production of any foreign concentrates plant, supplying bottlers in more than 90 national markets. See *Coca -Cola case*, above fn 5, at 28.
[121] The Singapore supply point supplies 17 national markets. See *Coca -Cola case*, above fn 5, at 29.
[122] *Coca -Cola case*, above fn 5, at 76.
[123] *Coca -Cola case*, above fn 5, at 20.
[124] For example, "ServCos play a leading role…a BU often developed platform material…eventually be shared with other BUs…for example, Mexican ServCo…" the "ServCos and BUs in fact referred to the same entity (ServCos) and the same group of staff (staff that performed in-country marketing). See *Coca -Cola case,* above fn 5, at 34.

constituted the major value-added activities.[125]

BUs helped to cut the nexus between ServCos and certain value-added activities. They were lines of managerial, meaning in all kinds of Coca-Cola's reporting for financial or management accounting purposes, BUs, rather than ServCos, were the "entities" that did in-country management. On the face of it, the ServCos did not perform management functions, making the marketing functions they performed more likely to be "routine". However, the BUs were not legal entities, so they could not hire staff legally.[126] All the leading roles in BUs were employed by ServCos,[127] so for transfer pricing purposes, ServCos perform both marketing and management functions.

The "routine" marketing was not priced at a high rate. The ServCos were compensated by cost plus method, with a 5% to 12% markup on certain marketing expenses, and on average 6% to 7%.[128] Though as the local marketers, ServCos were responsible for coordinating with the third-party marketers, they received no markup for the marketing expenses paid to third-party marketers, such as advertising agencies, media companies, and creative design firms, which constituted the largest category of expenses.[129] The ServCos would not have been paid at such a low rate if taking the functions performed by BUs into consideration. The market jurisdictions would and should challenge the ServCos by arguing that they created valuable marketing intangibles of their own or enhanced the value of the trademarks.

Second, the ServCos agreements were designed to make them riskless marketers that

[125] *Coca -Cola case*, above fn 5, at 20.
[126] *Coca -Cola case*, above fn 5, at 100.
[127] *Coca -Cola case*, above fn 5, at 19 and 101.
[128] *Coca -Cola case*, above fn 5, at 147.
[129] *Coca -Cola case*, above fn 5, at 51.

only enjoyed routine profits. Most ServCo agreements had a term of only one year.[130] The short-term contracts effectively avoided the ServCos being classified as "long-term licensees", who were more likely to enjoy residual profits (see Section 4.4). In reality, these contracts were renewable indefinitely without notice from either party of its intent to terminate.[131] It meant that ServCos were, in fact, "long-term licensees". If the notional contractual terms were 10 years like the third-party bottlers, they should include licensing agreements as assets with infinite useful life on their balance sheets.[132] Thus, these contracts would be valuable assets for transfer pricing purposes (see Section 4.5).

The ServCo agreements also specified that ServCos did not assume relevant risks and did not own the potential marketing intangibles:

> *"ServCo acknowledges that it does not take entrepreneurial risk in developing marketing concepts because the marketing advice provided by ServCo is within the strategic guidelines established by Export for the brands. ServCo also acknowledges that any marketing concepts developed by third party vendors are the property of Export."*[133]

This reservation clause appeared in 29 of the 37 ServCo agreements executed after 2004.[134] Coca-Cola's witness testified that the clause was added to:

> *"…minimize the risk that the ServCo would be treated by local tax authorities as*

[130] *Coca -Cola case*, above fn 5, at 50.
[131] *Coca -Cola case*, above fn 5, at 50.
[132] *Coca -Cola case*, above fn 5, at 186.
[133] *Coca -Cola case*, above fn 5, at 53.
[134] The wording in each agreement might be slightly different over time, but they had the same spirit. The most recent version had a variation of the first sentence, saying, "because the marketing is contracted for by ServCo with third-party service providers and is within [TCCC's] strategic guidelines." See *Coca -Cola case*, above fn 5, at 53.

> *creating, in that country, a 'permanent establishment' of TCCC or a foreign supply point."*[135]

Ernst & Young endorsed this approach with two "master platform documents" in 2008, saying the cost plus method was within arm's length range.[136] From those two documents, Ernst & Young developed 30 local transfer pricing reports lodged in various tax jurisdictions. These reports did not emphasise the effort ServCos took on marketing, but supported cost plus method with the observations that TCCC controlled the ServCos' annual budgets, provided key inputs to their marketing efforts, and supplied final approval for all business plans.[137]

It was not sure to what extent the TCCC had been engaged in consumer marketing. Its work could be argued to be "routine", such as routinely approving the annual budgets of BUs,[138] or "one-time off", such as providing guidelines and templates for consumer marketing materials.[139] It was not deeply engaged in in-country marketing.

On the contrary, the ServCos acted as masters of local marketing. They "played a leading role in regional marketing" and contributed to all the ideas of global consumer marketing.[140] They localized the global marketing campaigns to suit local tastes,[141] and they made initial decisions of whether to join a consumer marketing[142] or trade marketing campaign.[143]

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[135] *Coca -Cola case*, above fn 5, at 53.
[136] *Coca -Cola case*, above fn 5, at 51.
[137] *Coca -Cola case*, above fn 5, at 52.
[138] *Coca -Cola case*, above fn 5, at 37.
[139] *Coca -Cola case*, above fn 5, at 32.
[140] *Coca -Cola case*, above fn 5, at 34.
[141] *Coca -Cola case*, above fn 5, at 32, 34 and 49.
[142] *Coca -Cola case*, above fn 5, at 34.
[143] *Coca -Cola case*, above fn 5, at 50.

The above two designs artificially structured the ServCos as performing limited functions and bearing limited risks. A portion of profits was shifted out of ServCo. Hence, the focus of the Coca-Cola case was mislocated. The real issue was whether the market jurisdiction (ServCos) or the home country (headquarter) should tax this part of profits.

8.3.2 ServCos should share more profits

The ServCos should share at least a part of the residual profits for two reasons:

First, the ServCos have created marketing intangibles or enhanced the value of the trademarks. They had the ability and expertise to do so. The preamble of ServCos agreements typically stated that the ServCos were engaged because of their:

> *"…expertise and know-how on the production and marketing of the Beverages, including sales, advertising, promotion and business development."*[144]

The court found that Coca-Cola's bottlers, who only engaged in trade marketing, owned and controlled marketing intangibles.[145] The ServCos did more than the bottlers. They cooperated with bottlers in trade marketing and performed consumer marketing locally. Therefore, the ServCos should own valuable marketing intangibles just like the bottlers. They did not record these assets in the book only because they were a part of the MNE, unlike the independent bottlers, who needed to report these assets for a better bargaining position.

[144] *Coca -Cola case*, above fn 5, at 50.
[145] *Coca -Cola case*, above fn 5, at 186.

If the ServCos have not created marketing intangibles, they at least enhanced the value of the trademarks. Chapter 4 specified that the value of trademarks could be enhanced by many factors, including marketing and quality control. Though the ServCos did not bear marketing expenditures, they contributed to the ideas of global consumer marketing; made the decision of whether to activate a particular marketing campaign; localized the global marketing campaigns, and assisted TCCC in providing tools to bottlers for in-store marketing.[146] They also assisted the headquarters in performing quality control.[147]

Second, the ServCos performed functions other than marketing. They functioned as the country-level "headquarters" that manages all kinds of things. They have performed back-office functions;[148] performed management functions as BUs; assisted TCCCs in performing procumbent functions for the supply points;[149] performed R&D functions localizing the beverage flavour to local taste;[150] employed nearly all the staff other than manufacturing outside the US.[151]

Hence, the ServCos should share at least a portion of the residual profits arising from trademarks.

8.3.3 Failure of the planning

Coca-Cola's tax planning was aggressive but not delicate. The shifting of the profits

[146] *Coca -Cola case*, above fn 5, at 39.
[147] *Coca -Cola case*, above fn 5, at 20 and 21.
[148] *Coca -Cola case*, above fn 5, at 50.
[149] *Coca -Cola case*, above fn 5, at 24.
[150] *Coca -Cola case*, above fn 5, at 15.
[151] *Coca -Cola case*, above fn 5, at 19 and 101.

seemed to be successful from the market jurisdictions, but they did not land properly on the supply points.

