The **BEPS** Monitoring Group

Submission to the International Monetary Fund

ANALYSIS OF INTERNATIONAL CORPORATE TAXATION

These comments have been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Sol Picciotto, with contributions from Jeffery Kadet and comments from Tommaso Faccio, Tatiana Falcao and Suranjali Tandon.

We appreciate the opportunity to provide these comments and are happy for them to be published.

December 2018

SUMMARY

Following the excellent *Spillovers* report of 2014 further evidence has shown the revenue losses due to inadequate coordination of international tax rules, impacting more heavily on poorer countries. These also result from unilateral measures by states to protect their tax bases, the proliferation of which demonstrates that the G20/OECD project on base erosion and profit shifting (BEPS) has inadequately patched up the existing system. In addition to the macro-economic analysis of the welfare effects, we suggest that the IMF consider the micro-economic aspects of aggressive tax avoidance, notably abuse of dominant position and rent-seeking resulting from corporate concentration, and the encouragement to profit-shifting from the shift to hybrid territorial tax systems and from equity-based remuneration of senior corporate managers.

The BEPS project has so far failed to ensure that the profits of multinational enterprises (MNEs) are allocated to and taxed in source countries where their economic activities occur, and value is created. Although there have been extensive revisions of the rules on transfer pricing, this has made them even more complex and difficult to apply, because they still rest on the fictional underlying principle that members of a corporate group are independent entities dealing with each other at arm's length, despite being under common ownership and

centralised control. This approach entails detailed individual analysis of each taxpayer requiring specialist knowledge of its economic sector and business model, creating information asymmetries and an enormous administrative burden for tax administrations, especially in poor countries. Its subjective nature also creates conflict and uncertainty, instead of the predictability needed for decision-making by business.

What is required is a shift towards treating MNEs in accordance with the economic reality that a large part of these profits result from the economies of scale and scope and the synergies due to operating as unitary firms under centralised strategic direction. Three main approaches to unitary taxation have been proposed: residence-based worldwide taxation, a destination-based cash-flow tax, and formulary apportionment. We concur with the report of the Independent Commission on the Reform of International Corporate Taxation (ICRICT) that formulary apportionment is the best of these solutions.

We recognise that moving towards formulary apportionment will take time and needs preparation. A pragmatic approach towards such a system could be developed by building on the profit split method. This can be done by formulating standardised concrete allocation keys and weightings for common business models and industry sectors, refining and elaborating on the generic factors which generate profits: people, capital assets and sales. We urge the IMF, in conjunction with other relevant global and regional bodies, to devote serious resources to examination of this way forward.

1. Relevance and Importance of the Issue

The reform of international corporate taxation has in recent years jumped to a high place in the global policy agenda. This is due to several factors.

A significant concern is of course the government revenue losses due to inadequacies in international coordination of tax rules. These were highlighted and analysed in the 2014 paper on *Spillovers in International Corporate Taxation* (IMF 2014). As that paper showed, these revenue losses impact more heavily on low-income countries. A more recent research survey has highlighted further evidence that less developed countries are more heavily affected by cross-border profit-shifting.[1]

That paper further suggests that there are also spillover effects from anti-avoidance measures taken by states, which magnify distortions in capital allocation and hence produce some negative welfare effects. This is of particular concern in the current period, since many states are introducing unilateral measures to counter avoidance. This is because the G20/OECD project on base erosion and profit shifting (BEPS) resulted mainly in recommendations to patch up existing rules and has failed to tackle the central challenge of agreeing criteria for allocating profits according to where real economic activities take place. This demonstrates the urgent need for greatly improved coordination of international corporate tax rules, particularly from the perspective of the development of the poorest countries, as well as the world economy as a whole.

The 2014 *Spillovers* report also briefly examined some wider welfare implications of spillovers, essentially from a macro-economic perspective. In our view, however, it is also important to analyse the micro-economic effects on firm strategies and particularly on competition and corporate concentration.

Much of the international tax avoidance by multinational enterprises (MNEs) results from their exploitation of flaws in international tax rules. These were originally formulated nearly

[1] S. Beer, R. A. de Mooij and S. Liu, 'International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots', IMF Working Paper No. 18/168.

a century ago, when international investment was mainly of portfolio investment, and MNEs, partly due to the slow communications of the time, operated through local subsidiaries that had their own independent managements (i.e. local CEO, local sales and operations management, local treasury and accounting functions, etc.). With the rise of today's communication technologies allowing true central management of local operations, most MNEs have adopted centrally-managed business models and operate as unitary worldwide businesses.

