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Stabilizing “Pillar One”: Corporate Profit Reallocation in an Uncertain Environment

Itai Grinberg¹

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Abstract

This paper is about how the world reestablishes international tax order.

The paper focuses on the OECD’s work on profit reallocation and asks whether this multilateral effort can be successful in stabilizing the international tax system. The analysis centers on the current leading concepts for reallocating profit among jurisdictions under what is known as “Pillar One” of the OECD work programme. To analyze whether any Pillar One concept can be turned into a stable multilateral regime, it is necessary to specify certain elements of what a proposal to reallocate profits might entail. Accordingly, this paper sets out two strawman proposals. One strawman uses a “market intangibles” concept that explicitly separates routine and residual returns. The other strawman may reach a similar result, but does not explicitly attempt to separate routine and residual returns. Instead, in current OECD parlance, it might be described as a “distribution-based” approach.

The paper asks whether either of the two strawmen could be agreed and stabilized multilaterally given the tools of modern international tax diplomacy. I conclude that the current procedural and institutional architecture for cementing international tax relations among states is inadequate to stabilize either of the strawmen. Nevertheless, with certain changes, reestablishing order may be possible. Moreover, I conclude that there are six key structural decisions that impact the ability to stabilize the international tax architecture in any Pillar One approach, and that these decisions are likely to be implicitly made in the course of choosing a political direction for Pillar One work in 2019. The choices made with regard to these decisions determine whether or not it will be possible to stabilize Pillar One.

Even if good resolutions are reached along these six dimensions, there are only a couple paths to stabilize the system. One path would involve using every tool in the current OECD arsenal in new and more expansive ways, and then substantially depoliticize international tax matters and remove G20 involvement, such that logics of appropriateness developed among tax administrators isolated from political pressures and acting through transnational networks could lend stability to a new set of rules and principles. Even then, only a few Pillar One compromises could be stabilized this way. The alternative path, which could stabilize a broader range of proposals, requires formalizing the new regime in international law through a true multilateral treaty.

¹ Professor of Law, Georgetown University Law Center. I thank Zenia Memon for excellent research assistance and Will Morris, Michael Plowgian, and participants at the Oxford Centre for Business Taxation’s 2019 Summer Conference and Academic Symposium for helpful conversations. All errors are my own.

Introduction

Can a new system for corporate profit allocation in the cross-border setting be agreed to and implemented by tax authorities in a manner that provides for stable and consistent international coordination and enforcement?

In May 2019 the OECD released a work programme that involves undertaking a comprehensive review of profit allocation and nexus rules. The OECD labels this work as “Pillar One” of a two-part work programme. The work programme presents the skeletal outlines of various proposals to reallocate corporate cross-border income taxing rights. It also includes a basic workplan to address technical issues that need to be resolved if any proposal is to be operationalized. The goal of the workplan is to provide input to a political decision on the outlines of a proposal for a consensus-based reallocation of taxing rights.

Given the political pressures for change to profit allocation rules, it is important that the Inclusive Framework considers—including during the initial work to set a political direction—what legal and political instruments would be required to implement and stabilize any given proposal under Pillar One. Though the workplan alludes to this issue, to date the concern has not been widely discussed in public. Nor does the workplan underscore the importance of the issue. This paper therefore presents the available stabilization mechanisms and the considerations for when they can and cannot be effective.

The paper suggests that decisions reached along six key dimensions will determine what set of tools will be required for there to be a chance of stabilizing the agreed Pillar One approach. It seems likely that some or all of these six key decisions will implicitly be reached in settling on a “general approach,” to Pillar One. As a result, immediate consideration as to the impact of those six decisions for the prospect of stabilizing the international tax architecture is advisable.

To consider the question, some background on the extant multilateral system of governance in international tax affairs is required. That system currently involves two interrelated but quite different mechanisms for coordinating international tax affairs among jurisdictions; a G-20 soft law mechanism and a model treaty-based mechanism.² Part I of this paper first outlines these two mechanisms for achieving international coordination in corporate income tax matters. It then sets out the possibility of a true multilateral treaty, which is not a part of the current international tax landscape. Part II explores the proposals for reallocating taxing rights that are currently being discussed at the OECD. Part II first highlights that the parameters of this new concept are somewhat uncertain. I then outline two hypothetical versions of a Pillar One “solution” drawn from my interpretation of the

² Itai Grinberg, *The New International Tax Diplomacy*, 104 GEO. L.J. 1137 (2016). (describing the evolution of these mechanisms).

OECD's recent public consultation document,³ features of the public consultation itself, and the work programme. I do not intend these two hypothetical solutions to be indicative of my predictions of where the OECD process will end up. Rather, I hope they set out two extremes among the plausible range of possibilities. By so doing, the strawmen allow me to highlight key structural considerations that should be taken into account if relatively stable and consistent international coordination and enforcement is a desired goal of the present Pillar One negotiation. Part III asks whether it is possible and what it would take to stabilize either of the two strawman versions of Pillar One set out in Part II. One relevant question in this regard is whether the extant mechanisms for achieving international coordination in corporate income tax matters (as described in Part I) would suffice, or whether a true multilateral treaty would be required.

Part III suggests that the simplest extant proposal to alter profit allocation rules just might be implemented using a combination of tools previously used multilaterally by the OECD in the international tax area. In contrast, other proposals require a truly multilateral treaty on substantive taxing rights. Such a treaty has not previously been agreed upon by the nations of the world, despite having been discussed on and off for a hundred years.

Note that this paper never evaluates whether either of the strawmen, or any existing proposal for reallocating taxing rights, is normatively desirable. In a prior paper, I expressed substantial doubts about the conceptual basis and the administrative feasibility of both the "user participation" concept and certain versions of the "market intangibles" concept that have received a great deal of public discussion.⁴ This paper does not revisit those issues; my silence on normative matters is not meant to indicate approval (or disapproval) of any proposal discussed herein.

Rather, this paper is motivated by, and focused on, the question of international tax order. My interest in international tax order is fundamentally conservative; I view order in this area as a value in and of itself, regardless of what the substantive outcome of multilateral discussions on profit allocation might be. The two strawmen proposals I set out are accordingly meant simply to highlight important stabilization considerations that arise in the Pillar One debate.

I. Existing Mechanisms for Multilateral Coordination in International Tax Matters

A. The G20 Economic Soft Law Model

Most commentators would agree that the BEPS project was—before the current attempt to reallocate taxing rights and agree a global minimum tax regime—the most extensive effort

³ OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy: Public Consultation Document*, OECD/G20 Base Erosion and Profit Shifting Project (2019) [hereinafter *Consultation Document*], <http://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf>.

⁴ See Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate*, TAXES 85-118 (Mar. 2019).

to reset multilateral international corporate income tax norms since those norms were established under the auspices of the League of Nations in the 1920s.

A key procedural feature of the BEPS project was that it arose through G20 convocation. The G20 framework for international economic regulation is a “top-down” architecture, in which G20 convocation and agenda setting provides the impetus for law- and regulation-making. G20 led international economic regulation usually involves a request at G20 level for international coordination around standards to be created by a specific “standard-setter” that the G20 convenes. When it takes this step, the G20 also often asks for the establishment of monitoring bodies, enforcement vehicles, and technical assistance providers (“enablers”) to support compliance with the new international economic regulatory standards.

Once standards are set, a monitoring body may determine whether national regulators are complying with a standard, potentially imposing discipline. Enforcement mechanisms are often established or threatened by the G20 and tied to the monitoring bodies’ judgments. Finally, jurisdictions that lack the human capital needed to meet the standards may be offered technical assistance.⁵

This G20-based institutional and procedural system for multilateral action, which was adopted for the BEPS project, has existed for a longer period of time in other areas of international economic law. For example, the G20, working through the Financial Stability Board as a “standard-setter,” helped create monitoring bodies, enforcement mechanisms, and enablers that together represent a soft-law framework for what is now sometimes referred to as “international financial law.”⁶ The procedural similarities for G20 Soft Law made across various subdisciplines of international economic law allows some trans-substantive lessons to be drawn from historical experiences across subfields.

One such lesson from the history of G7 and G20 engagement with initiatives in various areas of international economic affairs is that once those bodies engage an issue area within international economic law, they tend to not disengage.⁷ In BEPS, the G20 certainly engaged with international tax. Moreover, in recent months both the OECD Centre for Tax Policy and Administration Director Pascal Saint-Amans, and EU Commissioner Pierre

⁵ CHRIS BRUMMER, *SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULE MAKING IN THE 21ST CENTURY* 61-114 (2d ed. Cambridge Univ. Press 2015). Before the G20’s emergence as a major player in 2008, the G7 had played a similar role.

⁶ See Chris Brummer, *How International Financial Law Works (And How It Doesn’t)*, 99 *GEO. L.J.* 257 (2011).

⁷ The G7 and G20 have made and sustained open-ended commitments to involvement in at least a dozen areas of international economic law over the last two decades. In contrast, the author’s investigations suggest only two areas where the G7/G20 committed to a subject and subsequently fully disengaged with the issue prior to the election of Donald Trump: these are the Doha trade round, during which the Leaders involvement was emphasized from 2008-2012, but set aside in 2013 as Doha appeared to collapse; and International Organization of Securities Commissions [“IOSCO”] reporting on the functioning of credit default swap markets. See *Goodbye Doha, Hello Bali*, *ECONOMIST* (Sept. 8, 2012), <http://www.economist.com/node/21562196>; *The Credit Default Swap Market Report*, IOSCO (2012), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD385.pdf> (concluding IOSCO’s research).

Moscovici have suggested that in a G20 environment that is otherwise deeply contentious, tax appears to be emerging as the anomalous success story where countries continue to cooperate. As a result, processes akin to the G20-led features of the BEPS project⁸ are likely to have an important role in the current debate over reallocation of taxing rights. In Parts II and III of this paper I will refer to these processes as the “G20 Soft Law Approach”.

Importantly, the G20 Soft Law Approach has the corollary effect of displacing “bottom-up” transnational governance by means of technocratic networks. Historically, multilateral dialogue about international tax matters did not rise above the level of the Committee on Fiscal Affairs at the OECD, a body whose membership consisted of leading technocrats with authority over international tax affairs in their respective countries.⁹ Topics for consideration by the Committee on Fiscal Affairs were most often generated by means of prior, often multiyear discussions in the Committee on Fiscal Affairs’ subsidiary bodies, staffed by lower-level technocrats.¹⁰ Prior to the BEPS project, international tax diplomacy largely had this “bottom up” character and thus, multilateral agreement on changes to international tax norms happened slowly and deliberately, with significant OECD projects involving even moderate changes to agreed-upon principles often taking as much as a decade from onset to completion.¹¹

All that began to change in 2009. At their London meeting in 2009, the leaders of the G20¹² endorsed a “more cooperative” international tax environment as part of their response to the financial crisis.¹³ For two years, the G20 limited its efforts in international taxation to the area of tax administrative cooperation, bank secrecy, and issues related to offshore tax evasion by individuals and families.¹⁴ Then, in 2012, the G20 identified BEPS

⁸ See generally Itai Grinberg, *The New International Tax Diplomacy*, 104 GEO. L.J. 1137 (2016).

⁹ Hugh Ault, *Reflections on the Role of the OECD in Developing International Tax Norms*, 34 BROOK. J. INT’L L. 757, 760 (2009). For instance, the representative of the United States at the CFA has usually been the International Tax Counsel of the United States or the Deputy Assistant Secretary of the Treasury (International Tax). *Id.*

¹⁰ *Id.* at 761.

¹¹ *Id.* at 762-63. For example, the OECD’s *Report on Attribution of Profits to Permanent Establishments* was over a decade in the making. *Id.*

¹² The G20 describes itself as “the premier forum for its members’ international economic cooperation and decision-making.” *About G20*, G20, <http://g20.org.tr/about-g20/> (last visited May 29, 2019).

¹³ The G20’s London Declaration explicitly committed to a “new cooperative tax environment,” and that commitment has been reiterated at each subsequent G20 meeting. Communiqué, G20, Declaration on Strengthening the Financial System—London, at 5 (Apr. 2, 2009), [hereinafter *London Communiqué*], available at http://www.treasury.gov/resource-center/international/g7-g20/Documents/London%20April%202009%20Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf, <http://perma.cc/4NG7-M657>.

¹⁴ Cross-border administrative cooperation in tax matters was the one area of international tax matters in which the G20—and previously the G-7—had maintained some level of continuing involvement since 1997. See Communiqué, G-8, Confronting Global Economic and Financial Challenges—Denver, at para. 33 (1997), available at http://www.g8.fr/evian/english/navigation/g8_documents/archives_from_previous_summits/denver_summit_-_1997/confronting_global_economic_and_financial_challenges.html; *London Communiqué*, *supra* note 14, at 4–5. See also Itai Grinberg, *The Battle Over Taxing Offshore Accounts*, 60 UCLA L. REV. 304, 313–317 (2012). Eventually the G20 Finance Ministers’ interest in transparency and information exchange expanded into a commitment to developing a global standard on automatic information exchange that would make information on offshore accounts broadly available to tax administrations around

as a threat to the G20's own public fiscs and, amidst a period of politically unpopular austerity following the financial crisis, and broadened its interest in international tax affairs to encompass the taxation of multinational corporations ("MNCs").¹⁵ The "action items" eventually endorsed by the G20 in the BEPS project took the same "top-down" G20 Soft Law Approach that the G20 had used in other areas of international economic law, and then in the battle against offshore tax evasion. In the process, a long-established process of technocratic "bottom-up" multilateral decision-making in international taxation was largely displaced. A decade on, although the new procedural architecture for international tax diplomacy may seem well-entrenched, it is of relatively recent vintage.

B. The OECD Model Treaty and the Multilateral Instrument

The international tax regime also includes a substantial treaty-based component in the form of a network of more than 3,000 bilateral tax treaties.¹⁶ Although it is technically soft law, the OECD Model Tax Convention on Income and Capital (the "OECD Model Treaty") informs the content of this tax treaty network in a way that is surprisingly self-enforcing.

Like the outputs of G20 Soft Law diplomatic processes, the OECD Model Treaty is a "soft law" instrument. However, in contrast to most G20 Soft Law Approach agreements of the type described in part IA, changes to the OECD Model Treaty and its commentaries (the "Commentary") impact the legal and administrative outcomes in taxation quite directly. Not only are the OECD Model Treaty and Commentary (together, the "OECD Model") highly influential, but in some instances, changes to the OECD Model are automatically incorporated into domestic law and administrative practice in many countries around the world.