Coca-Cola made two mistakes which left the supply points with no marketing intangibles either contractually (headquarters legally owned them) or in economic substance (ServCos had them). The ServCo agreement had a common counterparty of Export or TCCC, which owed all potential marketing intangibles arising from third-party marketing. The US tax law generally respects contractual terms unless challenged by economic substance (see Section 9.2.2). The petitioner would have stood a chance to argue that the supply points owned marketing intangibles contractually if they were the counterparties in the ServCo agreements. Also, the supply points were made to bear the marketing costs artificially, but the allocation was poorly done. The management team made sure all marketing expenses were deductible in jurisdictions where the supply points were located but did not figure out a sound rule to explain the allocation.[152]

The US tax court commented that the petitioner was attempting to create something similar to a "cost-sharing agreement" approved by law and the IRS, but such an agreement needed to be in written format.[153] The taxpayer could not simply claim to have entered into one.[154] Surprisingly, the petitioner did not even think about using the "cost-sharing agreement" as a point to support its argument.

The petitioner also did not put up a sound argument in court. It argued everything as if the supply points were located in the market jurisdictions. For example, it argued that the supply points had "local rights to petitioner's valuable brands" [155] or generated

[152] *Coca -Cola case*, above fn 5, at 48 and 49.
[153] *Ciba-Geigy Corp. v. Commissioner* (1985) 85 T.C. 172, 230 n.38.
[154] *Coca -Cola case*, above fn 5, at 153.
[155] *Coca -Cola case*, above fn 5, at 11 and 150.

demand.[156] It also tried to persuade the court to accept BUs or "the Field" as taxpayers.[157]

These arguments did not help it but rather harmed it. They outlined the critical functions of market jurisdictions in value creation and the nexus between the market jurisdictions and the potential marketing intangibles to the markets, which had nothing to do with supply points. The judge ironically commented that "we find no support for petitioner's argument in law, fact, economic theory, or common sense,"[158] and"[t]here are so many flaws in Dr Unni's construct that it is difficult to know where to begin".[159]

8.4 The market jurisdictions should challenge the tax planning: the Chinese experience

Interestingly, neither party questioned whether the ServCos were remunerated in accordance with ALP.[160] The petitioner was not concerned about the method of the remuneration of the ServCos because they were only remunerated at a small amount by 6% to 7% on average for the consumer marketing function performed, with no markup for the third-party services they outsourced and managed, such as the advertisements.[161] The IRS was similarly not concerned about how the ServCos were remunerated because the profits were limited and this would affect the overall amount the IRS could tax. The profits that the IRS could tax would not be significant if the market jurisdictions where

[156] *Coca -Cola case*, above fn 5, at 95.
[157] *Coca -Cola case*, above fn 5, at 100.
[158] *Coca -Cola case* above fn 5, at 152.
[159] *Coca -Cola case*, above fn 5, at 193.
[160] The court opinion reinforced it repeatedly. See *Coca -Cola case*, above fn 5, at 49, 83, 100, 110, 119 and 148.
[161] *Coca -Cola case*, above fn 5, at 51.

ServCos located tax them first. This situation is consistent with the argument of this thesis that it is the jurisdictions compete in the tax arena.

The US tax court also raised no question about this issue. The Court held that the ServCos' consumer marketing activities presumably enhanced the value of TCCC's intangibles"[162] but did not create free-standing marketing intangibles in the hands of the ServCos or the supply points.[163] The ServCos' service agreements provided that the ServCo did not take entrepreneurial risks in developing marketing intangibles, and consequently did not have ownership in the marketing intangibles.[164] The Court generally respected the legal ownership,[165] holding that even if the marketing expenditure on consumer marketing would be capitalised, which was the argument submitted by the petitioner, the value of the marketing expenditure should be added to the trademarks owned by the headquarters (TCCC).[166]

The Coca-Cola case is a good example of how MNEs have the capacity to shift profits away from market jurisdictions. However, the current ALP provides only short-term protection.[167] Market jurisdictions must reinterpret the ALP to effectively incorporate a "sales" element if they wish to secure enduring benefits.

The Chinese approach outlined in Chapter 7 might provide some useful insights.[168] The

[162] *Coca -Cola case*, above fn 5, at 156.
[163] *Coca -Cola case*, above fn 5, at 169.
[164] *Coca -Cola case*, above fn 5, at 158.
[165] *Coca -Cola case*, above fn 5, at 154 to 157.
[166] *Coca -Cola case*, above fn 5, at 169.
[167] For example, the recent introduction of the development, enhancement, maintenance, protection and exploitation (hereinafter DEMPE) functions to the intangibles in the OECD 2017 Report helped the market jurisdictions to share residual profits through enhancing the existing trademarks in the absence of marketing intangibles of their own. The wider application of the PSM in the OECD 2022 Report enlarged the benefits. The tax authorities of the market jurisdictions will share more profits than a 6% to 7% markup on marketing costs as long as they are willing to challenge Coca-Cola.
[168] Coca-Cola formed the first joint venture under China's "opening-up policy" — Shanghai Shen-mei Beverage & Food Co Ltd with a group of Chinese state-owned companies in 1979. The company has a concentrate plant and a bottling plant, which were jointly managed by Coca-Cola and the Chinese

Chinese approach implements the enterprise doctrine for members of the group that operate in China at the jurisdiction level, allowing the STA to consider the functions performed and risks assumed by all group members in China as a whole[169] (see Section 7.2.3). Applying this approach to the Coca-Cola case, the STA will assess all value-added activities occurring in China as a group effort, regardless of which member of the group carries them out. This method undermines Coca-Cola's artificial "entity" planning, rendering the separation of ServCos, BUs, or supply points irrelevant as long as the value-added activities take place in China. Given that marketing and management functions at the jurisdictional level are carried out in China, China will be enjoying an 'appropriate' share of taxing rights arising within its border.

The Chinese approach places greater emphasis on analysing the global value chain.[170] Instead of isolating segments of the value chain and attempting to match them to comparable transactions, the STA examines the overall global value chain and allocates profits based on a variety of factors, such as the contributions of intangibles and tangible assets that are used, functions performed and the risks assumed, as well as the LSAs and group synergies.[171].

In the Coca-Cola case, the STA is likely to assert that Coca-Cola possesses a valuable brand with valuable formulas. It is also likely to argue that since the entire group is responsible for maintaining the confidentiality of these formulas, group members should share the

companies. See <https://www.bloomberg.com/profile/company/8102074Z:CH> accessed on 22 December 2022, <https://www.swirecocacolazj.com/portal/t_aboutUs?aboutid=1480686961485> (in Chinese) accessed on 22 December 2022, and < http://www.china.org.cn/business/2017-12/05/content_50086924.htm> accessed on 22 December.

[169] UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries*, Part D.2 China Country Practice (2021), para 2.22.2.

[170] Ibid, paras 2.20.2.

[171] SAT, *Consultation Draft Circular: Implementation Measures for Special Tax Adjustments* (2015), published on 17 September 2015, in Chinese "特别纳税调整实施 办法(征求意见稿)", Article 73. In comparison, the OECD approach does not always consider LSAs in profit allocation.

residual profits generated by the brands rather than attribute all of them to the legal owner of the intangibles. The Chinese approach has a wider application to market jurisdictions where marketing and trade intangibles are realised and profits are generated.[172]

Coca-Cola has one of the most valuable trademarks globally. Its uniqueness and value make it exceptionally challenging to find comparable transactions under ALP,[173] especially for developing countries.[174] Expanding the Coca-Cola case from Chinese tax perspective, the Chinese STA is likely to contest the decision of using foreign bottlers as comparable third parties by asserting that the contributions from marketing and distribution functions in China are undervalued[175] due to the presence of the LSAs.

While the OECD emphasizes the LSAs are not intangibles because they are not owned or controlled by the entities,[176] China regards them as quasi-intangibles and unique contributions made by China through the Chinese entity. They are real benefits the MNE captures as a single enterprise, necessitating that relevant entities or jurisdictions share in the additional profits. Thus, from the Chinese tax perspective, the most appropriate method would be PSM.