The rules in place for the past century that allocate taxing rights between residence and source countries distinguish between passive and active income. These rules also adopted the 'arm's length principle' (ALP), which requires MNE group members to be treated as if they were independent entities. This may have been appropriate years ago when local group member subsidiaries did operate independently. Today, however, applying the ALP to the bulk of MNEs and their centrally-managed business models is no longer appropriate and only leads to BEPS motivation and a lack of any reasonably alignment of the allocation of income with the economic activity that generates that income.

Continuing to apply this outdated approach has created an incentive for aggressive tax planning by MNEs through the use of complex corporate structures. These are generally based on attributing control over functions which can be claimed to be high-value-adding, such as research and development, risk and finance, to entities in low-tax jurisdictions. Furthermore, tax competition has led not only to incentives for inward investment, but also to the home countries of MNEs weakening their rules on controlled foreign corporations, which were originally aimed at ensuring taxation of their worldwide profits. These factors have resulted in low effective tax rates on MNEs' source country profits, giving them a strong competitive advantage over local firms.

Hence, the opportunities for international tax avoidance have greatly contributed to distortions of competition and the domination of key economic sectors by the largest MNEs. Corporate concentration results from the ability to benefit from economies of scale and scope, and the advantages of synergy. Increased international economic integration enables MNEs to exploit these on a global scale. In addition, however, they can exploit differences in regulation or regulatory arbitrage, due to inadequate regulatory coordination between states. This importantly includes tax avoidance, which has a direct effect on a company's bottom line. Countering with the anti-competitive effects of corporate concentration, which include abuse of dominant position and rent-seeking, poses important challenges. However, these cannot adequately be dealt with through anti-trust or competition law alone. Indeed, these instruments are often inappropriate and ineffective in regulating the negative effects of corporate concentration. Hence, it is important to remove these inappropriate advantages by improving regulatory coordination between states, to match the level of economic liberalisation that has so encouraged concentration.

The effects on corporate concentration can be seen especially in the fastest-growing business models, those exploiting the digitalisation of business activities. The work on Action 1 of the BEPS Action Plan of the Task Force on the Digital Economy has shown how digitalisation permeates the whole economy and has exacerbated the problems caused by the flaws in international tax rules. Features of the digitalised economy such as network effects further

contribute to concentration, while multi-sided business models give further advantages to MNEs.[2]

Central to digitalisation also is the development and exploitation of intangibles, especially software. However, it should be made clear that the problems do not arise from the exploitation of intangibles in itself, but in the ways this has been done in some business models. Developers of business-enhancing software can easily access global markets through licensing, taxation of which can adequately be dealt with without any major reform of existing tax rules. The problems have been caused by deploying such software to build MNEs which have become dominant in various business sectors, such as retailing, tourist accommodation and taxi services. Local firms in these sectors evidently could benefit from digitalisation and access to superior software, but their ability to do so is hampered by the direct competition from these MNEs. Local software developers equally are disadvantaged by the competition from the integrated business models of the MNEs.

For example, Uber has built a significant presence around the world, including in many developing countries. It competes not only with local taxi firms, but also with software developers offering applications or platforms which drivers can use. Normal competition would be healthy, but such firms cannot exploit the same tax avoidance opportunities. The anomaly is that the drivers, as well as local software firms attempting to compete with Uber, are taxed, while Uber's revenues are untaxed in the source country, and Uber can benefit from a low effective tax rate on its global income. Ironically, Uber is willing to cooperate with revenue authorities by supplying them directly with data on the earnings of drivers using its application, to ensure they can be taxed effectively. Yet Uber's own revenues remain outside the nets of the tax authorities of the countries in which it does such lucrative business. Reform of international tax rules to ensure that the income of such firms can be taxed where their activities take place is essential in order to create a level playing field for local business and entrepreneurs.

We would also point to two additional features of today's international tax environment that produce perverted incentives and hence distortions of capital allocation. These may provide the IMF with additional areas in which to conduct research contributing to positive change.