The treatment of the OECD Model (particularly the Commentary) by both national courts and tax administrations, make the negotiation of treaty-based changes to the OECD Model akin to a single-stage negotiating game among states. My full views on the special status of the OECD Model as an instrument of soft law are described in Itai Grinberg, *The New International Tax Diplomacy*, 104 Geo. L.J. 1137 (2016). For purposes of this paper, it suffices to note that there are three key interlocking features of international tax policy, administration, and jurisprudence in a large number of states that give the OECD Model special force. First, the manner in which domestic courts and tax administrations¹⁷ in many countries around the world treat the Commentary substantially prewires an enforcement

the world. Communiqué, G20, Meeting of Finance Ministers and Central Bank Governors (Apr. 19, 2013), available at <http://www.g20.utoronto.ca/2013/2013-0419-finance.html>.

¹⁵ The G20 addressed the BEPS issue as part of its declaration about "reforming the financial sector and fostering financial inclusion." Communiqué, G20, G20 Leaders Declaration in Los Cabos, at 6-9 (June 19, 2012), [hereinafter *Los Cabos Communiqué*], available at <http://www.g20.utoronto.ca/2012/2012-0619-loscabos.pdf>.

¹⁷ For example, the Chilean Revenue Service, during the period that Chile was a non-OECD member, issued a circular indicating that the OECD Model and Commentary's interpretation of the concept of "beneficial owner" should be used to interpret Chile's tax treaties because Chile intended to follow the OECD Model interpretation in this regard. Chilean Revenue Service, Circular Letter N°57/2009.

mechanism for changes to the OECD Model Treaty,¹⁸ despite its technical status as soft law. Second, the “ambulatory theory” of treaty interpretation endorsed by the OECD, as well as tax administrations and national courts in various states, means that, as a practical matter, agreements to amend the Commentary, either in conjunction with or independent of changes to the OECD Model Treaty, significantly alter the legal meaning of existing tax treaties as well as tax treaties agreed to in the future. Finally, at least within the OECD, tax treaty negotiators feel substantially constrained to accept model treaty provisions in their future negotiations with other sovereigns where they have not registered a reservation or observation with respect to a given OECD Model Treaty provision. For these reasons, the existence of the OECD Model Treaty acts as an independent variable that affects international tax governance and differentiates the political economy of international tax affairs from what happens in other areas of international economic law.

The advent of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (“MLI”) in the BEPS project bolstered the legal efficacy of changes to the OECD Model.¹⁹ The MLI substantially streamlined the process by which tax treaty-based rules in existing bilateral treaties can be modified by participating states to incorporate agreements reached at the OECD. The MLI makes agreeing changes to the OECD Model and then choosing not to implement the changes more difficult for treaty negotiators because the two choices are highly proximate in time, rather than years apart. In part III of the paper I will refer to any process involving agreeing to amendments to, or new articles for, the OECD Model and incorporating these provisions into a further protocol to the existing MLI as the “MLI Approach.”²⁰

C. A Real Multilateral Treaty

Importantly, the existing OECD MLI is structured to bring new articles and other changes into force in existing tax treaties, without abandoning the basic bilateral structure of the tax

¹⁸ For example, the tax treaty between Colombia and Chile, neither OECD members at the time their treaty was negotiated, indicates that both States agree that when their treaties use the language of the OECD Model, the Commentary to the OECD Model should be considered as complementary means of interpretation of the treaty under the terms of Article 32 of the Vienna Convention on the Law of Treaties of 1969, regardless of the fact that the two countries are non-OECD members. Corte Constitucional [C.C.] [Constitutional Court], Sentencia C-5777/2009 (Colom.), <http://www.corteconstitucional.gov.co/RELATORIA/2009/C-577-09.htm>.

¹⁹ The advent of the MLI also raises questions about the efficacy of amendments to the OECD Model that are not eventually included in an MLI. From the ratification of the MLI going forward, only changes against the 2018 OECD Model baseline included in an MLI are likely to be viewed to be true multilateral consensus items.

²⁰ For purposes of this paper, Part VI of the MLI is particularly important. That portion of the MLI provides a vehicle for states to agree to a single cohesive mandatory binding arbitration provision as between competent authorities of two agreeing states. Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting Part IV, *opened for signature* Dec. 31, 2016, <https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf>; and *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ¶¶ 19-20, <https://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf>.

treaty system. Therefore, the OECD MLI cannot be used as a substitute to negotiating a tax treaty for a pair of jurisdictions between which no tax treaty existed before. Moreover, the MLI's commitment to the bilateral treaty structure makes it challenging to use the MLI to change the range of topics that the tax treaty system covers. In other words, the MLI structure is not conducive to changing which legal questions associated with taxing cross-border activities are addressed without, as opposed to within, the tax treaty architecture.²¹ Indeed, the original Report to the G20 on the MLI seemed to suggest that modifying these boundaries could be inappropriate given the overarching importance countries place on tax sovereignty.²²

“[I]n tax matters, the concept of sovereignty underpins the stable tax framework within which governments have been able to facilitate arrangements that allowed for the benefits of globalization to flow to all market economies... Recognizing the tax sovereignty concern, the report focuses on implementing treaty measures, even though a multilateral instrument could in principle also be used to express commitments to implement domestic law measures.”²³

A true multilateral instrument, unlike the OECD MLI, would not modify a series of existing bilateral agreements. Nor would it be reduceable to a compilation of bilateral, state-to-state obligations. Rather, such an agreement would include collective obligations that could not always be reduced into a bundle of bilateral components.²⁴ In this paper I describe stabilizing a new profit allocation regime using a legal instrument that does not require a prior bilateral tax treaty between the signatories, and is not reduceable to a bundle of bilateral obligations, as the “Multilateral Treaty Approach.”

Notably, the tax experts brought together by the League of Nations, who in the 1920s and 1930s did the initial work that underlies the OECD Model Treaty, originally conceived of their proposed tax treaty as a true multilateral treaty.²⁵ The 1963 OECD Model Treaty was similarly intended as a model for a multilateral tax treaty as among OECD member states. As late as 1977, OECD tax treaty documents still encouraged considering a multilateral approach where feasible.²⁶

Nevertheless, a true multilateral tax treaty of broad applicability (not to mention any form of “international tax organization”) has never been given serious political consideration. It would, at minimum, require “strong impetus at the highest political level” to achieve “political acceptance from a critical mass of jurisdictions” for a multilateral negotiation of

²¹ Multilateral Instrument, *supra* note 3, at 20-21.

²² *Id.* at 16.

²³ *Id.* at 26.

²⁴ Cf. Joost Pauwelyn, *A Typology of Multilateral Treaty Obligations: Are WTO Obligations Bilateral or Collective in Nature?*, 14 EUR. J. INT'L L. 907 (2003).

²⁵ Report Presented by the Fiscal Comm. on the Work of the Third Session of the Committee, League of Nations Doc. C.415.M.171 1931 II (1931) (Appendix I-III).

²⁶ See Jeffrey Owen & Mary Bennett, *OECD Model Tax Convention*, OECD Observer (Oct. 2008), http://www.oecdobserver.org/news/archivestory.php/aid/2756/OECD_Model_Tax_Convention.html; Klaus Vogel, *supra* note 3.

that type to even be contemplated.²⁷ Although anything can happen, it is not clear that we are at a political moment marked by the strong commitment to international economic multilateralism that could be required to launch such a negotiation.

II. The Possible Faces of Market Intangibles: Two Indicative Methodologies

The question posed by this paper requires exploring the profit reallocation concepts being discussed at the OECD, even though their parameters are somewhat uncertain. Accordingly, this section of the paper sets out two hypothetical proposals that represent two “extremes” among a set of possible specifications of a “market intangibles”²⁸ proposal that does not involve fractional apportionment.

I will refer to the two strawman approaches put forth in this paper as the “capital expenditures method” (“CE Method”) and the “operating margins method (“OM Method”).²⁹ These “strawman” proposals are intended to be directionally consistent with the language in the OECD public consultation document; the content of the public consultation itself; the OECD Work Programme; and public remarks made in various venues by the leading international tax officials of the largest economies participating in the Inclusive Framework and the OECD Secretariat. Importantly, various features of the CE Method described below could be ported into an OM Method structure, and various features of the OM Method could be ported into a CE Method structure. Nothing about the two proposals makes them incapable of incorporating individual features of the other; and many of the features of each method could (with greater complexity) be combined.

Moreover, the purpose of the strawmen is *not* to suggest they are leading Pillar One options, or that they are exactly what the OECD is presently discussing. Rather, the purpose of Part II is to lay out hypotheticals that motivate the analysis in Part III. The key question, addressed in Part III, is whether *any* version of the Pillar One proposals could be successfully enforced over time on a multilaterally coordinated basis (“stabilized”), and what technical features might increase or decrease the likelihood that an agreement could

²⁷ Multilateral Instrument, *supra* note 3, at 17.

²⁸ Unfortunately, nomenclature in the current profit reallocation debate is often a source of real difficulty. Different people use different nomenclature to mean the same thing; different people use the same nomenclature to mean different things. The OECD itself has now used different nomenclature to mean the same thing. Thus, for the sake of clarity, in this paper I adopt and explain my own nomenclature.

²⁹ The CE Method is clearly a “market intangibles” idea, whereas the OM Method is more of a “distribution-based” idea. Neither of the strawmen begin with arm’s length valuation of the respective value of the two groups of intangibles. \The OECD already seems to have dismissed a full arm’s length valuation approach. See Consultation Document, *supra* note 4, at 14 n.6; *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Inclusive Framework on BEPS, ch II (May 29, 2019) [hereinafter *Work Programme*], available at <https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf>. The consultation document does, however, contemplate a conceptual distinction between profits generated by “market intangibles” (e.g. proprietary market and customer data, customer lists, customer relationships, and other customer information, as well as attributes such as branding and trade names), and those generated by “trade intangibles.” The MRPS approach suggests similar ideas.

be stabilized multilaterally. The purpose of this Part II is simply to create a basis from which to “show the analytical work.”

Note that the descriptions below do not provide any guidance as to how to determine destination for those goods and services, and that this determination is a necessary component of both proposals. The destination determination issue is described in significant detail in a prior paper of mine.³⁰ While I make no further comments on that issue in this paper, I do view that difficulty as an important source of technical instability in any market intangibles concept. Indeed, I believe a solution to this gating issue must be found and clearly articulated if chaos under Pillar One is to be avoided.³¹ I previously suggested that we do not presently have a publicly-known workable solution to this problem.³² The importance of the issue is therefore hard to understate. I understand the OECD is now consulting quite widely on the destination determination question.

Since the destination determination issue affects every conceivable Pillar One proposal, it turns out not a consideration as to which type of Pillar One approach to support, at least once one has decided to support any Pillar One proposal at all. This basic reality explains why the destination determination question is excluded from this paper.

A. Capital Expenditure Method

The CE Method would begin by separating “excess” or “residual” returns from “routine returns.”³³ The CE Method provides a normal rate of return to productive economic functions. It uses arm’s length methods to determine this return, on the theory that the arm’s length method works reasonably well in the context of determining appropriate “non-entrepreneurial” returns for specific economic activities. Then, to allocate the remaining “entrepreneurial,” “non-routine,” or “residual” returns, the CE Method in effect deems the country in which customer sales take place to be an “entrepreneurial” affiliate with respect to local market sales. The CE Method treats part of the “non-routine” or “residual profits

³⁰ Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate*, TAXES 85-118 (Mar. 2019).

³¹ Some suggested solutions, which I view as unsatisfactory for reasons explained in Grinberg, *supra* note 5, are provided in the Skadden Arps submission to the OECD public consultation. Skadden, Arps, Slate, Meagher & Flom LLP, *Comments on Public Consultation Document: Addressing the Tax Challenges of the Digitalization of the Economy* (Mar. 6, 2019) [hereinafter *Skadden Consultation Document*], available at https://www.dropbox.com/s/hou6dvuckmahoft/OECD-Comments-Received-Digital-March-2019.zip?dl=0&file_subpath=%2FSkadden.pdf.

³² Grinberg, *supra* note 5.

³³ The CE Method raises various technical challenges. My prior paper focused on pragmatic administrative issues associated with implementing the proposal. In contrast, this paper focuses only on *stabilizing* the implementation and utilization of a market intangibles proposal internationally. Thus, my description of the method in this section does not restate the pragmatic administrative issues that I believe are raised by the CE Method, except to the extent these are relevant to stabilizing the proposal within the international tax system.

to be due to “market intangibles,” and allocates that part of the non-routine profits to the “entrepreneurial” affiliate in the market country.³⁴

Thus, splitting the residual profit between profits being allocated to market intangibles, and profits being allocated to other intangibles, is necessary in the CE Method. The CE Method for arriving at that split would involve specifying which expenditures contribute to developing market intangibles and which expenditures contribute to developing other intangibles (notably including production intangibles). Governments would then establish – presumably on a presumptive basis – “useful lives” for various buckets of expenditure. The “amortization schedule” adopted for the various buckets of expenditure would not produce actual deductions. Rather, the resulting relative “capitalized values” associated with functional costs incurred for market intangibles as compared to other intangibles would simply establish an annual ratio of “market intangibles” to “other intangibles” hereinafter referred to as the “CE Method Ratio”.³⁵

The CE Method Ratio would determine the ratio of excess return to be allocated through the current arm’s length system as compared to the excess return to be allocated to market jurisdictions in the CE Method.³⁶ Various mechanisms could be utilized to establish the CE Method Ratio. For purposes of the analysis in this paper, all that matters is that a CE Method Ratio is somehow established, based on the facts and circumstances of an individual taxpayer.

In the simplest case (assumed here), governments would agree to assign the same useful life for all buckets of expenditure. In that case, the only purpose of the amortization schedule would be to “average out” expenditures contributing to market intangibles, and expenditures contributing to other intangibles, over multiple years. Even so, the CE Method Ratio would change each year as a result of new expenditures by the MNC as well as the operation of the “amortization schedule.”