The STA will then apportion the profits generated in China according to the contributions of intangibles and assets used, functions performed, and risks assumed, as well as the LSAs and group synergies. Under this approach, all the Chinese entities will be treated as one enterprise participating in the PSM. Alternatively, The STA does not rule out a

[172] UN, *United Nations Practical Manual on Transfer Pricing for Developing Countries*, Part D.2 China Country Practice (2021),, para 2.21.1.
[173] Ibid, para 2.20.2.
[174] Ibid, para 2.20.4.
[175] Ibid, para 2.22.8.
[176] The 2022 Report, above fn 2, para 6.9.

formula apportionment that weights factors such as the assets and employee headcount (see Section 7.2.3).

The next chapter will propose a new paradigm based on previously discussed matters in this thesis. In particular, Section 9.4 will apply this paradigm to the Coca-Cola case, outlining how it will assist the market jurisdictions to obtain appropriate taxing rights.

Chapter 9

Conclusion: The Market-Source-Residence Country Paradigm

9.1 Introduction

This thesis argues that market countries deserve appropriate taxing rights over the profits arising from their borders because they represent the demand side of a transaction, which is a critical part of the value realisation (See Chapter 2). Formulary Apportionment (hereinafter FA), which includes sales as a profit allocation factor, is the optimal long-term solution. Nonetheless, due to political considerations, it is not viable in the short run. (see Chapter 3).

However, the inclusion of the sales factor does not need be a complete paradigm shift from the arm's length principle (hereinafter ALP) to the FA. Considering the ALP and the FA as two end points of a continuum of policy options,[1] it is possible to identify a policy option that moves away from the ALP towards FA along the continuum spectrum, by allocating a portion of taxing rights to market jurisdictions. This approach remains consistent with the ALP framework and harmonises effectively with the other arm's length rules.

One potential method explored in this thesis is to creatively interpret the transfer pricing tools. Inspired by the Chinese approach (see Chapter 7), this thesis proposed changes to

[1] Reuven S. Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation' (2007) *Law and Economics Working Paper*, at 2.

the concept of permanent establishment (hereinafter PE) in Chapter 4, creation of marketing intangibles in Chapter 5, and the application of profit split method (hereinafter PSM) in Chapter 6. These modifications synergise well, collectively forming what is labelled “market-source-residence paradigm” in this thesis.

In this chapter, Section 9.2 reviews the fundamental issues deliberated upon in the earlier chapters that could hinder the market jurisdictions from sharing appropriate taxing right. Section 9.3 introduces a theoretical framework consolidating the proposals from preceding chapters, including:

- Jurisdictional-level tax consolidations for all entities and PEs in the same country;
- A reconsideration of PE nexus rules, reaffirming proposals from Chapter 3; and
- Allocating trademarks to market jurisdictions under the ALP.

Section 9.4 applies this paradigm to the Coca-Cola case discussed in Chapter 8, followed by a conclusion of the thesis in Section 9.5.

9.2 Summary of the fundamental issues within the ALP

This thesis has illuminated several fundamental shortcomings within the ALP, thereby hindering market jurisdictions from securing the appropriate taxing rights they rightfully merit.

Firstly, the OECD's interpretation of the value creation principle is excessively narrow (see Chapter 2). If the value creation principle can be interpreted in a broader sense, the demand side of a transaction should be considered. In this context, market jurisdictions should share more profits from sales activities, regardless of functions performed, assets

used, and risks assumed. The distinctive roles that market jurisdictions and supply-side source jurisdictions play in value creation must be clearly defined. Although FA presents a potential solution, its realisation appears distant, including the OECD's version FA, namely Amount A within the Two-Pillars Approach (see Chapter 3).

Secondly, the concept of PE is outdated (see Chapter 4). Over the past decades, shifts in the business models of MNEs and consumer shopping behaviours have been profound. The traditional methods of allocating profits to source or market jurisdictions have become obsolete. The OECD, or whoever will lead the international taxation, needs to fully understand what the internet can bring to the MNEs and consumers.

Thirdly, the ALP rests on erroneous assumptions. It assumes that markets are isolated (see Chapter 5). Intangibles give entities “market advantages” to outperform the competitors in the same market, so their owners enjoy most of the residual profit. However, international taxation is designed to deal with tax problems arising from controlled international trading. Assuming market isolation essentially undermines the very foundation of international trade.

Furthermore, the ALP presumes entities, rather than jurisdictions, are the contestants in the tax arena (see Chapter 5). Consequently, the LSAs are neglected when adopting local comparable transactions. The strong connection between the market and marketing intangibles significantly weakens when examined in relation to marketing intangibles and individual entities. MNEs possess the capacity to manipulate intangible asset creation and engage in aggressive tax planning, shifting profits away from market jurisdictions (see Chapter 8).

Lastly, BEPS 1.0 falls short in empowering market jurisdictions to appropriately claim taxing rights over profits originating within their territories (see Chapters 5 and 6). Market jurisdictions merely receive short-term benefits by providing DEMPE functions to marketing intangibles intrinsically tied to markets (see Chapter 5). When licensors of trademarks terminate licensing agreements and establish new arrangements with other parties, the future benefits stemming from the intangible – which encapsulate prior licensees' DEMPE activities – are stripped away.

9.3 Theoretical framework of the market-source-residence paradigm

9.3.1 Jurisdictional consolidation for tax purposes

The traditional ALP has been criticised for disregarding that groups operate as single enterprises rather than separate entities (see Section 6.2). In theory, it is preferable to have a global consolidation and FA system under which the group synergies will be captured in full. FA may work in the future, but it is not an option soon due to political reasons. The second-best option apart from FA is a jurisdiction-level consolidation.[2]

The trouble of implementing the consolidation can be a problem. Not many countries have tax consolidation regimes, and a country-level tax consolidation will create an additional administrative burden for MNEs as well as tax authorities.

[2] For a discussion of tax consolidation, see Antony Ting, *The Taxation of Corporate Groups under Consolidation: An International Comparison* (Cambridge Tax Law, 1st ed, 2012).

There are two more realistic alternatives to tax consolidation regimes. The first one is the country-by-country (hereinafter CBC) reporting. With the domesticating of BEPS Action 13,[3] many countries require in-scope MNEs to prepare CBC reports.[4] It is a good start, although only the biggest MNEs will need to prepare these reports, and some MNEs only need to prepare reports in a few of the countries where they operate, depending on the various thresholds of jurisdictions.

The second alternative is to view the activities of an MNE in a jurisdiction holistically. The Chinese approach can be an excellent example (see Chapter 7). The assessment includes the functions performed, assets used, and risks assumed by all the entities and PEs in the same jurisdiction. For instance, some MNEs divide functions very specifically into small parts. Each small piece will be undertaken by an entity that specialises in it. Such an entity usually does this small function for all other entities in the jurisdiction or multiple jurisdictions. When the entity is assessed on itself, its function is routine, so it may be priced under the cost plus method. It is a different story if a couple of these service entities are viewed collectively. The problem with a holistic view is that even less reliable comparable transactions are available for transfer pricing purposes. It also counters the intention of Amount B in pricing the baseline distribution and marketing activities separately.

9.3.2 Nexus rules of the PE

[3] See <https://www.oecd.org/tax/beps/beps-actions/action13/> accessed on 9 December 2022.
[4] Such as Australia, see < https://www.ato.gov.au/business/international-tax-for-business/in-detail/transfer-pricing/country-by-country-reporting/> accessed on 9 December 2022.

Section 4.4 proposed that sales can be another limb for building nexus in addition to the existing physical presence nexus rules. The purpose of the nexus rule is to locate the geographic areas where significant value-added activities occur and allocate taxing rights accordingly. Wherever sales have reached a certain threshold, regardless of the sales form, the market jurisdiction will have a nexus to the income.

Section 4.4 also proposed to view the preparatory or auxiliary activities that aim to sell in the same way as sales. For instance, when online sales reach a certain degree, the local marketing and displaying activities are not of preparatory or auxiliary nature anymore. They will be viewed together with the sales to determine the tax base for the market jurisdiction. Another example discussed was data collection. If a company collects data to make sellable databases, it is of preparatory or auxiliary nature. On the contrary, data collected for research purposes regarding customer preference to serve sales purposes should be viewed holistically with sales.

Thus, the source countries and market jurisdictions have nexus rules that suit their distinct situations.

9.3.3 Allocate the trademarks to market jurisdictions

This thesis argued that market jurisdictions should be rewarded for being markets regardless of functions performed, assets used, and risks assumed. Amount A under Pillar One partially achieves this goal by allocating residual profits using revenue as an allocation key. However, some market jurisdictions are also source countries. The MDSH and the double tax elimination methodology under Pillar One reduce their original tax

base, so these countries will potentially have the same tax base as if the entities have only performed routine functions. The reallocation of taxing rights should not be in the cost of all well-performed source countries in general (see Sections 3.4.2 to 3.4.3).