First, home-country tax systems have come to create negative spillovers. Under the hybrid territorial tax systems adopted in past decades by so many countries, the profits earned within specified legal entities and sometimes branches established outside an MNE's home country will either not be currently taxed or will never be taxed by that home country. This *systemically* motivates MNEs to shift operations and profits outside their home countries. The worldwide residence-based taxation system and the unitary taxation system, both of which are mentioned below in section 3, would fully eliminate this systemic issue.

Secondly, the extensive use of equity-based compensation incentivises BEPS behaviour. MNEs commonly encourage their CEOs and management teams with equity-based compensation (e.g. stock options, stock awards, etc.) that gives management a short-term fixation on share price. While this short-term fixation is economically bad for many reasons, specifically in the tax area, it directly results in CEOs and managements being strongly incentivised to aggressively profit-shift so as to lower the group's effective tax rate and push up its share price. The IMF could review existing research in this area and consider

[2] OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1 2015 Final Report*, OECD 2015: p. 65. See also *Tax Challenges Arising from Digitalisation – Interim Report 2018*, OECD 2018.

approaches that could encourage other forms of executive compensation that do not motivate profit shifting.

2. The Current State of the International Corporate Taxation System

In the past five years there have been considerable changes to international tax rules, due mainly to the G20/OECD project on base erosion and profit shifting (BEPS). The main outputs from the project delivered in 2015 patched up some major loopholes in the current rules, but the result has been to make them more complex and difficult to apply. This is a particular problem for developing countries, which are both more dependent on corporate tax revenues than rich countries and lack the resources of skilled personnel needed to administer the complex rules.

The BEPS project outputs did not directly tackle the central issue of criteria for the allocation of income of MNEs so that they could be taxed 'where economic activities occur, and value is created', as mandated by the G20. This should entail establishing clear criteria for allocating income among source countries, where the business activities take place. However, the process was dominated by the OECD countries, many of which are home to large MNEs, and tend to defend residence-based tax rights. Hence, the BEPS Action Plan stated explicitly that it was not intended to affect the existing balance of tax rights between residence and source countries.

In particular, the BEPS Action Plan defined a narrow scope for the work on transfer pricing. It affirmed that the existing rules operate 'effectively and efficiently' in many cases and specified that work should focus on their misuse. This resulted in extensive revision and expansion of the OECD Transfer Pricing Guidelines (TPGs). However, attempting to refine the ad hoc approach on which the TPGs are based has only made them more complex, obscure, subjective and difficult to apply.[3]

The TPGs require an individual analysis of the facts and circumstances of each MNE to determine the functions performed, assets used, and risks assumed by each entity (referred to as 'functional analysis'). To apply functional analysis, tax authorities need staff with a range of skills, who not only are familiar with the legal and economic techniques needed to interpret and apply the TPGs, but also understand the taxpayer's business model and industry segment well enough to analyse the documented transfer pricing model, choice of method and selection of comparables. The approach creates a burden for taxpayers, who must ensure that their transfer pricing policies are properly justified and documented. However, large MNEs can assemble a team of transfer pricing specialists to design structures aimed at tax minimisation, and to produce the necessary documentation. This has created a boom for

[3] The report on BEPS Actions 8-10 included revisions to chapters I, II, VI, VII and VIII of the TPGs, which were incorporated into the version issued in 2017, which is now over 600 pages. The most authoritative account yet published of these changes is *Transfer Pricing and the Arm's Length Principle after BEPS* (2017), by Joe Andrus (the former OECD official responsible for transfer pricing during most of the BEPS project) and Richard Collier (an experienced private practitioner). Their analysis shows how, due to disagreements among participants in the BEPS project, the TPGs have become even more uncertain and obscure. They conclude that the result has been to make the transfer pricing process 'far more complex', mostly due to the 'level of factual detail' now required for the functional analysis (paras. 7.70-71). They trace in detail how, due to these disagreements, the TPGs have been made more complex and unclear on the key points. These are (i) the notion of control of risk ('very complex', para. 6.35; 'most confusing' para. 7.32; imposing 'only limited burdens on MNEs desiring to transfer risk to tax advantaged locations', para. 7.13; and leaving 'clear potential for heated disagreement', para. 7.16); (ii) the returns which can be attributed to a cash-box entity ('quite mysterious', para. 6.46; 'most confusing' para. 7.32; will 'give rise to substantial amounts of controversy', para. 7.31; and leaving 'a rather confused muddle, at least for now', para. 7.42); and (iii) how to allocate the difference between projected and actual returns from an intangible ('far from clear', para. 7.56; 'manifestly inadequate', para. 7.58).

professional advice, so that transfer pricing has become a principal area of international tax practice, growing ever larger as more countries adopted transfer pricing regulations.