The CE Method analysis could be undertaken on a consolidated MNC basis or, with substantially increased complexity, on a business unit or product line basis. The amount of residual return deemed attributable to market intangibles would then be allocated among market jurisdictions based on the percentage of gross sales revenue by country.

³⁴ See presentation of Michael Devereux at Tax Policy Center Conference on “A Corporate Tax for the 21st Century” (July 14, 2016), available at https://www.taxpolicycenter.org/sites/default/files/residual-profit-allocation-proposal_2.pdf.

³⁵ The CE Method splits residual profits based on relative stocks of accumulated and capitalized “functional” costs. In that sense, the CE Method bears some similarity to the Functional Cost Diagnostic (“FCD”) Model announced by the IRS’ Advanced Pricing and Mutual Agreement Program (“APMA”). *Functional Cost Diagnostic Model*, KPMG (Feb. 15, 2019), <https://home.kpmg/content/dam/kpmg/xx/pdf/2019/03/tnf-irs-diagnostic-model-mar4-2019.pdf>.

³⁶ In theory, the CE Method Ratio could function as a safe harbor. Some have suggested MNCs might be allowed to elect either the safe harbor method or, as an alternative means to computing their CE Method Ratio, a purer facts and circumstances transfer pricing valuation method for market intangibles on one hand and trade intangibles on the other. Skadden Consultation Document, *supra* note 29. However, it is unclear what would motivate governments to provide this election. The already high risk of controversy would increase without obvious systemic revenue or compliance gains.

The CE Method requires global consolidation (unitary taxation) because it requires a measure of taxable income at the consolidated level in order to measure the amount of residual return. Most discussion of market intangibles and residual profit allocation more generally in the OECD process assumes “top-down” calculations, and therefore implicitly requires this form of global consolidation.³⁷ Thus, all the issues that arise in unitary tax systems also arise in the CE Method. The tax base harmonization conundrum associated with unitary taxation is well-known.

B. The Operating Margins Method

The OM Method departs from the conceptual motivation for “market intangibles” proposals in the interest of administrative ease.³⁸ Taken as a whole, the resulting methodology is difficult to relate to the conceptual motivation for market intangibles. Importantly, advocates of simplified approaches might suggest that an appropriately calibrated OM Method-based proposal may, in practice, produce results that are no more or less likely to allocate only “market intangible” profit to market jurisdictions than the CE Method.³⁹

The OM Method has a conceptual relationship to the deemed profit methods that were common in Latin America a generation ago. Modified deemed profits method approaches were raised as an alternative in the same section of the OECD consultation document that presented the G24’s “significant economic presence” proposal. Thus, the OM Method

³⁷ In theory, an alternative mechanism for determining the amount of residual income allocable to each jurisdiction could be developed from the “bottom-up” Such an approach is described as an alternative in an Oxford group paper. Michael P. Devereux, Alan J. Auerbach, Paul Oosterhuis, Wolfgang Schön and John Vella, *Residual Profit Allocation by Income* (Oxford International Tax Group, Working Paper No. 19/01, 2019) [hereinafter *RPA-I*], https://www.sbs.ox.ac.uk/sites/default/files/2019-03/WP1901_0.pdf. The details of the Oxford group’s “bottom-up” system are not essential to the analysis in this paper. Nevertheless, it is worth observing that the Oxford group’s “bottom-up” system remains unitary in the sense that it requires a unitary definition of indirect expenses (notably including interest expense, global non-allocable sales and marketing expenses, R&D expenses, and other general and administrative expenses) that must then be allocated out according to a consistent and agreed multilateral system. Second, the Oxford group’s “bottom-up” system would only be workable if the concept of “residual gross income” developed in the RPA-I paper were adopted by all jurisdictions consistently and used by each of them as the allocation key for indirect expenses. Third, and most importantly, the RPA-I “bottom-up” method results in an allocation of all residual profits to the destination jurisdiction. In contrast, in a market intangibles concept, some mechanism is needed to split residual profits being allocated to market intangibles from residual profits being allocated to the destination jurisdiction. Methodologically, a “bottom-up” approach (unlike a “top-down” approach) for the CE Method would have to “take away” profits initially allocated to the destination country from that market country. Given the politics of the market intangibles debate, that last result seems extremely politically challenging.

³⁸ On the other hand, the OECD TPG already hints that sometimes it is worth considering the “trade-off between strict compliance with the arm’s length principle and administrability.” OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, ¶4.112 (2017) [hereinafter *OECD TPG*], <https://dx.doi.org/10.1787/tpG2017-en>.

³⁹ In other words, advocates would say the OM Method usually would in practice allocate only residual returns and returns that are the result of functions in market jurisdictions to market jurisdictions.

might be thought of as a compromise between the original U.S. Treasury proposal for restructuring profit allocation, and ideas put forth by the G24.⁴⁰

The OM Method would specify a minimum taxable income due from a multinational group in a given jurisdiction. The main variable that would determine this minimum market jurisdiction taxable amount globally would be a measure of global operating margin, either overall or by business line. A fixed return on sales would then be allocated to market jurisdictions in general. The fixed return percentage would vary based on operating margins. The minimum market profit amount deemed allocable to market jurisdictions would be calculated by multiplying the fixed return percentage by revenues, and would then be apportioned among market jurisdictions on the basis of local revenues (sales).

The return on sales percentage that determines the minimum market profit amount would increase or decrease for businesses or business lines with operating margins above and below an empirically determined average operating margin (the “Margin Adjustment Factor”). When a business has very low, zero, or negative percent operating margins, the deemed minimum allocation to market jurisdictions would be zero. Since the OM Method is not limited to residual returns, without a properly calibrated Margin Adjustment Factor, the market profit amount would disproportionately allocate profit to market jurisdictions for low margin businesses.

To avoid double taxation in the OM Method, it might be necessary to specify the “surrender jurisdiction” that would give up the right to tax the market profit amount. However, if tax due under otherwise applicable principles by MNC affiliates with traditional tax nexus to the market jurisdictions would be creditable against tax due on the “market profit amount” that is apportioned to any particular market jurisdiction, self-help to avoid double taxation would be available to MNCs. Therefore, at least outside the loss case, the double taxation concern might be reduced. MNCs would be encouraged to structure transfer pricing arrangements so as to ensure a taxable income amount arose in entities with traditional nexus to the relevant market jurisdictions that was at least equal to the market profit amount allocated to the relevant jurisdiction.⁴¹

⁴⁰ Consultation Document, *supra* note 4, at ¶54.

⁴¹ Absent a clear international agreement that specified the surrender jurisdiction under the OM Method, market jurisdictions would likely conclude that in a regime with a clear “alternative minimum tax” structure, a non-favorable rule for deemed liability due to the market profit amount allocation that was not reflected in reported local income, would aid with enforcement. In other words, market jurisdictions might conclude that MNCs that did not reach the minimum taxable income amount in their jurisdiction would be deemed to have such additional income in the jurisdiction, without specifying in domestic (or treaty) law from which entity in the consolidated group the amount was “removed”. For entities that did not book enough income in the relevant jurisdictions, the tax associated with the remaining minimum taxable income amount would explicitly be denominated as a non-deductible “market access fee.” A non-favorable rule for deemed liability that was not reflected in reported local income would encourage MNCs to structure tax nexus and transfer pricing arrangements so as to ensure the minimum taxable income amount arose under otherwise applicable principles in the relevant market jurisdictions. This non-favorable rule for the source of income creating the deemed liability that was not reflected in reported local income would encourage MNCs to structure tax nexus and transfer pricing arrangements so as to ensure the minimum taxable income amount arose under otherwise applicable principles in the relevant market jurisdictions. Of course, annual sales and operating

Key Technical Differences between the CE Method and the OM Method

The CE Method and the OM Method differ along six key structural dimensions.

1. Whether or not to attempt to impose a distinction between routine returns and non-routine returns in defining the new taxing right allocated to market jurisdictions
2. Whether or not to attempt to impose a distinction between returns associated with market intangibles and other returns in defining the new taxing right allocated to market jurisdictions
3. Whether or not to include traditional transfer pricing concepts as a component of the system for defining the new taxing right allocated to market jurisdictions.
4. Whether or not to rely on a consolidated tax base (unitary) calculations to define the new taxing right allocated to market jurisdictions
5. Whether or not to use a minimum tax architecture to implement the new taxing right allocated to market jurisdictions
6. Whether and how to use financial reporting concepts in defining the new taxing right allocated to market jurisdictions.

The CE Method and the OM Method each reflect a series of structural choices that together create a methodology for a significant but not total reallocation of taxing rights to market jurisdictions. Again, features of the CE Method described above could be ported into an OM Method structure, and features of the OM Method could be ported into a CE Method structure. Nothing precludes either proposal from incorporating features of the other. The purpose of laying out two strawmen is simply to highlight structural choices that can affect the stability of any agreed system.

Both the CE Method and the OM Method would create a “market profit amount” that governments might choose to describe as being “deemed attributable to market intangibles.” However, in the case of the OM Method this deemed return is simply a percentage of revenues determined on an overall or business line basis. Any purported link to some idea of market intangibles is tenuous. Determining the “market profit amount” based on only revenues and operating margins simultaneously simplifies the relevant calculation and distances it from the conceptual motivation for the market intangibles concept.

In contrast, the CE Method is structured to claim a more meaningful relationship between the conceptual motivation for the market intangibles concept and the technical methodology used to determine the new taxing right. Accordingly, in the CE Method includes a substantively attempt to separate routine returns from non-routine returns, and to measures the amount of investment in “market intangibles” and “other intangibles” in order to separate non-routine returns attributable to market intangibles from other non-

margins are only known definitively by MNCs at the end of the year. In contrast, transfer pricing arrangements are usually set years in advance. Thus, this structure incentivizes over-allocating profits to market jurisdictions. The resulting pressure to respect transfer pricing so as to avoid double taxation thus would fall on residence jurisdictions rather than market jurisdictions.

routine returns. The CE Method uses a variant of a residual profit split transfer pricing approach to measure the relevant amounts. Using a substantive measurement system that attempts to capture a return attributable to market intangibles provides the justification for treating the new taxing right in the CE Method as a final taxing right. In contrast, the OM Method is conceived of as having an alternative minimum tax structure. (

The allocation mechanism included in the basic OM Method does not include a substantive structural feature intended to distinguish between non-routine profit attributable to a “market intangible,” as opposed to any other intangible, nor is it limited to “non-routine” or “residual” profits. These design differences have two further important technical consequences. First, the OM Method would not require calculating the amount of expenditures made to support either marketing or trade (production) intangibles. Second, the OM Method would not necessarily require a unitary tax calculation (as traditionally conceived).

Nevertheless, the OM Method does require unitary calculations in a more limited sense. In particular, the OM Method requires a determination of the consolidated group’s operating margins.⁴² Notably, this form of unitary measurement is generally familiar from financial and managerial accounting systems currently used for non-tax purposes. If operating margins were determined on a groupwide global basis in accordance with the group’s financial statements then (at least for publicly traded companies) the definition of the inputs to determine the operating margin could (perhaps) be fully “outsourced” to financial accountants. In other words, the operating margin could be determined using financial accounting measurements of revenue and earnings before interest and taxes, and without any independently defined tax accounting rules.⁴³ Thus, in its simplest form, the OM Method largely dispenses with the problems associated with unitary taxation, even as it retains a unitary feature.

On the other hand, if requirements to calculate revenues and/or operating margins on a business unit or jurisdictional basis were added to the OM Method, then required public financial reporting likely becomes inadequate. Business line by business line operating margins are not required items of reporting under any existing financial reporting rules. Therefore, if business unit or jurisdictional basis calculations are added to the OM Method, unitary calculations being undertaken solely for tax purposes are reintroduced into the OM Method. The same is true of any other “adjustment factors” added to the basic result

⁴² Like the CE Method the OM Method would also require a determination of destination of sales or services under an agreed set of rules in order to allocate the minimum taxable income amount as among market jurisdictions.

⁴³ For this purpose I assume the OM Method would accept financial statements prepared in accordance with the generally accepted accounting principles prevailing a given MNC encounters in their ultimate parent entity’s country of residence. Assuming proper application of generally accepted accounting principles raises various issues, not least with respect to accounting statements available for privately held corporations, or with respect to business conducted in passthrough form. However, this paper is not intended to be an analysis of administrative concerns with any given proposal. It simply asks what it would take to stabilize a particular method to implement market intangibles in the international tax system. As a result, I do not delve fully into these questions.

reached by the OM Method. Adjustment factors generally require unitary tax-driven reporting, and therefore a need for more extensive multilateral coordination on methodology.⁴⁴ Financial reporting rules may still be relevant but would no longer be able to provide all the inputs required to reach a final result.

III. Stabilizing the Hypothetical Profit Reallocation Methods

There are two first order concerns regarding the stability of the potential regimes described in Part II. The first concern is that countries will defect from the hypothetically agreed-upon system and impose alternative unilateral rules. The second concern is that countries will disagree on the definitions of agreed-upon concepts or rules to such a degree as to create systemic incoherence.

Part III first considers whether any of the mechanisms for stabilizing international tax agreements described in Part I could stabilize the strawman proposals described in Part II. In my usage, “stabilizing” means alleviating the two first order concerns described above. Those questions are:

- 1) which decisions along the six key structural dimensions make stabilizing any of the Pillar One proposals easier or harder?
- 2) which open questions must be answered to determine what decisions along the six key dimensions are viable from a stability perspective?

Subpart A concludes that neither the CE Method or OM Method can realistically be stabilized using the G20 Soft Law Approach alone. Subpart B further concludes that neither strawman could be fully stabilized through the MLI Approach in the present environment, in which international tax has been highly politicized. However, I also conclude that the concerns with using the MLI Approach to stabilize the CE Method are more fundamental than the concerns with using the MLI Approach to stabilize the OM Method. Moreover, with respect to stabilizing the OM Method, a narrow set of design choices may make the concerns possible to overcome. Subpart C concludes that either the CE Method or the OM Method could be instantiated into international tax policy via the Multilateral Treaty Approach. However, even under the Multilateral Treaty Approach, whether any agreement could be stabilized depends on the design decisions that are taken. Certain design decisions are simply not possible to stabilize. Subpart D concludes by reflecting on what the strawmen teach us about the six key structural dimensions.