Amount A violates the value creation principle the OECD has been promoting in the Base Erosion and Profit Shifting (hereinafter BEPS) 1.0. The principle was narrowly interpreted and has just started to be coherent with the DEMPE. The design of Amount A will significantly reduce its credibility. The international taxation system will have no sound economic foundation (see Section 2.5). The ALP and Two-Pillar Approach will become two unrelated regimes working independently.

However, allocating appropriate taxing rights to market jurisdictions can be achieved by utilising transfer pricing toolkits creatively. Marketing intangibles have intrinsic connections to markets, making them ideal indicators for rewarding market jurisdictions. For example, trademarks typically hold no value upon registration. They must always be advertised in markets and among potential consumers to gain value, which connects them to the markets they are promoted (see Section 5.4).

Unfortunately, the ALP treats entities as separate, causing the link between trademarks and the markets they are advertised in to weaken when considered at the entity level (see Section 5.5). The ALP allows foreign entities to register trademarks, and locally created marketing intangibles can be transferred overseas. Consequently, under the current OECD model, the market does not sufficiently benefit from the marketing intangibles generated within it.

As a result, this thesis proposes that, ideally, jurisdictions should domesticate a rule only allowing resident entities to register trademarks that are used and protected in the local

market. For example, a Chinese entity should legally and economically own the trademarks and trade names to be promoted in China. There are three reasons underpinning this proposal:

- The trademarks are registered in each jurisdiction separately. The domestic law of each country should require a domestic entity or resident to register the trademarks, and the transfers should be limited to domestic entities. For the already registered trademarks, a country can choose to treat them as deemed to have been registered by local entities or leave the situation as it is now.
- The trademarks can be registered with hardly any barrier and often have zero value upon registration. A trademark owner enjoys tremendous benefits in a market, but the initial cost was nearly zero, making trademarks great for profit shifting. Fixing them to the market jurisdictions will help stop relevant tax planning.
- Usually, the headquarter, or the entities in the low-taxed jurisdictions registered them. Under the proposed paradigm, the former will be compensated under global minimum tax under Section 9.2.4, and the latter are the ones that shall be carefully distinguished. If no meaningful value-added activities have taken place within their borders, there may be tax havens that shelter profits, so fixing trademarks to market jurisdictions is consistent with the BEPS.

If achieving the first option is not feasible, the next best alternative is to insert tax rules stipulating that trademarks are to be regarded as owned by local entities for tax-related issues. This approach resembles but is limited in scope to the "marketing intangibles" proposal that the OECD introduced in 2019. In the proposed scheme, all marketing intangibles, including trademarks and second kind of marketing intangibles, were

deemed to have originated in the market jurisdiction.[5] However, the OECD ultimately chose not to adopt this proposal and shifted its focus to the Two-Pillars Approach.

One potential problem with both options is the scope of implementation. Allocating trademarks to market jurisdictions means the original owners will not generate any additional profits associated with trademarks, not limited to sales and promotion activities.

For instance, an MNE operates in three jurisdictions: A, B, and C. Jurisdiction A is not a market to this MNE, but the group member in Jurisdiction A performs routine manufacturing functions. Jurisdiction B is the market to the MNE, and the group member in Jurisdiction B performs routine marketing and distribution functions. Further, Jurisdiction C is where the headquarter is located and owns all kinds of intangibles, including trademark. Under the current arm's length system, Jurisdiction A and B will share routine profits as they perform routine functions, and all residual profits will be allocated to Jurisdiction C. While under the two proposed options, Jurisdiction C will not share any profits at all because its entity performs no function, contributed no asset and assumed no risk. Residual profits will be split between Jurisdiction A and B because both contributed trademarks, namely those used in manufacturing and those used in marketing.

The third alternative is to limit the market jurisdictions entities only deemed to have owned the trademarks for sales-related activities, such as marketing and distribution. The limitation is to prevent a supply-side source jurisdiction, such as Country A in the

[5] See OECD, *Public Consultation Document: Addressing the Tax Challenges of the Digitalisation of the Economy* (2019), part 2.2.2.

above example, from claiming residual profits by performing non-sales-related functions, such as manufacturing.

This way, the marketing countries will enjoy residual profits attributable to trademarks. The transfer pricing analysis works like before, except the trademarks belong to the market jurisdiction this time. The PSM is likely the most appropriate method, where the other party of the controlled transaction makes unique and valuable contributions, such as a trade intangible, development, enhancement, maintenance, protection and exploitation (hereinafter DEMPE) activities to the trademark, or a second kind of marketing intangible. Where the other party of the controlled transaction only performs routine functions, they will be priced under the traditional transactional methods, including CUP, cost plus and resale price methods, or transactional net margin method (hereinafter TNMM). Consequently, the market jurisdiction will share some of the residual value. Where an offshore team performs DEMPE activities that enhance the trademarks, they will share a portion of the residual profits depending on the extent of the DEMPE activities.

As licensors, the trademarks will help the market jurisdictions get a larger share of lasting benefits (see Sections 5.2 to 5.4). Whoever performs DEMPE functions to trademarks will only enjoy short-term benefits, but the licensors always benefit from the value increase of the trademarks. The benefits are volatile upon the sales, making it an ideal replacement for Amount A.

In opposition to this, the second kind of marketing intangibles will not be allocated to market jurisdictions by default. They are the result of studying the markets, such as a distribution channel, or the customers, such as a customer list, which need both a market

and a marketing team (local or remote). It is common for an offshore marketing team to collect data online and undertake marketing functions remotely.

The profit allocation of this approach will achieve a similar result to Pillar One (Amount A and B combined). In particular, it allocates more profits to market jurisdictions in a way that is much more straightforward than Amount A, and with the residual profits allocated shared through trademarks, it will be much easier for the market jurisdictions to accept a streamline of the distribution and marketing functions.

Moreover, the market related LSAs, such as market premium, shall not be considered because they will have been considered and allocated to the market jurisdictions along with the trademarks. For example, in the tuna example discussed in Chapters 2 and 5, the Japanese prefer premium high-quality tuna, so the price of premium tuna in Japan is higher than in other places. However, the market premium will only be considered under the existing OECD model when the overseas comparable transaction is used. However, under the proposed approach, the overseas supplier will be the tested party, or both parties will be tested under the PSM. The supplier provides the same quality products worldwide, so the price should be the same. Thus, Japan retains the market premium.

9.3.4 Global minimum tax[6]

[6] The explanation of the terms, such as “carve-out” and “top-up tax” can be found in the Glossy of Terms.

A global minimum tax like Pillar Two can be applied after the arm's length analysis to compensate residence jurisdictions for the potential taxing rights they will lose for handing out the taxing rights associated with trademarks.

Pillar Two could be an option to achieve this goal, but it has some problems, such as the low carve-outs for payroll and intangible assets.[7] The exhibition of these two items often distinguishes the countries with meaningful value-added activities from tax shelters. The low 5% carve-outs are not enough to serve its purpose. For instance, when an entity owns tangible assets of 80 million, generates an income of 10 million in a particular year, and the jurisdiction in which it is located has an effective tax rate of 10%, the entity will have a 0.3 million top-up tax payable to the ultimate parent jurisdiction. The calculations are as follows:

- GloBE Income = 10 million
- Adjusted Covered Taxes = 1 million
- Jurisdictional Effective Tax Rate = 1/10 = 10%
- Jurisdictional Top-Up Tax Percentage = 15%-10% = 5%
- Payroll + Carrying amount of tangible assets = 80 million
- Substance Based Income Exclusion = 80 million × 5% = 4 million
- Excessive Profit = 10-4 = 6 million
- Jurisdictional Top-Up Tax = 6 million × 5% = 0.3 million

[7] For a discussion of Pillar Two, see Appendix A.

However, for an entity that generates 10 million in income, 80 million is a decent amount of tangible assets it could potentially own. Entities with sufficient assets and employing a fair amount of employees should not be the targets for a minimum tax regime.