Matching the resources available to MNEs is impossible for tax authorities even from developed countries, which are often under-resourced.[4] The need to conduct a functional analysis creates a severe information asymmetry, since a company will always know more about its own business and its sector than any outsider, especially tax authorities who have little background in the industry of the MNE and no detailed knowledge of the taxpayer's operations.

Developing countries face an even greater challenge. Most of them have legislation allowing their tax authorities to adjust the accounts of affiliates of MNEs to prevent profit-shifting, while a smaller number have in recent years introduced more detailed regulations, usually based on the TPGs.[5] Some leading countries have, with support for capacity-building, begun to build up their international tax departments. Notably, Kenya created a special unit to audit MNEs after 2011 with a dozen staff in two teams; this has had some success in increasing tax revenues, although short of targets and resulting in some conflicts.[6] The unit has now expanded to 36 staff, but its head was recruited to lead Tax Inspectors Without Borders, a joint OECD-UNDP initiative. More typical is Madagascar, which enacted transfer pricing regulations in 2014 based on the TPGs, but it has had difficulty in developing an enforcement strategy and has made several requests for external assistance to do so.[7]

Despite the effort and resources needed, these methods also produce unsatisfactory outcomes. The identification of suitable comparables, even when done meticulously, only provides estimates, usually within ranges of results deemed acceptable. As the TPGs themselves point out, this is 'not an exact science', and the aim is to 'find a reasonable estimate' (TPGs 2017: para. 1.13). It is also inherently subjective, creating uncertainty and conflicts. This has been the experience of OECD countries, which have seen a continuing increase in tax disputes, as well as in the length of time taken to resolve them, the majority concerning the transfer pricing rules (see Figure 1).

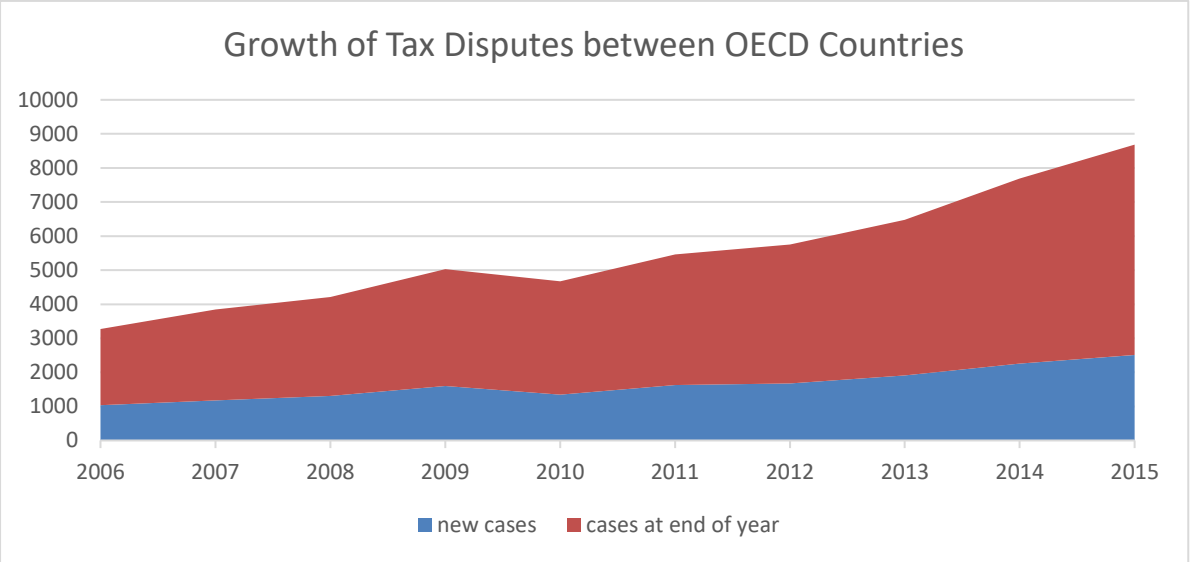
[4] In 2014 the US IRS hired a specialist consultant at a cost of $2m to assist its audit team in the examination of the transfer pricing arrangements of Microsoft (A. Gupta, 'Why has the IRS Outsourced Microsoft's Transfer Pricing Audit?', *Tax Notes International* 76: 847-51). In the UK, HMRC expanded its transfer pricing specialists from 65 to 81 between 2012 and 2016; its 6-year investigation of Google involved between 10 and 30 specialists at any one time, eventually resulting in a settlement agreeing payment of an additional £130m covering a 10-year period (UK Parliament, *Public Accounts Committee, Corporate Tax Settlements*, HC 788, 2016: paras. 4-6).