A. Stabilizing Profit Reallocation using G20 Soft Law Approach

⁴⁴ The submission by Johnson & Johnson to the OECD public consultation helps highlight some of these issues. Johnson & Johnson, *Comments on Public Consultation Document: Addressing the Tax Challenges of the Digitalization of the Economy* (Mar. 3, 2019) [hereinafter *Johnson & Johnson Consultation Document*], available at https://www.dropbox.com/s/hou6dvuckmahoft/OECD-Comments-Received-Digital-March-2019.zip?dl=0&file_subpath=%2FJohnson%26Johnson.pdf. The J&J submission suggested, *inter alia*, country-level marketing spend as an “adjustment factor” to any profit reallocation approach. *Id.* Any adjustment to the return on a sales-based minimum taxable income amount that turned on country-level marketing spend would need to determine country-directed marketing spend on a unitary and consistently agreed basis to avoid both manipulation and juridical double taxation.

1) Substantive Allocation Rules at the Level of Law

With enough international coordination, a G20 Soft Law Approach backed by coercive threats could conceivably prevent outright defection from the two strawmen. However, the developments that would be necessary are difficult to imagine, let alone implement.

At the G20's direction, it is possible to imagine the Inclusive Framework creating a peer review body that would develop a "terms of reference" and a "methodology" for determining whether countries were meeting their commitment to adopt a given Pillar One result as the new profit allocation norm within their domestic law.⁴⁵ The terms of reference and methodology could be used to monitor and assess compliance with a Pillar One result through reports on what countries have done to implement an agreed approach. Those reports would be developed through a peer review process akin to those used in the Global Forum with respect to information exchange and at the Inclusive Framework to assess compliance with BEPS Action 5. Moreover, the Inclusive Framework could also provide technical assistance and other enabling mechanisms to help jurisdictions seeking support in implementing the Pillar One result into their law.

Importantly, the terms of reference development process undertaken by the "standard-setter" that motivates the monitoring and other components of the G20 Soft Law Approach, has natural limits. Developing terms of reference requires a significant level of political engagement. Moreover, once terms of reference for peer review are agreed upon, methodologies that implement those terms of reference rarely reach a further level of detail that is sensitive (except when the sensitivity is limited to one or two jurisdictions). Therefore, peer review is substantially more difficult to implement successfully in an area where the details of a standard are likely to evolve rapidly.

For the sake of argument, one could imagine that over a few years, an international soft law meta-architecture, involving a standard-setter, a monitoring mechanism, enablers, and, importantly, enforcement threats, could be established to attempt to prevent outright defection from a given Pillar One result. G20 Soft Law Approach mechanisms backed by coercive threats from a few governments have been successful in the past. Successes even include occasional instances where the consequences of such success were redistributive as among major sovereigns.⁴⁶

⁴⁵ Cf. OECD, *Terms of Reference: To Monitor and Review Progress towards Transparency and Exchange of Information for Tax Purposes*, OECD (2010), available at <http://www.oecd.org/dataoecd/37/42/44824681.pdf> (describing in detail international standards for information exchange upon request in tax matters); Global Forum on Transparency & Exch. Of Info. For Tax Purposes, OECD, *Revised Methodology for Peer Reviews and Non-Members Reviews* (2011), available at <http://www.oecd.org/ctp/44824721.pdf> (detailing how to conduct reviews).

⁴⁶ One major lesson from the history of the utilization of the G20 Soft Law Approach over various fields of international economic law, is that even where preferences among the larger economies are aligned, some enforcement mechanism is usually needed to implement high-level political agreements reached under the auspices of the G20 Soft Law Approach. When the relevant agreements have a distributive character and impose a net cost on one or more of the largest economies, an even higher premium exists on meaningful defensive measures to deter non-compliance.

For example, the Basel I Accord⁴⁷ on capital adequacy for financial institutions was, in an important sense, redistributive. During the Latin American debt crisis of the 1980s, the U.S. and UK felt compelled to bail out Argentina, Brazil, and Mexico in order to indirectly rescue their own banks—which had loaned heavily to these countries—from the potential consequences of sovereign debt defaults.⁴⁸ Regulators in both countries then came under pressure to raise capital adequacy standards for domestic banks in order to limit the opportunity for banking concerns to socialize the cost of bad loans again at a future date.⁴⁹ The Basel I Accord effectively shifted part of the potential cost of these increased capital adequacy requirements (reduced competitiveness of U.S. and UK banking concerns internationally) onto the Japanese, French, German, and Swiss banks that were then the primary competitors of U.S. and UK financial institutions. The adoption of the Basel I Accord and its implementation worldwide, over the resistance of those other countries, was a function of relative power and coercive threats.⁵⁰ At the time, the dominance of US and UK financial markets was such that by threatening to exclude non-compliant foreign banks from their markets, the US and the UK were able to force implementation and overcome countervailing interests.⁵¹

As in Basel I, distributional considerations are central to the debate over reallocating MNC profits. In the international tax debate, different proposed solutions can encourage different allocations of revenue, business activity, or both as among large economies. Competitive dynamics are often at play; national interests either diverge or appear to diverge. In this type of distributive setting, peer review without a significant sanction for being found non-compliant by other member peer states simply would not be efficacious.

Rather, for the peer review to have meaningful effect, failure to be deemed compliant would have to create a license for jurisdictions to implement defensive measures. The exact details of those defensive measures are not important for this analysis, but to work they would need to be harsh, and they would need to be implemented.

If such defensive measures were agreed, every country in the world would not need to in fact impose them for the defensive measures to have global effect. For instance, if just any two of the United States, the European Union, and China were to agree that being found non-compliant with a peer review would trigger specified harsh defensive measures, that would probably be enough. After all, together those jurisdictions represent such a large share of the global marketplace

⁴⁷ The Basel Accords (Basel I, Basel II, and Basel III) set out international standards for how much capital banks need to hold to safeguard their solvency against the financial and operational risks they face. See Verdier, *supra* note 45, at 1466-67.; Pierre-Hugues Verdier, *Transnational Regulatory Networks and their Limits*, 34 *Yale J. Int'l L.* 113, 132 (2009) [hereinafter *Verdier II*].

⁴⁸ See, e.g., Wolfgang H. Reinicke, *BANKING, POLITICS AND GLOBAL FINANCE: AMERICAN COMMERCIAL BANKS AND REGULATORY CHANGE, 1980-1990*, 142 (1995).

⁴⁹ David Andrew Singer, *REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM* 9 (2007).

⁵⁰ *Verdier II*, *supra* note 49, at 136.

⁵¹ *Id.*

However, the political realities of the current international tax debate regarding market intangibles do not suggest the kind of potential for coercive coordination that arose in the runup to Basel I. Coercive coordination among any two of the United States, the European Union (acting collectively), and China will be difficult. Major states within the European Union have expressed concerns at the most senior levels regarding market intangibles (for example, Chancellor Merkel has publicly expressed concerns on behalf of Germany). Meanwhile, although one could imagine the United States and China agreeing on a market intangibles Pillar One approach, the more general economic diplomacy relationship between the United States and China is at a historic post-Nixon low. In this climate, a decision to set aside other concerns and cooperate very closely and bilaterally to coerce the world towards a market intangibles profit reallocation seems unlikely.

2) Preventing “Mock Compliance” with Substantive Allocation Rules

Assessing the adequacy of a country’s enforcement of multilaterally agreed substantive tax principles is a much more difficult and fraught task for peer review than determining whether implementing legislation is in place. Even if countries agreed in form on a given Pillar One approach, it would be almost impossible to ensure consistent enforcement using traditional G20 Soft Law tools. Moreover, peer review mechanisms lack any capacity to address specific cases and controversies, or even to determine whether at some general level the preponderance of cases and controversies are appropriately resolved. Put more simply, when it comes to taxpayer dispute resolution, peer review has little if any role. More generally, the G20 Soft Law Approach is broadly known to be susceptible to mock compliance. In regimes involving G20 Soft Law enforcement, mock compliance can be achieved by jurisdictions that wish to defect by combining formalistic implementation with alternative relief for regulated actors, systematic regulatory forbearance, and/or informal, administrative non-enforcement.⁵²

B. *Stabilizing Profit Reallocation using MLI+ Approach*

Attempting to stabilize a given Pillar One result through the MLI+ Approach likely involves using eight related sub-mechanisms: (a) modifying Article 9 of the OECD Model Treaty; (b) modifying Article 5 of the OECD Model Treaty; (c) modifying Article 7 of the OECD Model Treaty; (d) modifying the OECD’s TPG; (e) providing for mandatory binding arbitration with respect to the application of the new rules; (f) implementing the requisite treaty changes through the MLI itself; (g) amending the Convention on Mutual Administrative Assistance in Tax Matters to automatically exchange information to administer the system; and (h) revising country-by-country reporting (“CBCR”) rules. These eight mechanisms represent the complete panoply of relevant tools the OECD’s CTPA has used in the past to accomplish various international tax objectives. Subpart B.1) introduces each of the eight aforementioned sub-mechanisms. Those readers who are familiar with these eight mechanisms can skip subpart B.1). Subparts B.2) and B.3) ask whether the combination of all eight sub-mechanisms could successfully stabilize the CE Method or the OM Method.

⁵² Cf. Andrew Walter, GOVERNING FINANCE: EAST ASIA’S ADOPTION OF INTERNATIONAL STANDARDS (2008); Grinberg, *supra* note 9.

1) Background on the Components of the MLI+ Approach

a) Article 9 of the OECD Model Convention

Article 9 of the OECD Model Treaty is the source of the authoritative basic statement of the “arm’s length” principle of international transfer pricing.⁵³ Language identical or nearly identical to Article 9 of the OECD Model Treaty appears in thousands of bilateral tax treaties.

The arm’s length standard is designed to prevent MNCs from using transfer pricing to create tax advantages for themselves because they operate in group form rather than conducting business as independent enterprises transacting with one another across borders and as a result, can dictate the pricing of inter-firm cross-border transactions.⁵⁴ For more than thirty years, the arm’s length principle represented a consensual solution to the problem of allocating tax between different parts of an MNC, but now the principle is heavily criticized.⁵⁵

The key feature of the arm’s length standard inscribed in Article 9 is that it seeks to adjust profits by reference to comparable uncontrolled transactions conducted by independent enterprises. Article 9 therefore provides for a fundamentally transactional approach driven by “comparability analysis.”

The market intangibles concept is not transactional in the same sense and would apply without reference to third party comparability analysis. Thus, modifying Article 9 to incorporate a market intangibles concept would involve a substantial transformation of the provision and an overlay of a concept that is unrelated to the basis of current Article 9.

b) Article 5 of the OECD Model Convention

⁵³ Article 9 provides that “[where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.” OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017*, Article 9 (2017), https://doi.org/10.1787/mtc_cond-2017-en.

⁵⁴ See e.g. OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10*, OECD/G20 Base Erosion and Profit Shifting Project (2015), <https://dx.doi.org/10.1787/9789264241244-en>. The arm’s length principle requires that transactions between associated enterprises be priced as if the enterprises were independent, such that the pricing reflects what third parties operating at arm’s length would agree with one another.

⁵⁵ John Neighbour, *Transfer pricing, Keeping it at arm’s length*, OECD Observer (Apr. 21, 2002), http://www.oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html. Of course, important academic critiques and alternative proposals existed before the onset of the BEPS project. E.g., Reuven Avi-Yonah, *Splitting the Unsplittable: Toward a Formulary Approach to Allocating Residuals Under Profit Split*, Univ. of Michigan Public Law and Legal Theory Working Paper Series, No. 378, Working Paper (2013) (proposing that the OECD use formulary apportionment to allocate residual profit of the “profit split method”).

Article 5 of the OECD Model Convention presents the conventional standard for when an enterprise based in one state has a sufficient connection to another state to justify taxation by the latter state. Under Article 5 of the OECD Model Tax Convention, a sufficient connection exists when an enterprise resident in one state (the “residence state”) has a “permanent establishment” (“PE”) in another state (the “source state”). The PE threshold must be met before the source state may tax that enterprise on active business income properly attributable to the enterprise’s activity in the source state. The permanent establishment rule encapsulated in Article 5 thus represents the basic international standard governing jurisdiction to tax a non-resident enterprise.

A market intangibles concept requires creating nexus to tax in circumstances where only sales tie an enterprise to a jurisdiction, and thus would require changes to Article 5 of the OECD Model Convention (which might include creating an additional nexus rule that was separate from but coordinated with the remainder of Article 5).⁵⁶

c) Article 7 of the OECD Model Convention

Under the most recent version of Article 7 of the OECD’s Model Tax Convention, profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities which cause it to be a PE.¹⁹ Fundamentally, this rule was developed by tax treaty experts because they all recognized that if associated enterprises in different countries were taxed under the Article 9 arm’s length standard, but PEs were taxed under some other rule under Article 7, distortions between structures involving PEs and structures involving subsidiaries would arise.

As a result, in 2010 the OECD Model Tax Convention was revised to incorporate rules that attempt to apply the Transfer Pricing Guidelines (“TPG”) and the arm’s length principle as consistently as possible to subsidiaries and PEs.⁵⁷ At that time, the OECD issued a report on the attribution of profits to permanent establishments. The report concluded that a PE should be treated as if it were distinct and separate from its overseas head office, and that assets and risks should be attributed to the PE or the head office in line with the location of “significant people functions.” Thus, under the Authorized OECD Approach (“AOA”) the attribution of profits to a PE is meant to be determined via an analysis of the amount of revenue and expense that the PE would have recognized if it were a separate and independent enterprise.

⁵⁶ In addition to taxing rights under Article 7 discussed below, the existence of a PE also creates various special source country taxing rights under articles of the OECD Model Convention related to the distribution of dividends (Article 10), the payment of interest and royalties (Articles 11 and 12), and the realization of capital gains (Article 13). Market intangibles-driven alterations to the PE rules would have to address the interaction of new nexus rules with these references to Article 5.

⁵⁷ See Commentary to Article 7, para 2 of the OECD Model Treaty, para 16 (“the basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person... that fiction corresponds to the arm’s length principle which is also applicable, under the provisions of Article 9, for purposes of adjusting the profits of associated enterprises.”)