Alternatively, the minimum tax should be applied to the shell entities in the tax heavens, which do not own many tangible assets or employees. This goal will be more approachable if the carve-outs are increased to, for example, 12.5%. In this case, the Jurisdictional Top-Up Tax is zero, meaning the country does not have Excessive Profit for an additional tax. It is equitable for a country with a significant payroll and tangible assets. It will encourage more countries to join the approach, especially the ones like Hungary and Poland that wish to keep a low tax to attract foreign direct investment (hereinafter FDI).

Furthermore, the carve-outs can be a variable, taking location saving into consideration, which is the LSAs left out from Section 9.2.3. The variation must consider the price difference among different geographic areas, such as the pay difference. The World Bank has a few databases that may help, such as the Inflation or Consumer Price Index (hereinafter CPI).[8] No matter how much the carve-outs are, they must be supported with empirical data.

9.4 Application of the market-source-residence country paradigm

This section applies the proposed market-source-residence country paradigm to the

[8] The World Bank keeps databases containing CPI for most countries over 60 years. See < https://data.worldbank.org/indicator/FP.CPI.TOTL.ZG> accessed on 10 December 2022.

Coca-Cola case discussed in Chapter 8.

Firstly, the activities within the same jurisdiction must be aggregated, including the functions performed, assets used, and assumed risks. In Coca-Cola's case, the activities undertaken by the ServCos, supply points, and Coca-Cola-owned bottlers in the same jurisdiction will be viewed in their entirety. In this way, in a jurisdiction that hosts multiple types of entities that perform various functions, the MNE can hardly price the activities under cost plus or TNMM because these entities represent a more significant part of the global value chain.

Secondly, the trademarks will be allocated to market jurisdictions for sales-related activities, such as marketing and distribution. It means that profits attributable to trademarks will be allocated to market jurisdictions rather than the ServCos (which are only located in a few market countries) supply points or headquarters. Supply points and bottlers will pay royalties for using the trademarks in distributions.

The ServeCos may be rewarded for performing DEMPE functions in exploiting the trademarks. If so, they will share a portion of the residual profits associated with trademarks in the short run until their service contracts are terminated.

In cases involving sales to third parties, the headquarters will likely be the tested party as the value or significance of their contributions to the transactions is minimal. In certain scenarios, the headquarters may receive a portion of the residual profits. This could occur, for instance, when they engage in activities that add value to the trademarks, like quality control or overseeing marketing platforms. Nonetheless, if the headquarters ceases to perform these functions, the remuneration will also cease accordingly. However, they will retain the right to collect royalties on intangibles other than trademarks.

Lastly, a minimum tax rate applies, and the jurisdiction where the ultimate parent entity is located, in this case, the US, will have the right to tax any uncollected top-up tax worldwide.

9.5 Limitations of the Market-Source-Residence Country Paradigm

The proposed paradigm has two limitations that need to be dealt with:

Firstly, the implementation of jurisdictional consolidation presents a notable challenge. It would add an additional layer of administrative complexity on MNEs as well as tax authorities. This change may prove particularly burdensome for developing jurisdictions, which may lack the administrative capacity necessary for effective implementation and oversight. Although there is a global trend towards considering value-added activities in a comprehensive manner, such as with CBC reporting, Pillar Two, and Amount A, the OECD has also proposed Amount B, which isolates marketing and distribution functions for separate markup. This approach may impede market jurisdictions' ability to collectively assess value-added activities.

Secondly, revising the PE nexus rules presents significant political obstacles. Any amendments to these rules require negotiations to amend double tax treaties or introduce new multilateral conventions. This process entails navigating a complex web of diplomatic negotiations, which can be protracted and challenging to navigate.

The political hurdles involved in changing PE nexus rules mirror those faced during the implementation of initiatives like Amount A.[9] Countries may have divergent interests and priorities when it comes to tax policy, and reaching a consensus on changes to the PE nexus rules can be difficult.

Likewise, reallocating trademarks to market jurisdictions could encounter political resistance. It can have far-reaching implications for MNEs and national tax revenues. Countries may be concerned about potential revenue losses or unintended consequences resulting from reallocating trademarks. As a result, there may be a reluctance among certain countries, such as the US, to support such revisions without assurances concerning their potential impact and benefit.

9.6 Conclusion

The proposed market-source-residence paradigm, inspired by the Chinese interpretation of the OECD model, harnesses transfer pricing toolkits without a complete paradigm shift to the FA. It effectively allocates appropriate taxing rights to market jurisdictions with few changes and amendments.

The market-source-residence paradigm balances the interests of diverse jurisdictional groups and is perferable to the Two-Pillars Approach. It does not diminish the interests of most source jurisdictions, except those with a significant number of trademarks, such as the United States. These jurisdictions, often are where MNE headquarters located, will

[9] For a discussion of how jurisdictions are not keen about signing the multilateral convention for various reasons, see Robert Goulder, Expectations for 2024: Pillar 1 Finds an Off-Ramp' (2023) 112 (12) *Tax Notes International* 1819.

be rewarded by the global minimum tax regime that comes into play last. Low-tax nations marked by little meaningful value-added activities within their borders and tax havens will bear the brunt. This aligns with the BEPS Project's original focus, directing attention towards regions that shouldn't anticipate substantial tax collection.

The recommendations presented in this thesis offer an avenue for policymakers to consider both as a comprehensive package and as individual components. For instance, a jurisdiction might choose to introduce “sales” as a nexus rule to the PE concept without fully embracing the entire "market-source-residence paradigm." Similarly, a jurisdiction could take a holistic approach, encompassing all activities occurring within its borders under transfer pricing considerations.

Future research could expand the findings of this thesis in several ways. One avenue is to examine alternative policy options for the equitable distribution of taxing rights in regard to sales factors and market jurisdictions while retaining elements of the ALP.

Alternatively, further investigations might examine specific intricacies within the thesis proposals. This could include a deeper exploration of the tax issue from an economic perspective and gain a better understanding of how the market is an indispensable element in value creation. Such research could challenge the validity of the 1923 Report's assertions, suggesting that contemporary circumstances necessitate a new framework akin to the FA approach.

Another potential direction is to delve into the nexus rule of PE, particularly considering the concept of virtual PE thereby modernising the PE framework in light of the digital economy. For instance, aligning with the OECD's original intention to identify a comparatively "fixed" nexus for PE, marketing activities emerge as a potentially more

suitable criterion than sales, given that sales can be artificially booked anywhere, whereas marketing only targets specific sales destinations.

An additional idea is to explore marketing intangibles in terms of their historical development and to study the comparative treatment across different jurisdictions, such as China compared to India. For example, the Indian tax authority appears to favour using marketing intangibles as a way of claiming more share of taxing rights compared to China. The Indian tax authority has leveraged this concept to challenge MNEs in several tax cases. The comparative research could also discuss the potential impact of Amount B and Pillar Two on emerging markets such as China and India.

Appendix A

Global Minimum Tax Proposal: Pillar Two

A.1 The theoretical frameworks of Pillar Two[1]

Pillar Two puts a floor to the global corporate tax to ensure that the large MNEs pay a minimum tax rate of 15% on residual profits other than the portion arising from payroll and tangible assets in all countries. Not like Pillar One, it will give rise to additional taxes. The key component of Pillar Two is the Global Anti-Base Erosion (hereinafter GloBE) Rules, which consist of the IIR and the UTPR. The former is prioritized over the Latter. Among all countries that adopt Pillar Two, IIR allocates the taxing right to the residence country of the entity that stands on the top of the corporate ownership structure, so usually, the residence country of the MNE headquarters will have the rights over IIR. Then the UTPR gather the top-up tax left over by the IIR and allocates them to eligible jurisdictions based on the level of their employee numbers and tangible asset value.

The GloBE Rules apply to MNEs that have annual revenue of EUR 70 million or above in the Consolidated Financial Statement of the Ultimate Parent Entity (hereinafter UPE, it is the ultimate owner of the MNE group) at least two of the four Fiscal Years immediately preceding the tested Fiscal Year.[2] The smallest unit relevant to GloBE Rules is not "entity", but "Constituent Entity" (hereinafter CE) which consists of a main entity and its PEs.[3] The

[1] Appendix A is based on the rules and public documents published as of 30 November 2022.
[2] OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)* (2021), Article 1.1.1.
[3] OECD, *2021 Pillar Two Document*, above fn 2, Article 1.3.

relevant concept and ratios, such as GlobBE Income, Adjusted Covered Taxes and Top-Up Tax, are calculated at the CE level first and then aggregated to the jurisdictional or global level.