[5] For example, all but 8 of the 54 African countries have a general power to adjust accounts, while 17 have introduced detailed regulations, mostly within the past 5 years: S. Picciotto, *Problems of Transfer Pricing and Possibilities for its Simplification*, Working Paper 86, International Centre for Tax and Development, 2018, Appendix.

[6] Platform for Collaboration on Tax, *Enhancing the Effectiveness of External Support in Building Tax Capacity in Developing Countries*, 2016: 31; A. Waris, *How Kenya has Implemented and Adjusted to Changes in International Transfer Pricing Regulations, 1920-2016*, Working Paper 69, International Centre of Tax and Development, 2017.

[7] An IMF exploratory mission in 2015 recommended the establishment of a specialist transfer pricing unit, while also reporting that the Large Business unit had 21 inspectors, covering 576 firms, of which 93 were known affiliates of MNEs. It found that the available data indicated that MNE affiliates were generally as or more profitable in relation to domestic firms, and hence paid a relatively higher level of tax; although this probably also reflected under-declaration by domestic firms. By 2017, the Large Business unit had some 627 dossiers, and the entire staff of the revenue authority was 93, of whom 31 inspectors, six specialising in international tax, although none with in-depth skills in transfer pricing (personal communication). It still had not decided on a transfer pricing enforcement strategy.

Figure 1



Source: OECD MAP statistics, available at http://www.oecd.org/tax/dispute/map-statistics-2006-2015.htm Data collected for years from 2016 separate transfer pricing from other disputes, showing that of the 8002 cases open at the start of 2016, 56% concerned transfer pricing, and these disputes take on average around twice as long to resolve; see http://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm

Hence, there is an urgent need to develop clear and simple criteria for allocation of the income of MNEs. These could greatly reduce compliance costs for taxpayers and tax authorities and provide greater certainty for investors. Such a policy reform would be far more cost-effective than providing increased aid to build the capacity in poor countries to attempt to administer the current rules.

Indeed, tax certainty has been identified as a priority by the G20 world leaders in 2016. Its importance both for taxpayers and tax authorities, including in developing countries, has been confirmed in reports by the OECD and the IMF.[8] Yet so far nothing has been done to attempt to make the tax rules themselves clearer and easier to apply. The efforts have focused particularly on improving international tax dispute settlement. This itself is an admission that the reforms made so far will actually lead to an increase in conflicts due to lack of clarity.

3. Towards Simpler and More Effective Rules for Allocation of the Income of MNEs

Simpler and more effective rules should be based on the economic reality that MNEs operate as unitary firms, instead of the inappropriate fiction of the arm's length principle. Three main systems are available that are based on this principle: (i) worldwide residence-based taxation; (ii) a destination-based cash-flow tax, and (iii) unitary taxation with formulary apportionment. The advantages and disadvantages of these have been evaluated by the Independent Commission for the Reform of International Corporate Taxation (ICRICT). The Commission's report, concludes in favour of formulary apportionment, as the other two alternatives are unlikely to favour developing countries, which are not home to multinationals (and therefore would not benefit from a move to worldwide residence-based taxation) and often are net exporting states (which would lose out under a move to a destination-based cash-flow tax.

[8] The most recent is the *Update on Tax Certainty*, Report for the G20 Finance Ministers and Central Bank Governors, July 2018.