The post-2010 OECD approach to attributing profits to a PE is commonly referred to as the “AOA”.²⁰ This approach is incorporated into soft law in the 2010 version of the business profits article (Article 7) of the OECD Model Tax Convention. Under those rules, which are meant to produce a result as similar to the Article 9 arm’s length result as possible, step one of the AOA leads to the recognition of internal dealings between the PE and its head office.²¹ Under step two, the guidance in the OECD TPG is applied by analogy to determine the arm’s length pricing of the internal dealing between the PE and the head office.²²

However, the AOA has not been included in most existing bilateral tax treaties. As the OECD observed just last year:

“[M]any tax treaties contain a version of Article 7 that does not require the use of the AOA. In cases governed by those treaties, the method of attributing profits to a PE for the purpose of Article 7 of the applicable treaty might differ significantly from the AOA. This might be a function of the interrelation between the treaty and the domestic law of the jurisdiction where the PE is located (e.g., if the treaty expressly permitted the use of a customary domestic law apportionment approach, and domestic law contained such an approach). In other cases, the treaty might expressly prohibit the recognition of notional dealings between the PE and the non-resident enterprise of which it is a part (e.g., treaties with a version of Article 7 based on the United Nations Model Double Taxation Convention between Developed and Developing Countries).”

Notably, the BEPS MLI did not include a provision that encouraged jurisdictions to adopt the AOA. In contrast, certain other provisions that were not explicitly part of the BEPS project but that would help with consistent application of BEPS recommendations, were included in the MLI to aid in improving tax treaty conformity around the world. Given that broader adoption of the AOA would certainly have helped improve consistent implementation of the Article 5 results approved in BEPS, a logical conclusion to draw is that AOA language was not included in the MLI because its inclusion was or would have been too controversial or generated too much opposition from participating states.

Commentary on additional guidance issued by the OECD in 2018 on the attribution of profits to PEs suggests that the OECD may have abandoned or failed in the effort to get jurisdictions to agree to consistent, standardized rules of application of the AOA.⁵⁸ For instance, former U.S. Deputy Assistant Secretary for International Tax Affairs Robert Stack concluded that by not “affirmatively reaching consensus that the Article 9 analysis precedes the Article 7 analysis (or vice versa),” and by not “harmonizing the significant people functions analysis under Article 7 with the risk control framework under Article 9,

⁵⁸ *Id.* at 3.

the 2018 guidance leaves unresolved the fundamental issues that WP6 set out to address post-BEPS.”⁵⁹

Separately, the OECD has recognized that permanent establishments that are created other than by a physical presence (such as an office or the like) in a host jurisdiction pose special administrative challenges, both within and without the AOA.⁶⁰ The basic problem is that local businesses with a physical presence tend to establish independent financial accounting records at least for managerial purposes; these accounting records provide a starting point for the attribution of profit for tax purposes. In contrast, when a PE is simply deemed to exist in a given jurisdiction for tax purposes but without being tied to any physical presence of the enterprise in that jurisdiction, the corporation generally will not have established any separate managerial records with respect to business deemed to be attributable to the jurisdiction in question. As a result, in these cases the attribution of profits to the market jurisdiction must be “invented” from scratch (entirely via tax rules that attribute profits to the jurisdiction, rather than by beginning from some non-tax foundation).

d) OECD Transfer Pricing Guidelines

The OECD’s Transfer Pricing Guidelines are dedicated to providing guidance on applying the arm’s length standard enshrined in Article 9 of the OECD Model.⁶¹ Hundreds of pages of text in the OECD TPG are dedicated to this endeavor. Among other things, the OECD TPG repeatedly explains that it is inappropriate for either MNCs or tax administrations to deviate from the application of the arm’s length standard. Thus, the OECD TPG is an awkward vehicle for inscribing changes to profit allocation that go beyond the arm’s length principle, and into the international tax architecture.

Nevertheless, small portions of the OECD TPG in recent years began to include discussions of non-traditional transfer pricing methodologies that are then deemed “arm’s length.” The discussions in Chapter IV of the OECD TPG regarding safe harbors and advance pricing agreements are examples. Similarly, the model competent authority agreement now included in Annex I to Chapter IV of the OECD TPG contemplates a formulary markup that governments bilaterally or multilaterally could agree would be “deemed to constitute an arm’s length level of compensation.” In this limited sense, the OECD TPG already

⁵⁹ Deloitte, *OECD releases additional guidance on attribution of profits to permanent establishments, ARM’S LENGTH STAND. 3* (June 2018), available at <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dtt-tax-armslengthstandard-180611.pdf>.

⁶⁰ OECD, *Report on the Attribution of Profits to Permanent Establishments*, OECD/CTPA 63 ¶247 (July 22, 2010) [hereinafter *Report on Attribution of Profits*], available at <https://www.oecd.org/ctp/transfer-pricing/45689524.pdf>.

⁶¹ For example, all of Chapter I of the TPG is devoted to identifying the commercial or financial relations between associated enterprises and accurately delineating the controlled transactions for purposes of applying the arm’s length principle. Chapters II and III of the TPG are devoted to methods for comparing the conditions and the economically relevant circumstances of controlled transactions with comparable transactions between independent enterprises. OECD TPG, *supra* note 35, chs I-III.

imagines redefining the meaning of the “arm’s length standard,” and thereby modifying the application of Article 9 of the OECD Model Treaty without changing the words in the model treaty and tax treaties based thereon.

Although the OECD TPG represents an extended interpretation of the arm’s length standard, it is outside the OECD Model Commentary because of its length, detail, and an unwillingness by at least some jurisdictions to give the same weight to the OECD TPG that they give to the OECD Model Commentary. Indeed, the physical separation of the guidelines from the Commentary has led courts and tax administrations in various jurisdictions to think of the OECD TPG as a distinct soft law instrument with a different persuasive status than the Commentary. Sovereigns around the world have adopted detailed domestic transfer pricing rules that address the OECD TPG in quite varied ways.⁶²

Any effort to bring a market intangibles concept into effect multilaterally would almost certainly require, as part of that effort, one or more new chapters of the OECD TPG explaining the relationship of this concept to the prior arm’s length standard, as well as a substantial rewrite of the existing parts of the OECD TPG. The work would be essential, since countries would need guidance on how to implement market intangibles. Moreover, some countries incorporate the OECD TPG directly into their domestic law by cross-reference. For such countries, without changes to the TPG their law would not change.

e) Arbitration under bilateral tax treaties (Article 25(5))

Article 25 of the OECD Model Treaty generally provides a mechanism for tax administrations to resolve disputes among themselves as to the application of a bilateral tax treaty. The BEPS project accomplished relatively little to make this dispute resolution mechanism, known as the “Mutual Agreement Procedure” (“MAP”), more effective.

Most of Article 25 is devoted to facilitating elective dispute resolution mechanisms that can solve disputes when both competent authorities (the tax administrations of the two countries that are party to the bilateral tax treaty) agree on how to resolve the situation of a particular taxpayer, or a more general administrative issue related to the interpretation or application of the tax treaty. As the world’s most well-known tax treaty treatise explains, the difficulty with Article 25 paragraphs 1 through 4 is that “[t]he taxpayer has a weak position in the proceedings, the proceedings may take too long to complete, there is no guarantee that a mutual agreement will be implemented, and lastly there is no guarantee that a mutual agreement will be reached in the first place.”⁶³

⁶² For example, the Nigerian Income Tax Regulations specify that they are to be “applied in a manner consistent with” the OECD TPG “as supplemented and updated from time to time.” Income Tax (Transfer Pricing) Regulation No. (1) (2016), § 11 (Nigeria). *See also* Tanzania Income Tax (Transfer Pricing) Regulations (2014), § 9 (same). In contrast, for countries like the United States, Brazil, India, and China, the domestic transfer pricing guidance process involves evaluating changes to the OECD TPG at the administrative level and determining whether or not to incorporate those changes into domestic law and regulations.

⁶³ Johannes Becker, Ekkehart Reimer and Alexander Rust, Klaus Vogel on Double Taxation Conventions ¶ 104, at 1810 (2015).

In contrast, paragraph 5 of Article 25 provides a mechanism for binding arbitration of double taxation disputes that the relevant tax authorities have been unable to resolve among themselves. The binding dispute resolution mechanism of paragraph 5 provides for an independent decision on the unresolved issue. Importantly, after two years a taxpayer can submit an unresolved dispute that concerns that taxpayer to arbitration, without regard to whether one or both of the competent authorities would prefer for the arbitration not to occur.

The mechanism provided by Article 25(5) is last best offer arbitration (colloquially known in the US as “baseball arbitration”). Thus, in the mandatory binding arbitration system in place in those tax treaties that include Article 25(5), each of the two tax administrations that are treated as the “parties” to the dispute disclose a proposed settlement to the dispute. The taxpayer in some instances is also allowed to make a submission. The independent arbitration panel’s task is then to pick one of the two proposals made by the two tax administrations, without giving any reasoning for the arbitral panel’s decision. This mechanism for arbitrating tax disputes is favored by most governments that support mandatory binding arbitration because it resolves disputes without creating any supra-national body of international tax law.

Although Article 25(5) is part of the OECD Model Treaty, it is unusual as compared to other provisions of the treaty in the sense that the provision (or any version thereof) appears in only a small minority of actual bilateral tax treaties as between OECD member states. In the BEPS project, the United States advocated for Article 25(5) mandatory binding arbitration to be a minimum standard, but nothing of that sort was agreed. Twenty countries (including the United States, Canada, Japan, Australia, and several European countries) did declare their commitment to provide for mandatory binding arbitration in their bilateral tax treaties as a corollary to the increased controversy that could be engendered by BEPS measures. However, the majority of the world’s economy did not make this declaration, nor did any emerging or developing economy endorse mandatory binding arbitration.

f) The multilateral instrument (“MLI”)

The MLI is a legal instrument that was developed during the BEPS project to modify existing bilateral tax treaties through a subsequent multilateral treaty.⁶⁴ Historically, the sheer number of bilateral tax treaties (3800+) hampered the effectiveness of multilateral efforts to amend the treaty network, because individually negotiated bilateral updates to the treaty network were burdensome and time-consuming for governments.⁶⁵ In November 2016, over 100 jurisdictions concluded negotiations on the MLI. Eighty-seven

⁶⁴ See also Note by OECD Directorate for Legal Affairs on the MLI: Functioning under Public International Law (Oct. 1, 2015), available at <http://www.oecd.org/tax/treaties/legal-note-on-the-functioning-of-the-MLI-under-public-international-law.pdf>.

⁶⁵ Cf. *Explanatory Statement to the Multilateral Convention to Implement Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, OECD at ¶4 (Nov. 24, 2016), <http://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf>.

jurisdictions have now signed the treaty, producing changes to more than 1500 bilateral tax treaties.⁶⁶ The MLI is a flexible instrument that was originally used to swiftly implement changes to tax treaties agreed to in the BEPS project across the treaty network of participating jurisdictions. However, the OECD clearly contemplates the MLI as one model for future implementation of tax treaty standards agreed to at the OECD.⁶⁷ Moreover, Article 33 of the MLI provides a mechanism for amending the instrument, and Article 31 in effect allows any majority of jurisdictions that are parties to the MLI to proceed with an amendment to the MLI that would have effect as among the bilateral treaties of the electing group of states. Changes to OECD Model Treaty articles intended to stabilize any agreed market intangibles concept would almost certainly be put forth by the OECD as amendments to the MLI under Article 33 thereof.

g) The Convention on Mutual Administrative Assistance in Tax Matters

As amended in 2010, the Convention on Mutual Administrative Assistance in Tax Matters (the “Administrative Assistance Convention”) provides a mechanism for multilateral automatic information exchange through provisions intended to facilitate such exchange.⁶⁸ The Administrative Assistance Convention is a full-fledged legal vehicle for automatic information exchange for tax purposes as among signatories, while requiring countries to protect taxpayer information from misuse and respect taxpayer rights.⁶⁹ The Administrative Assistance Convention as amended in 2010, allows competent authorities to reach further competent authority agreements in order to establish automatic information exchange with respect to any category of foreseeably relevant information.⁷⁰ Two such agreements, one of which covers country-by-country reporting (CBCR), have already been reached.⁷¹

The Administrative Assistance Convention also includes a provision that allows for collection assistance. That provision is one of the only articles of the convention on which reservations by signatories are permitted.⁷²

⁶⁶ See *MLI Database – Matrix of options and reservations*, OECD, for status of ratification available at <https://www.oecd.org/tax/treaties/mli-database-matrix-options-and-reservations.htm>.

⁶⁷ See *Frequently Asked Questions on the Multilateral Instrument (MLI)*, OECD at ¶17 (July 2017), <http://www.oecd.org/tax/treaties/MLI-frequently-asked-questions.pdf>.

⁶⁸ Convention on Mutual Administrative Assistance in Tax Matters [hereinafter *Administrative Assistance Convention*], available at <https://dx.doi.org/10.1787/9789264115606-en>.

⁶⁹ *Id.*

⁷⁰ *Id.* at art. 6.

⁷¹ See *Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information*, available at <http://www.oecd.org/ctp/exchange-of-tax-information/multilateral-competent-authority-agreement.pdf> (implementing the Common Reporting Standard, which is the OECD’s FATCA-based standard for the automatic exchange of financial account information with respect to offshore accounts); *CRS Multilateral Competent Authority Agreement*, available at <https://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/multilateral-competent-authority-agreement.pdf>. Each of these agreements have over a hundred signatory jurisdictions.

⁷² *Administrative Assistance Convention*, *supra* note 71 at art. 11.

Finally, the Administrative Assistance Convention includes features that provide the legal basis for the establishment of a standard-setting body. The Convention has a “coordinating body” with legal authority to furnish opinions on questions regarding the application of the provisions of the convention, including those governing automatic information exchange.⁷³ Importantly, the membership of the coordinating body is limited to competent authorities of jurisdictions that have signed the Convention. Thus, the “price” of being part of the potential standard-setting body established within the Convention, is to agree to a legally binding instrument that requires compliance with the terms that are set.

As of May 2018, the Administrative Assistance Convention covered 128 jurisdictions.⁷⁴ Notably, the United States ratified the original convention (in 1991), and signed the 2010 amendment to the convention, but has not ratified the 2010 amendment.⁷⁵ As a practical matter, a country that has not ratified the 2010 amendment cannot effectively use the Convention as the legal basis for new forms of automatic information exchange, as organized through the competent authority agreement process created via the Convention.⁷⁶

h) Country by Country Reporting

Under the CBCR rules agreed to in the BEPS project, large MNCs are required to file a Country-by-Country Report that reports annually to each tax jurisdiction in which the MNC does business, the amount of revenue, profit before income tax, and income tax paid and accrued in each jurisdiction around the world. CBCR also requires MNCs to report their number of employees, stated capital, retained earnings, and tangible assets in each tax jurisdiction. Finally, it requires MNCs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities that each entity undertakes.⁷⁷ All OECD and G20 countries committed to implementing CBCR, and almost all are now doing so.