A.1.1 Top-Up Tax

The GloBE calculations start from The Top-Up Tax calculations. The jurisdictional Top-Up Tax is basically a multiply of the Top-Up Tax Percentage and Excessive Profit, with adjustments.[4]

A.1.1.1 Jurisdictional Effective Tax Rate

In a low-tax jurisdiction, a CE's current tax expense accrued in profit before tax (with adjustments) is called the "Adjusted Covered Tax" of a CE.[5] Likewise, the financial profit and loss (with adjustments) for a CE is called the "GloBE Income or Loss" of a CE.[6] An aggregation of the former divided by an aggregation of the latter is the Effective Tax Rate of a jurisdiction:[7]

$$Effective\ Tax\ Rate\ of\ a\ Jurisdiction = \frac{\Sigma Adjusted\ Covered\ Taxes\ of\ each\ CE\ in\ the\ jurisdiction}{\Sigma Net\ GLoBE\ Income\ of\ the\ jurisdiction}$$

[4] Ibid, Article 5.2.3.
[5] Ibid, Article 4.1. It can be less than zero. See Article 4.1.5.
[6] Ibid, Article 3.1 and 3.2.
[7] Ibid, Article 5.1.

Appendix A

The Effective Tax Rate represents the actual tax rate of a jurisdiction. When smaller than the minimum tax rate of 15%, it gives rise to a positive Top-Up Tax Percentage: the gap rate an MNE needs to top up in a jurisdiction.[8]

A.1.1.2 Excessive Profit

However, not all profits must be taxed at a minimum rate. The OECD introduced a concept named "Excessive Profit" of a jurisdiction to exempt a portion of return arising from payroll and tangible assets:[9]

$$Excessive\ Profit$$
$$= \Sigma Net\ GLoBE\ Income\ of\ the\ jurisdiction$$
$$- \Sigma Substance\ Based\ Income\ Exclusion\ for\ each\ CE\ in\ the\ jurisdiction$$

In which, the Substance Based Income Exclusion is basically a 5% carve-out on eligible payroll costs and a 5% carve-out on the carrying amount of eligible tangible assets.[10] These two ratios are subject to transitional relief runs from 10% and 8%, respectively, down to 5% in 10 years. The larger these ratios are, the lower the Excessive Profit will be, which means the MNE will have less Top-Up Tax in a particular jurisdiction.

Like Pillar One, the OECD did not support these ratios with empirical data. Neither did it explain the gap between a 40% return on depreciation and payroll under Pillar One MDSH and selection of Specified Jurisdictions, and here, a 5% carve-out on similar items.

[8] $Top - Up\ Tax\ Percentage = Minimum\ Tax\ Rate - Effective\ Tax\ Rate$ See Ibid, Article 5.2.1.
[9] Ibid, Article 5.2.2.
[10] Ibid, Article 5.3. The carve-outs are a cost-plus "top-up" return on how much has been determined under the ALP.

If the carve-outs are deemed to distinguish tax havens from the jurisdictions with value-added activities within its border, they shall be considerably enhanced.

The 5% low carve-outs will terminate the "low tax for FDI" policy worldwide. Assume an MNE has a factory in a low-taxed jurisdiction with a considerable amount of tangible assets and staff. Like many other MNEs, it also has a return higher than 5% of payroll costs and a carrying amount of tangible assets. These numbers give rise to a positive Excessive Profit, subsequently, a positive Jurisdictional Top-Up Tax in the low-taxed country. It may not be a participating jurisdiction of Pillar Two, but as long as one of the direct or indirect owners locates in a participating jurisdiction, the Top-Up Tax will be collected by IIR. It will result in a reallocate of the tax base from a low-taxed country to a high-taxed one, even though the low-taxed jurisdiction has a significant level of value-added activities within its border. In this way, countries cannot use the proved efficient low tax, tax incentives, and tax holidays to attract FDI. They must find another way.

A.1.1.3 The calculations of the Jurisdictional Top-Up Tax

The Top-Up Tax Percentage and Excessive Profit are the critical elements of Jurisdictional Top-Up Tax. Multiplication of these two gives rise to the amount of tax an MNE need to top-up in a jurisdiction to make the excessive profit being taxed at 15%. This number is then adjusted by Additional Current Top-Up Tax and Domestic Top-Up Tax. The former is triggered when the GloBE Income is zero in a jurisdiction and the CEs get a tax refund,[11] or when the Effective Tax Rate and Top-up Tax for a prior Fiscal Year need to be

[11] Ibid, Article 4.1.5.

recalculated.[12] The latter is the tax credit for Qualified Domestic Minimum Top-Up Tax (hereinafter QDMTT).[13] It outlines that QDMTT gets priority taxing rights over the IIR. To summarize the calculations:[14]

$$Jurisdictional\ Top-Up\ Tax$$

$$= Top-Up\ Tax\ Percentage\ of\ a\ Jurisdiction \times Excessive\ Profit$$

$$-Additional\ Current\ Top-Up\ Tax - Domestic\ Top-Up\ Tax$$

The Jurisdictional Top-Up Tax is the starting point for both IIR and UTPR. If it equals zero, the MNE does not pay any top-up tax under GloBE Rules to this particular jurisdiction. Article 8.2.1 sets out a Safe Harbour for qualified CEs:

> *"... the Top-up Tax for a jurisdiction (the safe harbour jurisdiction) shall be deemed to be zero for a Fiscal Year when the Constituent Entities located in this jurisdiction are eligible for a GloBE Safe Harbour..."*[15]

The details are not ready yet, so it is unclear whether the safe harbour is to relieve MNEs from top-up tax or help struggling countries maintain a low tax rate to attract FDI.

[12] Ibid, Article 5.4.
[13] Ibid, at 64.
[14] Ibid, Article 5.2.3.
[15] Ibid, Article 8.2.1.

Appendix A

A.1.2 Income Inclusion Rule

IIR takes priority over UTPR.[16] When the Jurisdictional Top-Up Taxes are ready for each participating jurisdiction, the next step is to aggregate and allocate them under IIR.

The residence country of the UPE has the primary right to claim the Top-Up Tax under IIR for all the CEs that it directly or indirectly owns. However, if such jurisdiction does not embrace Pillar Two, the taxing right will pass down to the residence countries of the CEs that it owns directly, and so on.[17] For instance, if Jurisdiction A is the residence country of the UPE, which owns CE X in Jurisdiction X and Y in Jurisdiction Y directly. It also owns CE O, P, and Q indirectly through X, CE R, S, and T indirectly through Y. Assume CE O, P, Q, R, S, and T are all located in low-taxed jurisdictions. The primary right of collecting IIR belongs to Jurisdiction A, but when it is not a Two-Pillar Approach participating jurisdiction, Jurisdiction X will have the right to tax CE O, P, Q and Jurisdiction Y have the right to tax CE R, S, T, respectively.

A.1.2.1 The calculations of IIR

IIR excludes Top-Up Tax attributable to third parties. When a CE has more than 20% of the Ownership Interests in its profits held directly or indirectly by other owners that are

[16] Ibid, Articles 2.5.2. and 2.5.3.
[17] "An Intermediate Parent Entity of an MNE Group located in [insert name of implementing- jurisdiction] that owns (directly or indirectly) an Ownership Interest in a Low-Taxed Constituent Entity at any time during a Fiscal Year shall pay a tax in an amount equal to its Allocable Share of the Top- Up Tax of that Low-Taxed Constituent Entity for the Fiscal Year.
Article 2.1.2 shall not apply if:
(a) the Ultimate Parent Entity of the MNE Group is required to apply a Qualified IIR for that Fiscal Year; or
(b) another Intermediate Parent Entity that owns (directly or indirectly) a Controlling Interest in the Intermediate Parent Entity is required to apply a Qualified IIR for that Fiscal Year.
See ibid, Article 2.1.2.

not group members, the GloBE Income attributable to these interests will be reduced proportionately.[18] The GloBE Income rate attributable to the interests of group members is called the "Inclusion Ratio".[19] This is a CE-level ratio. Likewise, the Top-Up Tax also needs to be allocated to each CE so that it can be reduced proportionately to its ownership interests held by non-members.[20] The multiplication of the Inclusion Ratio and the Top-Up Tax of a CE is the share of the top-up tax per CE:

$$Allocable\ Shares\ of\ the\ Top-Up\ Tax\ per\ CE = Top-Up\ Tax\ per\ CE \times Inclusion\ Ratio\ per\ CE$$

The IIR a Jurisdiction can collect is a sum of all the Allocable Shares of the Top-Up Tax for eligible CEs. If all the CEs in a jurisdiction are wholly owned subsidiaries, a jurisdictional Top-Up Tax will be a simple aggregation of Top-Up Taxes of all CEs.