The advantages of formulary apportionment have indeed been widely recognised, including by many business representatives. The main obstacle to adoption of such a system on an international scale is the difficulty of reaching international consensus on the methodology, especially the apportionment factors. However, it is possible to adopt an evolutionary approach and move towards an apportionment system pragmatically. This could be done by building on the profit split method (PSM), which is one of the five methods accepted in the TPGs.

The PSM has the significant merit of starting from the aggregate or consolidated profits produced by the combined activities of associated enterprises, in contrast to the one-sided methods which consider each affiliate in isolation. This is recognised in the TPGs which point out the advantages of the PSM as including that all relevant entities can be 'specifically identified and their relative values measured in order to determine an arm's length compensation'.[9] Although it has not been possible through the BEPS process to reach an international consensus on an agreed methodology, this does not preclude individual states, or preferably groups of states, from adopting more concrete methodologies that would allow objective application and an elimination of much of the subjectivity and ad hoc analyses that the TPGs now require. The TPGs have the status of international soft law, providing guidance to the interpretation of the provisions of tax treaties. This leaves considerable scope to modify the methods they recommend, especially if it can be done by groups of states acting in concert.

Such an initiative has already been taken by the European Commission, in the context of proposals for reforming tax rules to the digitalised economy for adoption by the EU. Its draft Directive issued in March 2018 proposes both a new definition of taxable presence and a methodology for attributing profits based on 'economically significant activities'.[10] It would mandate taxpayers to use the profit split method unless they can prove 'that an alternative method based on internationally accepted principles is more appropriate having regard to the results of the functional analysis' (article 5.6). It specifies the activities that should be regarded as economically significant for digitalised business models. Further work is being done on this in the EU's Joint Transfer Pricing Forum, which includes both governmental and nongovernmental members.

The draft Directive is of course only a proposal. However, it demonstrates that this approach is gaining influential support. It is clearly desirable that there should be serious examination of this approach in all relevant international forums. This should include intensive study by the IMF. The merits of the approach are not limited to digital business models. As explained in section 1, digitalisation has only exacerbated the problems with the arm's length principle. Indeed, these problems are far more acute for the poorest countries. It is difficult for such countries to act alone in pioneering a new approach. This may be easier through regional groupings. However, it is incumbent on key intergovernmental organisations such as the IMF to put significant resources into helping to formulate appropriate options especially for developing countries. It should also study in more detail the various elements of a formulary apportionment system, towards which these pragmatic reforms should aim.

[9] *Revised Guidance on the Application of the Transactional Profit Split Method*, Inclusive Framework on BEPS: Action 10, OECD June 2018, para. 2.122. This revised text has not yet been incorporated into the version of the TPGs issued in 2017 which consolidated the other revisions agreed in the BEPS reports published in 2015.
[10] *Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence,* COM(2018) 147 final.

4. Building on the Profit Split Method

A significant expansion of the use of the PSM could be achieved by making it truly easy for both taxpayers and tax authorities to apply, through the elimination of much of the subjectivity inherent in the TPGs. This can be accomplished by developing standardised concrete allocation keys and weightings for common business models. Rather than focusing on subjective issues of relative risk and the relative values of varying economic functions, solely objective and location-specific factors should be used as the standardised concrete allocation keys to apportion profits. This approach would ignore internal group-controlled and tax-motivated arrangements such as intercompany contractual terms. It would also dispense with the need for subjective value judgments, greatly reducing the potential for conflict and uncertainty.[11]

It must be accepted that the application of any transfer pricing method, including even the comparable uncontrolled price method, can only produce an estimate. Under the present approach, any transfer pricing method will involve significant subjective judgments that will materially affect the outcome. These subjectively determined outcomes will usually be a range of possible prices. This is due to both the subjective judgement inherent in the individual and factual nature of functional analysis, and the difficulty of identifying appropriate comparable transactions between independent entities. This process generally produces ranges of estimated outcomes so that, in the words of the TPGs, it is 'not an exact science' (para. 1.13).

Although it has come to be used more frequently, the PSM has remained a fall-back method, often viewed with some suspicion by both taxpayers and tax authorities. This is because the way it has been applied until now increases rather than decreases the complexity of transfer pricing audits. Since its introduction in the 1995 TPGs no work has been done by the OECD to attempt to develop and standardise this method. Hence, at present it has severe limitations.