⁷³ *Id.* at art. 24.; *See Explanatory Report to the Convention as Amended by the Protocol, Protocol Amending the Convention on Mutual Administrative Assistance in Tax Matters*, OECD ¶240 (May 27, 2010) [hereinafter *Explanatory Report on Amended Administrative Assistance Convention*], available at <http://www.oecd.org/dataoecd/7/62/48091084.pdf>. The OECD is the secretariat for this coordinating body. *Id.* at ¶238.

⁷⁴ *Jurisdictions Participating in the Convention on Mutual Administrative Assistance in Tax Matters*, OECD, https://www.oecd.org/tax/exchange-of-tax-information/Status_of_convention.pdf (last visited May 29, 2019).

⁷⁵ The 2010 amendment to the convention was primarily concerned with updating the information exchange standards to reflect the new more cooperative environment for international tax information exchange that emerged in the years immediately following the financial crisis.

⁷⁶ For example, without signing the protocol no country can use the convention in its administrative assistance relationship with countries that were not in the Council of Europe or the OECD in the 1990s. *See also generally* JOINT COMM. ON TAXATION, *Explanation of Proposed Protocol Amending the Multilateral Convention on Mutual Administrative Assistance in Tax Matters*, JCX-9-14 (Feb. 21, 2014).

⁷⁷ OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (2015), <http://dx.doi.org/10.1787/9789264241480-en>.

To date, CBCR is the most notable corporate tax example of a G20-convened information reporting standard. Given how deeply objectionable CBCR reporting was for the private sector, and the high levels of disagreement in revising substantive transfer pricing guidance among governments, the ease with which CBCR was agreed upon between governments and is now being successfully implemented is quite striking. The key lesson, consistent with the scholarship on international financial law,⁷⁸ is that in G20-convened processes, information reporting can often be agreed to even when the coordination of related substantive law proves too difficult.⁷⁹

When it comes to regulating MNCs, the information reporting context differs from the substantive law context in that global imposition of a standard can often be achieved without affirmatively coercing dissenting states, so long as the required reporting is clearly specified and agreed as soft law in a multilateral setting. CBCR is in effect a G20 Soft Law rule that lacks a coercive measure agreed to at the international level in order to ensure compliance. However, once CBCR was adopted at the OECD level, the basic reality was that any sovereign could require the local subsidiary of an MNC to report CBCR information on the activities of an entire multinational group. Furthermore, after the BEPS project such a sovereign could point to international norms endorsing CBCR and providing a template for how the information should be reported to justify its reporting requirements and to suggest that the MNC would have developed systems to collect the relevant data, since it would need to report CBCR information to one country or another. Thus, non-compliance by any individual sovereign (even a powerful sovereign like the United States) was not likely to be effective.

As the United States Treasury Department and the IRS wrote in the preamble to their final regulations implementing CBCR “U.S. MNC groups will be subject to country-by-country (“CbC”) filing obligations in other countries in which they do business if the United States does not implement CbC reporting.” The U.S. Treasury and the IRS went on to note that for this reason, not only would non-implementation be futile, but failure to adopt CbC reporting requirements in the United States may increase compliance costs because U.S. MNC groups may be subject to CbC filing obligations in multiple foreign tax jurisdictions. U.S. MNC groups might also be subject to varying CbC filing rules and requirements in different foreign tax jurisdictions, such as requirements to prepare the CbC report using the

⁷⁸ See generally Pierre-Hugues Verdier, *The Political Economy of International Financial Regulation*, 88 Ind. L.J. 1405 (2013).

⁷⁹ G20 Soft Law Processes that create reporting standards have often been successful. For example, the G20 convened the soft law standard-setting process that the International Organization of Security Commissioners (“IOSCO”) undertook to reach their Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information. The IOSCO MMoU improved and standardized exchange of information cross-border for the purpose of regulatory enforcement regarding securities markets. Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMoU), INT’L ORG. OF SEC. COMM’N, <http://www.iosco.org/about/?subsection=mmou> (last visited Feb. 2, 2015). See generally, Kal Raustiala & Anne-Marie Slaughter, *International Law, International Relations, and Compliance*, THE HANDBOOK OF INTERNATIONAL RELATIONS (Walter Carlsnaes, Thomas Risse & Beth Simmons, eds., 2002). Similarly, the OECD’s Common Reporting Standard began in part as a G20 convened information reporting standard setting exercise. It too has been quite successful.

local currency or language.”⁸⁰ As a result of the dynamic correctly described by the U.S. Treasury and IRS, every major MNC headquarters jurisdiction adopted CBCR rules.

2) Stabilizing CE Method using MLI Approach

In the CE Method, tax disputes would inevitably be multi-country income-based (rather than two-country transaction-based) disputes. The main reason the disputes would be multi-country arises from two interacting features of the CE Method. First, in the CE Method a residual return must be calculated on a unitary basis at the level of the consolidated group. That unitary residual return is then split so as to allocate a portion thereof to market intangibles and apportion that amount to multiple jurisdictions. Second, the determination of what constitutes a residual return as opposed to a routine return involves applying conventional bilateral transfer pricing concepts. As a result, every jurisdiction in theory has an interest in what were conventionally purely bilateral disputes. Moreover, every jurisdiction has an interest in the fraction of the residual that any given jurisdiction claims should be apportioned to them, because the result may affect what is “left over” for all other jurisdictions to claim. The destination fraction is relevant in all cases as a result of the final liability structure (as contrasted with a minimum tax structure) of the CE Method.

Consider what would be required to embed the CE Method calculation in the tax treaties. First, Article 9 and the OECD transfer pricing guidelines would clearly need to be amended to include all specifications required to reach a consistent, unitary calculation of residual returns. Otherwise it would not be possible to prevent double taxation, as intended by the tax treaties, because the residual return allocated to market intangibles would vary based on each country’s calculation of the size of that residual return.

Article 5 would similarly need to be amended to revamp the PE standard so as to allow for some form of taxable nexus for the new taxing right in a case where the only connection between a taxpayer and a jurisdiction is a given level of sales (or “users”). Presumably this change would be made (somehow) without changing the PE standard for other purposes.

Article 7 and the AOA would then need to be revamped to parallel the changes that were made to Article 9 to allow for the CE Method. All jurisdictions would then need to adopt the new Article 7. In the CE Method, consistent adoption of the revised profit attribution rules would be much more important than is consistent adoption of the AOA under current law.⁸¹

Now consider whether amending only a subset of tax treaties could adequately implement the CE Method. Even if Articles 5, 7, and 9 of the OECD Model Treaty and the OECD TPG were all modified to include a methodology for implementing the CE Method, actual

⁸⁰ Country-by-Country Reporting, 81 Fed. Reg. 42482 (June 30, 2016).

⁸¹ Alternatively a new special nexus article with associated profit allocation rules that somehow stood independently from Articles 5, 7 and 9 and nevertheless integrated and interact with them would need to be added to the treaties. As a first order matter this neither seems simpler nor to fundamentally affect the analysis.

implementation would remain inadequate. If some countries or country pairs continued using the old arm's length Article 9 standard, or the old Article 5 PE standard, and the prior AOA or other domestic approaches to attributing profits to PEs, while other countries reallocate some significant fraction of unitary income based on the CE Method, incoherence would almost inevitably result.

Further consider whether the bilateral tax treaty system would resolve disputes in a CE Method even if all countries agreed in principle on a methodology for the unitary calculation underlying the CE Method. Assume (perhaps heroically) that the countries were able to reduce the CE Method agreement to language amenable to being incorporated into Articles 5, 7, and 9 of the OECD Model Treaty, all to be implemented in extant tax treaties through an amendment to the MLI that all IF jurisdictions signed. Would this suffice to successfully implement the CE Method? The answer is: no.

The problem that arises with implementing the CE Method through an MLI Approach is related to all of the following: 1) the split between routine and non-routine returns; 2) the use of transfer pricing to determine the split between routine and non-routine returns, as well as the value of routine returns and non-routine returns associated with market intangibles; and 3) the unitary nature of the CE Method.⁸² The unitary issue is the most central problem. As a result of the unitary approach, when one jurisdiction has determined that it is owed more than is appropriate, either because it has claimed too much routine profit or because it has claimed too large a share of non-routine profit, it is not clear which of the other jurisdictions in which the MNC reports income, has been harmed.

Said another way, in the CE Method, when one jurisdiction is due more tax revenue than the MNC pays that jurisdiction, it is deeply unclear which jurisdiction in the world should receive less tax base. If multiple countries take the position that they may claim more tax base than the MNC believes is properly allocable to those countries, a treaty system consisting exclusively of bilateral, state-to-state obligations, combined with a calculation of tax liability based on facts and circumstances bilateral transfer pricing and unitary measurements of residual taxable income, simply cannot effectively resolve the question of which tax administration should lose out when another tax administration either appropriately or inappropriately claims revenue.

Another way to see the issue is to consider whether "last best offer" arbitration (of the type that appears in Article 25(5)) could resolve disputes that would arise in a CE Method system. Last best offer arbitration by definition only works in disputes between two parties. A panel of three judges can pick between two outcomes by means of a vote without specifying why they prefer one outcome over the other. The same panel cannot produce

⁸² Some of the problems raised by the combination of the unitary nature of the CE Method and the attempt to impose a distinction between residual returns associated with market intangibles and other residual returns in defining the new taxing right allocated to market jurisdictions might (perhaps) be lessened through reliance on underlying managerial accounting figures used to develop financial reporting. But in that case the problems associated with relying on financial accounting with respect to measurements that are of minimal independent importance to investors arise. See fn [y] and accompanying text, *infra*.

that outcome in multiparty disputes.⁸³ As a result, any dispute resolution system intended for the CE Method would have to take decisions that formally or informally serve as precedent. Moreover, it is impossible to imagine that governments would allow a panel of arbitrators to reach an independent determination of the amount of tax multiple jurisdictions should collect from a given MNC, without requiring the arbitrators to explain themselves. So, the CE Method requires reason-based multiparty arbitration.

If tax treaties do not provide the arbitration outlet for MNCs to contest multiple inconsistent assessments in a CE Method system, MNC litigants would attempt to draw in neighboring international economic law regimes to resolve the arising double taxation matters.⁸⁴ The investment and trade treaties that neighbor tax treaties often provide for compulsory adjudication (albeit with tax carve-outs built into some agreements). However, they are an extraordinarily imperfect fora to interpret and develop the meaning of complex new international tax rules that are intended to be of general application. If tax authorities and ministries of finance want to retain any semblance of control of the adjudication that would arise in a CE Method system, they would eventually be forced to establish dedicated world tax tribunals. The alternative would be to be sidelined by trade officials, investment arbitration lawyers, or foreign affairs/state department diplomats. Yet the establishment of a world tax court is difficult to imagine given the importance states place on tax sovereignty.

If a true multilateral treaty and a world corporate income tax court is an impossibility, the CE Method seems extremely challenging to stabilize internationally using mandatory binding arbitration. The tax treaty network, the OECD TPG, the MAP system, and the MLI+ Approach in general provide no avenue for stabilizing such a regime, because that entire system is by definition bilateral, while the CE Method is fundamentally unitary; even worse, unitary with an underlying reliance on facts and circumstances transfer pricing.

3) Stabilizing the OM Method using the MLI Approach

The OM Method would specify the minimum taxable income due from a multinational group in a given jurisdiction as a fixed return on sales that would vary based on global operating margins. The OM Method does not rely on taxable income calculations at the consolidated group level, nor does it require determining market intangible-related

⁸³ There are of course ordinal ranking voting systems that can usually produce a result with any number of voters and any number of options. But this requires creating weighting factors or other tiebreaking systems for second and third preferences and has never been used in any legal or arbitral process of which I am aware.

⁸⁴ Indeed, such migration has already begun, in part as a result of the growing pressures on the international tax regime. Consider, for example, the tax component of the *Yukos v. Russia* arbitration, which was arbitrated under the Energy Charter Treaty. *Yukos v. Russia*, PCA Case No. AA 227, Final Award (Perm. Ct. Arb. 2014), <http://www.italaw.com/sites/default/files/case-documents/italaw3279.pdf>; Panel Report, *Argentina – Measures Relating to Trade in Goods and Services*, WTO Doc. WT/DS453/R (adopted Sept. 30, 2015) (under appeal). Cf. Itai Grinberg and Joost Pauwelyn, *The Emergence of a New International Tax Regime: The OECD's Package on Base Erosion and Profit Shifting (BEPS)*, 19 ASIL Insights 24, <https://www.asil.org/insights/volume/19/issue/24/emergence-new-international-tax-regime-oecd%E2%80%99s-package-base-erosion-and>

development expenses, product research and development expenses, or any other intangible development expenditures at the consolidated group level. The substantial reduction in unitary components makes the OM Method more amenable to implementation via the MLI+ Approach than the CE Method.^{85 86}

As in the CE Method, in the OM Method one jurisdiction could determine that it is owed more than is appropriate. However, in the OM Method, the deviating jurisdiction would do so either by reaching a higher operating margin than is appropriate, or higher revenue numbers than are appropriate, or a higher destination percentage for their jurisdiction than is appropriate. As in the CE Method, if this happened it would not be clear which other jurisdiction had been harmed. But in the OM Method the conflicts seem more manageable, even if they are multijurisdictional, simply because there are only three levers that can lead to inappropriately high allocations to a given market jurisdiction. Facts and circumstances transfer pricing has no role at all. Moreover, one can imagine relatively clear guidance specifying how to calculate the appropriate unitary operating margins and revenue numbers, as well as the destination percentage calculation. In the most basic case, the asserted values for overall operating margins and overall revenues would clearly be uniform as among jurisdictions, because the system would rely entirely on financial accounting principles and audited financial statements.