A.1.2.2 De minimis exclusion

De minimis exclusion exempts a jurisdiction when its CEs generate little revenue and profits:

> *"…the Top-up Tax for the Constituent Entities located in a jurisdiction shall be deemed to be zero for a Fiscal Year if, for such Fiscal Year:*

[18] Ibid, Article 2.2. This type of CEs is named "Partially-Owned Parent Entity". See the definition on page 62.

[19] $Incusion\ Ratio = \frac{Total\ GLoBE\ Income - GLoBE\ Income\ attributable\ to\ Ownership\ Interests\ held\ by\ other\ owners}{Total\ GLoBE\ Income}$ See Article 2.2.2.

[20] $Top-Up\ Tax\ of\ a\ CE = Jurisdictional\ Top-Up\ Tax \times \frac{GLoBE\ Income\ of\ a\ CE}{Total\ GLoBE\ Income}$ See Ibid, Article 5.2.4.

(a) the Average GloBE Revenue of such jurisdiction is less than EUR 10 million; and

(b) the Average GloBE Income or Loss of such jurisdiction is a loss or is less than EUR 1 million."[21]

When the exemption applies, the jurisdiction will not give rise to any collectable IIR. On the contrary, it will have the right to collect IIR from other countries if it has, for example, a UPE for an in-scope MNE.[22] The De minimis exclusion does not apply to UTPR. It reduces the post-allocation CE level Top-Up Tax to zero, but the UTPR starts with the Jurisdiction Top-Up Tax, which is the amount pre-allocation.

The De minimis exclusion encourages the MNEs to have a flat structure with some value-creation activities in each jurisdiction but keep the revenue under 10 million or profit and loss under 1 million. The application of IIR generally encourages the MNEs to keep flat corporate structures, at least at the early stage of Pillar Two when only a few countries domesticate the GloBE Rules. A flat structure ensures fewer entities are owned directly or indirectly by a parent that locates in participation jurisdiction.

A.1.3 Under Tax Payment Rule

UTPR is a classic form of FA. It sums the total top-up tax across all jurisdictions for an MNE and then reduces it by the IIR.[23] It may not exist if the IIR has claimed all the top-up

[21] Ibid, Article 5.5.1. The Average GloBE Revenue or Income or Loss are three-year average among the current and the two preceding years. See Article 5.5.2. The OECD did not define "Revenue" of a CE. A reasonable guess would be the revenue from financial accounts.
[22] The OECD did not require the IIR collector Jurisdiction to have an Effective Tax Rate higher than the minimum rate.
[23] $UTPR\ Top-Up\ Tax = \Sigma Jurisdictional\ Top-Up\ Tax - IIR$ See Ibid, Article 2.5.1.

tax.[24] Where the IIR didn't, the total amount of the UTPR Top-Up Tax will then be allocated to UTPR-qualified jurisdictions:[25]

$$Allocation\ of\ UTPR\ Top-Up\ Tax\ to\ a\ Jurisdiction$$

$$= Total\ UTPR\ Top-Up\ Tax\ Amount \times Jurisdictional\ UTRP\ Percentage$$

In which, the Jurisdictional UTRP Percentage is:[26]

$$50\% \times \frac{Number\ of\ Employees\ in\ the\ jurisdiction}{Number\ of\ employees\ in\ all\ UTPR\ jurisdictions}$$

$$+50\% \times \frac{Total\ Value\ of\ Tangible\ Assets\ in\ the\ jurisdiction}{Total\ Value\ of\ Tangible\ Assets\ in\ all\ UTPR\ jurisdictions}$$

The Jurisdictional UTPR Percentage passes on a few messages:

First, it potentially represents the amount of value-added activities in such a jurisdiction. Tax heaven will not have a very high Jurisdictional UTPR Percentage. In contrast, a source country that performs functions such as manufacturing will likely have a higher percentage, consequently, share a more significant portion of the UTRP.

Second, the value of tangible assets here is measured by total value. In accounting, it can be the cost of the assets or revalued amount. In contrast, the carve-out applies to tangible assets on the carrying amount: cost minus accumulated depreciation, which is much smaller. The Jurisdictional UTPR Percentage will be a comparatively involatile ratio, but Substance Based Income Exclusion diminishes. Keeping everything constant, the

[24] Ibid, Article 2.5.2.
[25] Ibid, Article 2.6.
[26] Ibid, Article 2.6.1.

Excessive Profit will increase yearly with the tangible assets depreciating. The low-taxed jurisdictions, even those that host meaningful value-added activities, will have higher and higher Top-Up Tax, which are eventually shared by all UTPR jurisdictions. It will put much pressure on the low-taxed jurisdictions, forcing them to introduce a qualified QDMTT.

It will not work if the jurisdiction puts UPTR in force on the one hand and provide tax credits afterwards to offset it. Its UTPR Percentage will be reduced to zero in the subsequent year.[27] The low-taxed jurisdiction will still give rise to Jurisdictional Top-Up Tax, but it will not share a portion.

Like IIR, UTPR also has exemptions. It exempts MNEs in their initial internationalisation phase with operations in no more than six jurisdictions, and the sum of the carrying amount of tangible assets in all operations (except the one with the most tangible asset) does not exceed EUR 50 million.[28] However, the UTPR exclusions pass on a different message from the De Minimis Exclusion. The latter encourages a flat structure, while the former encourages otherwise, so an MNE cannot enjoy two exemptions simultaneously. IIR will partially capture the flat-structured MNEs, and the UTPR will catch the tall-structured MNEs. The ones likely to escape from Pillar Two are the medium-sized digital MNEs that do not have much revenue/profits and operate in no more than six jurisdictions.

A.1.4 Qualified Domestic Minimum Top-Up Tax

[27] Ibid, Article 2.6.3.
[28] Ibid, Article 9.3.

Appendix A

The QDMTT is designed for the low-taxed jurisdictions to top-up the minimum tax prior to it being collected by other jurisdictions. A qualified QDMTT will be carried out in a way consistent with Pillar Two and reduce the Jurisdictional Top-Up Tax.[29] It includes the following steps:

> *"[QDMTT] means a minimum tax that is included in the domestic law of a jurisdiction and that:*
>
> *(a) determines the Excess Profits of the Constituent Entities located in the jurisdiction (domestic Excess Profits) in a manner that is equivalent to the GloBE Rules;*
>
> *(b) operates to increase domestic tax liability with respect to domestic Excess Profits to the Minimum Rate for the jurisdiction and Constituent Entities for a Fiscal Year; and*
>
> *(c) is implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Rules and the Commentary, provided that such jurisdiction does not provide any benefits that are related to such rules."*[30]

Jurisdictions with a notional tax higher than 15%, such as the US, may also give rise to top-up tax when the Effective Tax Rate is lower than the threshold. Hence, the Biden Administration proposed a 15% Book Minimum Tax (hereinafter BMT) through Inflation Reduction Act, hoping it would be a qualified QDMTT.[31] Also, the Biden administration tried to reform the GILTI so that it could be considered a qualified IIR in line with the

[29] Ibid, Article 5.2.3.
[30] Ibid, at 64.
[31] Elodie Lamer, 'Corporate Alternative Minimum Tax Is Not a Pillar 2 Substitute' (2022) 108 (1) *Tax Notes International* 76, at 76.

GLOBE rules through the Build Back Better Act.[32] In fact, Pillar Two brings the US little tax benefits since it has GILTI already. However, the former will still catch any differences between the GloBE and the GILTI. If the Build Back Better Act is not passed and the current US GILTI is non-conforming, the US MNEs' subsidiaries in the participating jurisdictions may be stripped by Pillar Two.