Firstly, it is frequently used only through the 'residual analysis' approach, which is a two-step process. This requires an initial functional analysis and application of one of the other methods to determine remuneration for activities considered not to involve 'unique and valuable contributions', before the PSM is applied to the 'residual' profits. In our view, the 2-step process introduces unnecessary complexity and uncertainty. The concepts of 'unique and valuable contributions' are highly subjective and applying them in practice produces conflicts. The 2-step approach can also result in inappropriate allocations of the benefits of synergy for a MNE. The aim should be to develop effective methodologies for the PSM which can properly evaluate the contributions by all relevant parties in a single step. Introducing a 2-step process negates the merits of greater ease of administration, predictability and certainty, which should be the overriding aims.

Secondly, the OECD TPGs have until now provided only generalised guidance on the selection of allocation keys. They state that the criteria used for division of the profit 'depend on the facts and circumstances of the case' and that it is therefore 'not desirable to establish a prescriptive list of criteria or profit splitting factors' (Revised PSM Guidance 2018 para. 2.166). This adds further to the ad hoc and discretionary character of transfer pricing, which makes it hard to administer, lacking in legitimacy, and a source of conflict and confusion. The lack of standardised allocation keys also leaves scope for each taxpayer to select those which most suit BEPS structures and objectives.

[11] See J. Kadet (2015), 'Expansion of the Profit Shift Method: The Wave of the Future', *Tax Notes International*, 77: 1183, and J. Kadet, T. Faccio, and S. Picciotto (2018), 'Profit Split Method: Time for Countries to Apply Standardized Approach', *Tax Notes International*, 91: 359.

We propose adoption of a combination of principles and pragmatism to systematise and standardise the PSM. The goal of simplification and clarification entails moving towards a standardisation of concrete splitting factors and weightings. However, the identification of appropriate factors, how they are quantified, and their weighting should be done bottom-up by analysing common business models. There are also some industry sectors or sub-sectors with common business models. Industry and sectoral associations could be consulted in an open and multilateral process.

These standardised allocation keys and weightings by business model/industry sector would best be agreed and set within a multilateral environment that includes countries, reputable industry and sectoral associations, and bodies such as the IMF. We believe that the IMF either alone or in conjunction with other bodies (e.g., the OECD, the World Bank, and the UN) could take a leadership position in organising and guiding the multi-party discussions and analyses that will result in these standardised keys and weightings by business model/industry sector.

While we believe strongly that a multilateral process is best, if no country or body takes a lead in creating a broad multilateral process, we encourage individual countries or groups of countries to develop their own standardised keys and weightings for the specific business models/industry sectors that are of particular importance to them. Again, such countries could involve industry and sectoral associations as part of the process.

Once standardised concrete allocation keys and weightings are agreed, they should of course be made public, a step that would increase transparency, eliminate the risk of sweetheart tax deals, and encourage other countries and regional groups to adopt the same or similar keys and weightings for common business models relevant to them. Such an approach could also be applied on a sectoral basis under Advance Pricing Arrangements.

A particularly important part of the simplification and fairness to both taxpayers and tax authorities alike is that where this PSM approach is adopted for a common business model and/or in a particular sector, all MNEs using that model or in that sector would be *required* to use the specified keys and weightings. We believe that opting-out could be permitted for an MNE, but *only if* the MNE can establish to the satisfaction of the relevant tax authority that other allocation keys and weightings, or alternatively another transfer pricing method, truly provides a demonstrably more arm's length result. The burden of proof would thus be on the MNE if it wishes to opt out and use another method, or any keys and weightings other than those set out in the specified business model/sectoral arrangement.

This is true simplification for tax authorities and MNEs alike. Under this approach, it would only be necessary for tax authorities to get involved in understanding and analysing the accurately delineated controlled transactions when a taxpayer group makes a claim that another transfer pricing method or other keys and weightings should be used. Taxpayers would gain the predictability of being able to rely on the prescribed methodology and standardised allocation keys and weightings. This would dispense with the need for taxpayers to employ a small army of specialists to devise transactional transfer pricing methodologies, and produce the detailed documentation (including very expensive functional analyses for each product or service line) needed to defend them in case of audit.