Moreover, one can at least begin to imagine capturing any additional concepts that would be required (destination of sales, measurement of revenues or operating margins on a business line basis) in a revised CBCR report that would present relevant figures that jurisdictions would then be expected to apply to determine the allocable market profit amount. Finally, if a rule specifying when a jurisdiction is a “surrender jurisdiction” was also adopted into bilateral treaties through the MLI, MNCs could then use MAP and binding arbitration to ask the surrender sovereign to bring a proceeding where a jurisdiction was asserting excessive taxing rights.

Special rules to automatically provide information that would further aid in auditing the OM Method could be incorporated through a competent authority agreement entered into pursuant to Article 6 of the Administrative Assistance Convention (the restrictions of Article 22 of the Administrative Assistance Convention should not be material in this regard). Such rules could be adopted either as an amendment to the existing country-by-country reporting architecture, or as an entirely separate multilateral competent authority agreement under the auspices of the Administrative Assistance Convention.⁸⁷

⁸⁵ In other words, the basic OM Method is more amenable to implementation through a network of bilateral mechanisms because it represents a generally “bottom-up” approach, as contrasted with a “top-down” unitary approach.

⁸⁶ Note, however, that this conclusion is not intended to suggest that the OM Method is normatively desirable.

⁸⁷ While the Administrative Assistance Convention is only able to provide for administrative assistance (and not substantive reallocation rules), in the context of a project with distributive consequences, the ability to require signing onto a policy amendment to the treaty in order to keep voting rights in future work around the project may be a meaningful tool for encouraging compliance.

As the OECD points out in a less consequential context, making such arrangements work would likely require “consistent reporting of income in each country” that is a party to the agreement.⁸⁸ Consistent reporting is most easily enforced if it is based on some set of externally established financial reporting concepts.

Applying such reporting arrangements to enforce the OM Method would constitute a transformational expansion of competent authority agreements. Nevertheless, a competent authority agreement might be used to further underpin the OM Method.

In sum, at a high level the MLI+ Approach seems more workable for the OM Method than for the CE Method. Three key technical features lead to that result. First, the OM Method relies on a minimum tax architecture. This means that in many cases the precise results of the OM Method are not determinative of tax liability; rather they create incentives for MNCs to plan to meet some realistic threshold of liability through transfer pricing. Second, it is highly reliant on financial accounting, and therefore to a substantial degree avoids the tax base conformity conundrum of unitary taxation.⁸⁹ Finally, the OM Method does not mix arm’s length transfer pricing concepts into the determination of the minimum tax amount.

The OM Method in its simplest form largely dispenses with the problems of unitary taxation, but in doing so raises questions about the policy consequences of relying on financial reporting to obtain tax results. There is an extensive literature on this subject. Tax policymakers, financial market regulators, and others concerned with issues of financial accounting policy all have a stake in these types of book-tax conformity questions.⁹⁰

The first fundamental concern of the book-tax conformity literature that has relevance in this context involves the interest governments might have in influencing financial reporting rules in an environment where those rules determine the allocation of tax revenues as among jurisdictions. Importantly, the relevant financial reporting rules are in principle

⁸⁸ OECD TPG, *supra* note 36, at ¶ 4.124. The safe harbors discussion of the OECD TPG observes that a multilateral competent authority agreement among jurisdictions in tax treaties with one another “could, by agreement, define [one or more] categor[ies] of taxpayers and/or transactions to which a safe harbour provision would apply and by agreement establish pricing parameters that would be accepted by each of the contracting countries if consistently applied in each of the countries. Such agreements could be published in advance and taxpayers could consistently report results in each of the affected countries in accordance with the agreement.” *Id.* at ¶ 4.119.

⁸⁹ Note that the fact that a portion of all returns rather than just non-routine returns are allocated to the new taxing right in the OM Method does not, per se, make it easier to stabilize the OM Method using the MLI+ Approach. But any mechanism to separate routine and non-routine returns would either worsen the problem of relying on financial accounting with respect to measurements that are of minimal independent importance to investors, trigger the tax base conformity conundrum, or both.

⁹⁰ *See, e.g.,* Michelle Hanlon & Edward Maydew, *Book-Tax Conformity: Implications for Multinational Firms*, 62 NAT. TAX J. 127, 139-40 (Mar. 2009).

controllable through legislation enacted by residence country jurisdictions.⁹¹ In the OM Method, such rules, as potentially altered by residence country legislatures or residence country accounting standards-setters, could determine the magnitude of the new taxing right that accrues to market country jurisdictions.⁹²

Separately, there is a heated debate in the accounting and finance literature about the benefits and burdens of steps to conform any given financial reporting regime with tax reporting.⁹³ The key detriments identified for book-tax conformity in the literature are 1) a reduction in the quality of information available to investors because reporting is manipulated so as to influence tax outcomes; and 2) potential changes in capital structure among firms subject to increased book-tax conformity.⁹⁴ Generally, the literature suggests that firms subject to increased book-tax conformity requirements tend to take on more debt and reduce equity.⁹⁵ On the other hand, there are analysts that believe that some forms of book-tax conformity can reduce opportunistic reporting to engage in earnings management, tax avoidance, or both.⁹⁶

⁹¹ Even in the absence of legislative responses, determining minimum tax obligations to market country jurisdictions on the basis of financial reporting rules may incentivize MNC management to alter their accounting choices. Theoretically the incentive would be to defer revenue and accelerate expenses. Study of a natural experiment created by certain legal changes in the United States' 1986 tax reform that made certain firms conform their book and tax income showed that firms in fact do engage in this kind of behavior when tax liability can be manipulated thereby. Gary Guenther, CRS Report for Congress, *The Taxpayer Relief Act of 1997: An Overview* (1997). Thus, behavioral questions related to increase reliance on financial reporting for purposes of allocating taxing rights may be important but are generally beyond the scope of this paper.

⁹² Separately, the accounting literature on book-tax conformity documents a notable change in capital structure among firms subject to increased book-tax conformity. Generally, these firms tend to take on more debt, and reduce equity. Bradley Blaylock, Fabio B. Gaertner & Terry Shevlin, *Book-Tax Conformity Capital Structure*, 22 T. REV. ACCOUNT STUD. 903-932 (Feb. 23, 2017).

⁹³ See, e.g., Tanya Y. H. Tang, *Does Book-Tax Conformity Deter Opportunistic Book and Tax Reporting? And International Analyses*, 24 EUR. ACCT. REV. 441 (June 3, 2014).

⁹⁴ See, e.g., Michelle Hanlon & Terry Shevlin, *Book-Tax Conformity for Corporate Income: An Introduction to the Issues*, 19 TAX POL'Y & ECON. 101 (Sept. 2005); Michelle Hanlon, Edward Maydew & Terry Shevlin, *An Unintended Consequence of Book-Tax Conformity: A Loss of Earnings Informativeness*, 46 J. ACCT. & ECON. 294 (2008); Michelle Hanlon, Stacey Kelley Laplante & Terry Shevlin, *Evidence on the Possible Information Loss of Conforming Book Income and Taxable Income*, 48 J. L. & ECON. 407 (Oct. 2005)

⁹⁵ See generally Bradley Blaylock, Fabio B. Gaertner & Terry Shevlin, *Book-Tax Conformity Capital Structure*, 22 T. REV. ACCOUNT STUD. 903-932 (Feb. 23, 2017).

⁹⁶ See, e.g., Mihir Desai & Dhammika Dharampala, *Earnings Management, Corporate Tax Shelters, and Book-Tax Alignment*, HBS Finance Working Paper No. 884812 (Jan. 19, 2009) (concluding that the corporate governance view of taxation recommends an increased reliance on alignment of financial and tax accounting whenever possible); Mihir Desai & Dhammika Dharampala, *Corporate Tax Avoidance and High-Powered Incentives*, 79 J. FIN. ECON. 145 (2006); Judith Freedman, *Aligning Taxable Profits and Accounting Profits: Accounting Standards, Legislators and Judges*, 2 E-J. TAX RESEARCH (Jan 7. 2005); Wolfgang Schön, *The Odd Couple: A Common Future for Financial and Tax Accounting*, 58 TAX L. REV. 111 (Dec. 2005). In the last fifteen years, however, many countries (including, for example, Brazil, China, France, Germany, India, and Russia) have moved away from basing their financial reporting standards on tax rules, and instead have chosen to rely on international financial reporting standards ("IFRS"). As a result, these countries have in effect moved from a tax-based financial accounting system to a book-tax independent system. See, e.g., Tang, *supra* note 97 (pointing out that Brazil, China, France, Germany, India, and Russia all made the change to book-tax independent systems in the last fifteen years).

If the OM Method were pursued, it would seem imperative to determine how the accounting and finance policymaking and private sector communities might analyze the particular form of book-tax conformity represented by the OM Method. After all, under the OM Method, the OECD and tax administrators would be relying on financial regulators to maintain rules that would allow the OM Method to be enforced.

Moreover, if the system relies on financial reporting measurements to determine Pillar One outcomes, decisions made by financial auditors at the Big 4 accounting firms would determine the allocation of corporate tax revenues as among governments. Outsourcing the allocation of taxing rights as among sovereigns to private sector advisors may raise concerns about blurring the line between the appropriate roles of government and the private sector.

Further, all four of the Big Four accounting firms are decentralized (although they are publicly branded as a single entity, they each in fact consist of a series of independent national partnerships). In a financial reporting-driven Pillar One system, the relevant auditing decisions would be made in the country of residence. Thus, for example, a UK-headquartered MNC would be audited in the UK. Query if non-UK market jurisdictions would be comfortable with a private UK financial auditing partnership that is unrelated to any entity in the relevant market jurisdiction deciding how much tax revenue should be allocated to non-UK market jurisdictions by UK-headquartered MNCs. Separately, query whether the non-tax financial auditing components of the Big 4 would have concerns about this new role.

a. Country Pairs without Bilateral Tax Treaties

Importantly, even as among the thirty-seven largest world economies (representing 90% of global GDP), 20% of the bilateral country pairs do not have tax treaties with one another.⁹⁷ Thus the OM Method, even if implemented fully through the MLI+ Approach would not be fully enforceable through treaties. An open question in this regard is whether, with 80% treaty coverage, the remaining country pairs (and other countries pairs lacking a tax treaty with each other) would gravitate towards general compliance with the OM Method.

The first question is whether jurisdictions would follow a revised OECD TPG on OM Method deemed profit amounts in circumstances where they were not in a tax treaty with the designated surrender jurisdiction. Using the OECD TPG as a primary vehicle to stabilize the OM Method in these circumstances does not initially seem viable. Changes to the OECD TPG will tend not to have the same distinctive legal force as changes to the OECD Model Treaty. Various countries (including a number of the largest economies) treat the OECD TPG as merely advisory. Moreover, countries that are not in tax treaties with one another generally cannot enter competent authority agreements (or advanced pricing agreements) with one another.

⁹⁷ Skadden Consultation Document, *supra* note 29.

On the other hand, a true multilateral treaty might not be needed to simulate the relevant arrangements between non-treaty pairs. Rather, to stabilize the most basic OM Method, a substantial degree of internalized transgovernmental comity as among taxing authorities might be imperfect, but sufficient. Furthermore, in principle domestic law on both the market country and surrender jurisdiction sides could in effect mimic the outcome of the OM Method as instantiated into treaties.

History does provide some reason to hope such comity is possible. The relative stability of the international tax system over the course of a fifty year period from the late 1950s until the financial crisis (in the absence of a multilateral organization with legal force), suggests that when disaggregated from broader political pressures, tax administrators in transnational networks tend to form an epistemic community with fairly strong internalization of norms. When politicization of international tax enforcement was low, caring about one's reputation among one's peers transnationally appears to have played an important role for international tax administrators.⁹⁸ Indeed, the creation of the OECD's Forum on Tax Administration was premised on the idea that those pressures could be mobilized to ensure greater harmonization and coordination among tax administrations. Moreover, domestic law and tax treaty standards converged on many important issues over the course of the latter half of the 20th century.

Unfortunately, scholarship suggests that as the political salience of an issue increases, the likelihood of agreed concepts among participants in transnational regulatory communities declines.⁹⁹ Instead, calculations about domestically determined national interests (logics of consequences) increasingly trump technocratic and transnationally constructed understandings of policy coherence (logics of appropriateness).¹⁰⁰ These dynamics are especially powerful when the issues at hand have distributive consequences, as for example with respect to resources as among states.¹⁰¹

The post-BEPS experience provides yet another example for this general finding in the political economy literature. Catalyzed by a high level of political attention to the taxation of multinational enterprises, agreements of a conceptual nature were reached in the BEPS project at a speed that was not imaginable pre-BEPS. Some of those agreements

⁹⁸ Cf. ANNE MARIE SLAUGHTER, *THE NEW WORLD ORDER* 54 (Princeton Univ. Press 2005).

⁹⁹ See Itai Grinberg, *The New International Tax Diplomacy*, citing, among others, DANIEL DREZNER, *ALL POLITICS IS GLOBAL: EXPLAINING INTERNATIONAL REGULATORY REGIMES* (2007); STEPHEN D. KRASNER, *SOVEREIGNTY: ORGANIZED HYPOCRISY* (1999) (arguing that in the international system, when decisions are made by actors subject to or cognizant of domestic political pressures, logics of consequences, meaning rational calculation designed to maximize a given set of unexplained national preferences, tend to trump logics of appropriateness, meaning, for example, regulator community understandings about policy coherence and consequent "appropriate" courses of action for sovereigns); Pierre-Hugues Verdier, *The Political Economy of International Financial Regulation*, 88 *IND. L. REV.* 1405 (2013).

¹⁰⁰ See Grinberg, *supra* note 104.

¹⁰¹ Cf. Peter J. Katzenstein, *BETWEEN POWER AND PLENTY: FOREIGN ECONOMIC POLICIES OF ADVANCED INDUSTRIAL STATES* (Madison: University of Wisconsin Press, 1978). Moreover, logics of appropriateness are at their weakest when there is no principle for a result, as is the case in the OM Method, where a somewhat arbitrary formulaic scale must be used to determine what percentage of sales revenue should be labeled market profit at any given level of operating margin.

meaningfully reduced opportunities for base erosion and profit shifting. Others (most notably the transfer pricing outcomes) were failures that added confusion. Overall, however, the complete package is most fairly judged to have reduced opportunities for base erosion and profit shifting.