A.2 The potential outcome of Pillar Two

Pillar Two will be more influential than Pillar One: it has a much bigger scope and can be implemented unilaterally with a multilateral convention. Domesticating Pillar Two means a country can almost ensure it will share some top-up tax from UTPR, particularly in the early stage when QDMTT and IIR are comparatively small. Pillar Two is designed to offer a "first-mover advantage": if one country introduces the rules before others do, it can pick up the entire low-taxed profits of the in-scope MNEs.[33]

Some countries welcome Pillar Two. The UK and Canada intend to introduce the IIR in 2023 and the UTPR in 2024.[34] The jurisdictions that have traditionally been investment hubs, such as Switzerland, Singapore, Mauritius, Hong Kong, and the United Arab Emirates, have expressed interest in implementing QDMTTs likely in 2023.[35] Other

[32] Stephanie Soong Johnston, 'Biden Voices Support for Global Minimum Taxation at U.N.' (2022) 107 (13) *Tax Notes International* 1571, at 1571. See Build Back Better Act at HR 5376 < https://www.taxnotes.com/tax-notes-today-international/corporate-taxation/excerpts-are-available-house-reconciliation-bill/2021/10/29/7ck4g> Accessed on 7 December 2022.
[33] Ibid, at 31.
[34] Ibid, at 31.
[35] Ibid, at 31.

countries, such as Australia and Japan, will start to announce their plans following this schedule.[36]

Others keep vetoing it. When the other EU member states were keen to implement Pillar Two, Hungary was the sole handout multiple times.[37] EU needs unanimity among member states to pass an issue, so Hungary alone stopped the EU from implementing Pillar Two. Without the EU's recovery funds, Hungary needs to keep its 9% corporate income tax rate for a competitive business climate to attract FDI. A post-Pillar-Two tax incentive will likely not work either.[38] Hence, Hungary will only support Pillar Two if the EU passes its recovery plan.[39]

EU cannot be stopped for very long. The EU members can unilaterally participate in Pillar Two. If Hungary eventually stays in, at least it can protect its tax base. Otherwise, other participating countries will strip Hungary's tax base, raising the effective tax rate from 9% to 15%. Its MNEs profitability will be impaired, and most importantly, it may not attract as much FDI as it used to. As discussed in Chapter 2, attracting FDI is not the priority of the market jurisdictions and the residence countries. The former provides markets, which the MNEs need to sell their products, and the latter provides capital, which is the FDI to other countries. However, the source countries are different. Attracting FDI, for

[36] Ibid, at 33.
[37] Elodie Lamer, 'Hungarian Veto Remains as Deadline Approaches' *Tax Notes Today International* (5 December 2022). For an analysis of why Hungary and Poland are not keen to participate in Pillar Two, see Bálint Fetter, 'The Global Minimum Corporate Tax: Why Are Certain Visegrád Countries Reluctant to Embrace It?' (1 November 2022) *Hungarian Conservative* <https://www.hungarianconservative.com/articles/current/the-global-minimum-corporate-tax-why-are-certain-visegrad-countries-reluctant-to-embrace-it/> accessed on 7 December 2022.
[38] Tax credits or refunds will be reduced from Covered Tax. See OECD, *2021 Pillar Two Document*, above fn 2, Articles 4.1.2 and 4.1.3. The OECD also warns the tax authorities to reassess tax incentives carefully in the post-Pillar-Two environment. OECD, *Tax Incentives and the Global Minimum Corporate Tax – Reconsidering Tax Incentives After the GloBE Rules* (2022), at 3.
[39] Elodie Lamer, 'Czech Presidency Warns of All-or-Nothing Deal for Pillar 2' *Tax Notes Today International* (7 December 2022).

many of them, is the priority. The OECD needs to significantly raise carve-outs for Substance Based Income Exclusion to give countries like Hungary room to attract FDI. In this case, when a country has enough tangible assets and staff, its Excessive Profit will be minimum, so GloBE Rules will mainly capture the profits from the under-staffed and under-equipment low-taxed jurisdictions – the tax heavens. Hence, countries with a similar worry to Hungary will be more likely to join Pillar Two, and an international consensus is easier to reach.

A.3 Applying Pillar Two rules to the Coca-Cola case

Pillar Two put a floor of 15% on corporate tax. Coca-Cola's seven supply points had a low weighted average income tax rate of 6.3%, which means most of them would likely have Top-Up Tax, particularly the Irish supply point, which had an income tax rate of 1.4%.[40]

Ireland will be used as an example. The Top-Up Tax Percentage for Ireland was:

$$Top-Up\ Tax\ Percentage = Minimum\ Rate - Effective\ Tax\ Rate = 15\% - 1.4\%$$
$$= 13.6\%$$

It was worth noting that the Effective Tax Rate would be larger if Amount A applied in the same year. Ireland would undoubtedly be one of the countries that provided tax credits to Amount A and was likely to be on the top Tier.

The Coca-Cola case shows that the ROA for the Irish supply point was 227.9% for 2009,[41]

[40] *Coca -Cola Co. v. Commissioner* (2020) 155 T.C. No. 10, at 28 and 76.
[41] *Coca -Cola case*, above fn 40, at 82.

and the gross profit for 2009 was US $2,456 million operating income.[42] Hence, reversing the calculations, its operating asset should be (in million):

$$Operating\ asset = Gross\ profit \div ROA = \$2{,}456 \div 227.9\% = \$1{,}078$$

Ireland supply points mainly undertook routine manufacturing functions, so the operating assets were tangible.

Coca-Cola employed 2,500 employees in Europe in 2009.[43] Assume all of them were employed by the Irish supply point for a conservative estimation. The average annual pay for Ireland was US $49,081.[44] Hence, the overall payroll would be:

$$Payroll = \$49{,}081 \times 2{,}500 = \$122.7\ million$$

The Substance Based Income Exclusion would be (in million):

$$Substance\ Based\ Income\ Exclusion = 5\% \times Payroll + 5\% \times Tangible\ assets$$

$$= 5\% \times 122.7 + 5\% \times 1{,}078 = \$60$$

Excessive profit was calculated as (in million):[45]

$$Excessive\ Profit = \text{Net GloBE Income} - \text{Substance Based Income Exclusion}$$

$$= 2{,}456 - 60 = 2{,}396$$

[42] *Coca -Cola case*, above fn 40, at 75.
[43] Coca-Cola 2009 Annual Report, <https://d1io3yog0oux5.cloudfront.net/_f1dd1dc2b140f8a9d199df635c39ce7e/cocacolacompany/db/734/5988/annual_report/2009.pdf> accessed on 23 December 2022, at 37.
[44] See OECD, Average wages (indicator) (2021) <https://data.oecd.org/earnwage/average-wages.htm> accessed on 23 December 2022.
[45] The operating income reported in Coca-Cola case would be used as an approximation of GloBE Profit. See *Coca -Cola case*, above fn 40, at 75.

Finally, the Jurisdictional Top-Up Tax for Ireland would be calculated as (in millions):

$$Top - Up\ Tax\ Percentage \times\ Excessive\ Rate = 13.5\% \times 2{,}396 = 323$$

If the Two-Pillar Approach had been implemented in 2009 and Ireland had not implemented a QDMTT, Coca-Cola Ireland would have attributed 323 million extra taxes under Pillar Two. The residence country of the headquarter, the US, would have the priority to collect it. If the US did not participate in the Two-Pillar Approach, this amount of tax would be left to Cayman Island, the residence country of Atlantic, the parent company of the Irish supply point. If the Cayman Islands were not part of the Two-Pillar Approach, it would likely be shared by all participating countries under UTPR.

The estimation for the carve-outs was not accurate. The employee number included all the European staff in 2009, not limited to the Ireland supply points. The 2009 average salary in Ireland was adopted as the salary per head. The actual salary might be different. Yet, the estimation served its purposes. The carve-outs only constituted about 2.5% of the Net GloBE Income,[46] which meant that it only had minimal influence. It proved that in a case where the MNE shifted profits to a low-taxed jurisdiction, the carve-outs level does not significantly influence.

However, it is not the case for a jurisdiction aiming to use low-tax rates to attract FID. The percentage of the carve-outs needs to be reasonably enhanced so that the jurisdictions with value-added activities, such as manufacturing within their borders, do not have to suffer too much from Pillar Two. Some countries, such as Hungary, still need a lower tax rate to attract FDI, and it has the right to place a lower tax rate if it holds real economic

[46] It was calculated as 60÷2,456=2.5%.

activities. The author believes that the tax reforms, including Two-Pillar Approach, should only target the jurisdictions that do not add value.

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