From the perspective of principles, the main factors that can be considered to generate profit are: (i) employees, (ii) capital assets and (iii) sales revenues. The first two represent the factors that create value: labour and capital. The third is essential for realisation of profits. It is no coincidence that these are the factors that have been used in formulary apportionment

systems on a sub-national level, notably in the USA, and for the EU's proposed Common Consolidated Corporate Tax Base (CCCTB).

These factors have three merits: (i) they reflect at a generic level the factors which generate profits; (ii) they can be quantified, and (iii) they are location-specific, so can be used to allocate profits according to where real activities take place. They would not eliminate tax competition, but it would be more benign competition, to attract real activities. Using a balance of production factors and sales (to reflect consumption) would minimise the impact of tax on the choice of location for productive activities.

It should be pointed out that these factors are already used in a pragmatic way when the PSM is applied to an individual MNE. The OECD Guidance on the Profit Split Method (revised in 2018) stresses that the allocation factors should be based on objective data (e.g. sales to independent parties) and should be verifiable (para. 2.166). It suggests the use of operating assets or fixed assets (para. 2.171). It also specifies employee compensation, while adding that in some circumstances headcount or time spent could be appropriate (para. 2.172). Similarly, in determining the assumption or control of risk, the authorised OECD approach to the attribution of profits to a permanent establishment uses the concept of 'significant people functions', which is usually quantified by using payroll costs. However, the pragmatic approach should be used to move away from ad hoc and individualised application of the PSM, by adopting standardised factors and weightings.

Conversely, systems for formulary apportionment also provide for industry-specific variations for distinctive sectors, notably extractive industries and financial services. These broad sectors also include sub-sectors, or different business models. For example, some extractive industry MNEs are vertically-integrated, while others specialise only in exploration and/or extraction. The financial sector also includes a wide variety of sub-sectors. Hence, it would be more appropriate to identify appropriate splitting factors by analysing these sub-sectors.

A bottom-up approach could also be very helpful in clarifying both how the factors should be quantified and their weightings, which could vary according to the industry and business model. For example, in relation to the people factor, there may be issues in relation to the definition of employees in business models which extensively use self-employed contractors. Similarly, a bottom-up approach will help determine how to attribute employee contributions to a specific location, where employees are mobile. Also, it may be appropriate to adjust the quantification of payroll costs by using purchasing power parity, or to use either one or a combination of payroll and headcount.

The definition and quantification of assets also require clarification, as accounting standards are notoriously uncertain in this respect, even for physical assets. The need to ensure that factors are location-specific means that transferable intangible assets such as intellectual property rights are not appropriate to be used as splitting factors. The TPGs have now moved away from mere ownership of intangibles as a basis for allocating profits, and now point to the contributions made by entities in the 'development, enhancement, maintenance, protection and exploitation' of intangibles (DEMPE functions: TPGs 2017: ch. VI, section B). An appropriate way of quantifying these contributions is likely to be the payroll costs of entities fulfilling these activities. Although some intangible assets can be location-specific (for example, marketing assets such as customer lists), they cannot be objectively measured, so should not be included as possible allocation keys. Rather, they are indirectly reflected through the sales factor. Also, in the context of digitalisation of the economy and business models that include as assets their contributing user base and/or user-provided data, there can

be objective measures of the number of users and the quantum of data. These types of factors, where appropriate, should be included as objective allocation keys that reflect real assets.

We believe that a significant number of highly integrated MNEs operate through a limited number of sufficiently similar business models such that determining standardised allocation keys and weightings that would be applicable to these MNEs would result in fair results with significantly less expended resources for both taxpayers and governments.

Base erosion and profit shifting techniques are aimed at minimising taxable profits in the country of source, so that the balance of profits is allocated to the home country of multinationals or in conduit jurisdictions, where profits are taxed at low or zero rates. A wider and standardised application of profit split will rebalance this allocation of profits to ensure that MNE income and tax are attributed where they have real activities and create value. This will almost invariably benefit both developed and developing countries. The lack of correlation between reported income and activities creating value was what so motivated governments to initiate the G20/OECD BEPS project in the first place. In our view it is time to move away from the fictitious and ineffective arm's length principle, and to develop a methodology for allocation of MNE profits which would be fairer, easier to apply, and provide much predictability and certainty for all concerned.