Nevertheless, the BEPS project's success did not prevent what the OECD called the specter of "international tax chaos" when it embarked on the BEPS project in 2013.¹⁰² The budding tax/trade war over the French DST is just the tip of the iceberg. Simply look at the growing backlog of mutual agreement procedure disputes that the OECD itself has chronicled; pending MAP cases have more than doubled since the BEPS project began. This statistic understates the magnitude of the problem, because of the growing phenomena of competent authorities refusing to allow disputes to enter the competent authority processes.

A key reason the BEPS project's success in reducing opportunities for base erosion and profit shifting did not translate into preventing international tax chaos, is the continuing high level of politicization of international tax policy. High levels of politicization encourage domestic politics to focus on responses to international tax issues. In contrast, in a depoliticized international tax environment, internalization of norms and concern regarding reputation as among the transnational community of international tax administrators and bureaucrats could act as an informal mechanism to help reduce disputes. This idea is already alive at the OECD and is implicitly embedded in the work being done under the heading of the "Tax Certainty Agenda."¹⁰³ Moreover, bureaucrats have greater authority over tax policy and legislation in such environments.

However, for international peer pressure mechanisms to work to stabilize something like the OM Method, depoliticization of corporate international tax policy would be required. Transnational regulatory interactions that produce shared interpretation and internalization—the kind of interactions that former U.S. State Department Legal Adviser and Yale Law School Dean Harold Koh once labeled "transnational jawboning"—work much more effectively when the domestic political pressures faced by the working level bureaucrats are lower.

For international tax administration to become more consensual and less conflict-ridden, international tax policy would need to be returned to the hands of the technocrats.¹⁰⁴ Today, leading political figures in the U.S. and Europe take positions with respect to corporate international tax multilateral debates for the purpose of strengthening their hand in domestic political fights. If that stopped, to paraphrase Robert Putnam, the actors in the

¹⁰² OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD/G20 Base Erosion and Profit Shifting (2013), <https://www.oecd.org/ctp/BEPSActionPlan.pdf>.

¹⁰³ See, e.g. *FTA Santiago Communiqué* (2019) [hereinafter *Santiago Communiqué*], available at <https://www.oecd.org/tax/forum-on-tax-administration/events/forum-on-tax-administration-communique-2019.pdf>.

¹⁰⁴ For example, regulatory agreements intended to force public disclosure of information can create non-excludable benefits that are also largely non-rival among G20 countries, thereby approaching a global public good, which facilitates agreement.

international tax game would again play only on their own multilateral board, and not be pawns on their respective domestic political game boards as well.¹⁰⁵ They would still, of course, face domestic interest group pressures, but these would not “reach a high political level,” in the manner the OECD has repeatedly stated international corporate tax matters have done since 2012.¹⁰⁶

At the tax administration level, depoliticization of international tax matters would clearly bolster the importance of transnational reputational capital in ways that are likely to improve comity and be highly beneficial to the tax certainty agenda. Joint audits, the FTA large business international programme, ICAP, and multilateral APAs and MAP are all more likely to be effective, not just in solving specific disputes, but in ensuring consistent internalization of norms as among tax administrators in an environment where those tax administrators are subject to only limited domestic political pressures.¹⁰⁷ Even peer review on issues such as whether audits are being undertaken consistent with “Pillar One standards” would likely be more effective if peer review were depoliticized. The key would be to have peer review that was in fact for peers, rather than in order to produce summary reports to the finance ministers of the G20.

Accomplishing the requisite depoliticization would certainly require insulating steps from finance ministers and national leaders, but also from the OECD Secretariat. At the OECD level, it would require the OECD Secretariat holding fewer high-visibility global policy network events that bring together businesses, NGOs, and other stakeholders with government officials. It would require the OECD to return to a more exclusive focus on organizing transgovernmental meetings that tackle technical questions, the role for which the OECD is justly most well-known.¹⁰⁸ At the level of the Secretary General and other senior OECD officials, it would require prioritizing a longer-term, quality policy outcome in international corporate taxation over high-profile processes and institutional prominence.

C. Stabilizing the CE or the OM Methods using a Multilateral Treaty

If depoliticization is not possible, there is always the other path to stabilizing either the CE or the OM Method. This path would involve a true multilateral treaty.

1) Stabilizing the CE Method using a Multilateral Treaty

The Multilateral Treaty Approach is the only way to stabilize a system that includes CE Method components. A true multilateral instrument, unlike the OECD MLI, could create formal, collective state-to-state obligations. For this reason, a multilateral treaty with some meaningful enforcement mechanism is capable of stabilizing many different Pillar One

¹⁰⁵ Robert Putnam, *Diplomacy and Domestic Policy; The Logic of Two-Level Games*, 43 *International Organizations* 427 (1988).

¹⁰⁶ Given the relatively small percentage of national revenue that cross-border taxation generates, this result is quite plausible.

¹⁰⁷ See, e.g. *Santiago Communique*, *supra* note 109.

¹⁰⁸ Anne Marie Slaughter describes the OECD as “the quintessential host of transgovernmental regulatory networks.” SLAUGHTER, *supra* note 104, at 46.

proposals. Unitary components (taxable income calculations at the consolidated group level, a unitary concept of market intangible expense, etc.) still would raise challenges, but rules for consistent measurement and reporting principles and dispute resolution are much more likely to be stable if inscribed into a multilateral treaty. For the same reason, a split between routine and non-routine returns or between non-routine returns attributable to market intangibles and other intangibles becomes somewhat more administrable. Informal comity among tax administrators is less important in the presence of a multilateral treaty. Rather, the principle stabilization mechanism could be through domestic court-based enforcement mechanisms, combined with a transnational arbitral process.

The Vienna Convention on the Law of Treaties also provides for an additional enforcement mechanism in the case of a true multilateral treaty that is never available in the bilateral tax treaties familiar to tax lawyers (or in the case of the MLI). In the event of a material breach of a true multilateral treaty by one of the parties, Article 60.2 of the Vienna Convention allows a party “specially affected” by the breach to suspend the treaty in whole or in part, not only in relations between itself and the defaulting party, but in relation to all parties. The idea is that in an interdependent multilateral treaty, performance of the treaty by each state is a necessary condition of performance by all other states. The consequence in the context of taxation is that if a government believes another sovereign is fundamentally failing to uphold the treaty it can bring meaningful legal pressure to bear from the entire global treaty network to attempt to rectify the situation.

However, high levels of political will would be required to accept the requisite constraints on sovereign autonomy that a true multilateral treaty entails. Historically, jurisdictions have been reticent to sign such a multilateral tax treaty because of the perception that it would reduce tax sovereignty. For over a hundred years, various academics and multilaterally oriented policymakers have dreamed of a true multilateral tax treaty (or a world tax court). But countries have never been interested—the desire to preserve tax sovereignty has always been too strong. Instead, governments have used domestic legislation and bilateral treaties to reach the appropriate balance between national sovereignty and international cooperation in the tax area.¹⁰⁹ Only shared conviction at the finance minister and leader level is likely to overcome the traditional concern that a true multilateral instrument (with, for example, a dispute resolution body) would undermine sovereign autonomy in the tax area.

The question is whether this is a sufficiently cooperative moment in the history of international economic relations such that the political willpower for creating entirely new legal instruments and institutions for multilateral global tax coordination will arise.¹¹⁰

¹⁰⁹ OECD, *Developing a Multilateral Instrument to Modify Bilateral Treaties, Action 15 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (2015), available at <https://dx.doi.org/10.1787/9789264241688-en>.

¹¹⁰ See, e.g., Richard M. Bird, *Shaping a New International Order*, BULL. INT’L FISC. DOC. 292, 297 (1988) (characterizing the desire for a world tax system as “utopian” and unrealistic). Even in circumstances where political will has been quite strong, multilateral tax treaty negotiations have often failed. For example, the first attempt to make a collective agreement on direct taxes, by the States of succession of the Austro-Hungarian dual monarchy, failed due to non-ratification (the so-called ‘Rome treaty of 1922’). In July 1963,

2) Certain Outcomes are Practically Impossible to Stabilize

Importantly, even if a true multilateral treaty were agreed to, it would not fundamentally resolve the stabilization challenges that would arise if the chosen Pillar One solution mixed arm's length transfer pricing and unitary taxation components. In the true multilateral treaty case, the problem is not one of legal impossibility. However, even a multilateral treaty cannot solve the problem of administrative overload. In other words, a system where a residual return must be calculated on a unitary basis at the level of the consolidated group, but the determination of what constitutes a residual return involves applying conventional bilateral transfer pricing concepts, means that every jurisdiction now has an interest in what were traditionally purely bilateral disputes, regardless of the legal instrument that instantiates that system. Unlike the MLI+ Approach, a true multilateral treaty could, in theory, include a mechanism to resolve the resulting disputes. However, as a practical matter it is hard to see how the multilateral treaty would create sufficient dispute resolution capacity. The system would likely suffer from administrative overload and collapse under its own weight. When every jurisdiction has an interest in the size of the residual, which another jurisdiction claims should be allocated under arm's length pricing to the routine returns part of the system, the potential for disputes is just too high.

3) Stabilizing the OM Method using a Multilateral Treaty

One should also note that if a true multilateral instrument were to be agreed upon, it would have a number of clear advantages over any other approach for purposes of stabilizing the OM Method. First, it is much easier to ensure that formulaic market profit amounts based on operating margins are uniform and remain uniform over time in a true multilateral instrument. The rules in an MLI can always be superseded by subsequent bilateral treaties. In contrast, a multilateral treaty can be structured to prevent subsequent bilateral treaties from undermining the broader system. Second, the enforcement mechanisms in a true multilateral treaty would probably be more robust.¹¹¹

Moreover, a rule specifying when a jurisdiction is a "surrender jurisdiction" will be clearer and more effective in a multilateral treaty than under the MLI+ Approach. Relatedly, a true multilateral treaty incorporating the OM Method would be more likely to produce a

the OECD asked what was then the Fiscal Committee 'to report to the Council, as and when appropriate, on the feasibility of concluding a Multilateral Convention for the avoidance of double taxation with respect to taxes on income and capital among all Member countries of the OECD'. That report was never successfully concluded. In 1964 the council of the European Free Trade Area appointed a working party to examine the question of whether a multilateral tax treaty as among the members of EFTA was technically feasible and workable. After five years they concluded it was not. The only existing multilateral tax treaties I am aware of (the Nordic treaty and the Andean treaty) are not truly multilateral; rather they are reducible to a set of bilateral pair agreements.

¹¹¹ The OM Method depends on consistently calculated operating margins, revenues, and destination determinations. Each of these numbers must necessarily be calculated at the consolidated group level, and likely requires information from the parent's residence jurisdiction to audit effectively. A multilateral instrument could easily enshrine such audit assistance. However, as described earlier, such assistance can also be provided through the Multilateral Administrative Assistance Convention.

stable arrangement for addressing loss companies than an OM Method instantiated into law via the MLI+ Approach.

In the MLI+ Approach, the relevant international law in a profit allocation dispute will often be a bilateral tax treaty between an intermediate holding company jurisdiction and a market jurisdiction. Such instruments are ill-suited to a rule that creates an exception based on the loss position of an MNC headquartered in a third country that is not a party to the relevant bilateral treaty. Special rules for loss companies are easier to imagine both being negotiated and remaining operative in a true multilateral instrument. The loss company concern is not a secondary issue: approximately 20% of multinational firms globally have negative earnings before interest and taxes in any given year.

D. Reflecting on the Key Dimensions: Still One Overwhelming Issue, And Now Six Additional Important Considerations

Where does all this leave us? In this paper, the ultimate question is what key structural decisions would make it easier or harder to stabilize any Pillar One proposal, and what questions remain unanswered that would help guide those decisions.

The number one technical question for any Pillar One proposal is defining the destination of sales (without a VAT mechanism to address intermediary distributors and related issues). The destination of sales is the gating issue: without an answer to this question, no Pillar One solution is viable. This problem is described in some detail in my earlier work. Serious attention to the question of how to define destination without reliance on a VAT mechanism is urgently needed.

One key insight of this paper is that the destination problem is somewhat diminished in a minimum tax structure. The problem is less severe because the destination fraction for any given jurisdiction does not necessarily have an impact on final liability to that jurisdiction. Nevertheless, the minimum tax architecture does not adequately resolve the destination fraction issue. What can be said at this juncture is that one would think that a multilateral treaty would more easily instantiate a shared definition of destination into law than an MLI+ Approach.¹¹²

Setting destination aside leaves the six structural decisions that were at the heart of this paper. What did analysis of the strawmen teach us about those six key structural decisions?

First, the analysis shows that the decision to impose a distinction between routine returns and non-routine returns in defining the new taxing right, is not as important to the stabilization question as one might intuit. Rather, the key is how the distinction between routine and non-routine returns is determined. The same is true for any distinction between

¹¹² The point that ex ante a multilateral treaty seems better than the MLI Approach is somewhat obvious. Of course, the counterpoint is that a multilateral treaty is harder to agree upon. The bottom line remains that the CE Method, the OM Method, and all options on the continuum in between require a destination definition. Figuring out how to stabilize the definition multilaterally is ancillary to coming up with a definition in the first place.

residual returns associated with market intangibles and other residual returns. The central point highlighted in the analysis, is that if traditional transfer pricing and valuation concepts are incorporated into a methodology to make either of these two distinctions, the system becomes irreparably unstable.

The problem of distinguishing between routine and non-routine returns at the unitary level while applying transfer pricing concepts is even worse if an MLI+ approach is used to implement the system. But that is not the key point. Rather the central takeaway is in effect that a system that mixes 1) a new taxing right that is based on any destination principle with 2) traditional transfer pricing concepts, cannot possibly be stabilized. Even a true multilateral treaty cannot realistically solve the problem.¹¹³

Second, unitary calculations to define the new taxing right allocated to market jurisdictions are not amenable to being stabilized using the MLI+ Approach. The basic OM Method is easier to stabilize than the CE Method in an MLI+ Approach for the reason that it nearly eliminates reliance on unitary elements. Where it does rely on unitary elements, it relies entirely on financial and managerial accounting measurements. The conclusion holds but is substantially weakened if the OM Method is applied by business line and therefore uses a limited number of measurements that build on, but are not required by, current financial reporting principles. In that case, one might imagine the measurements being sufficiently discrete that they might be added to CbC-style reporting in an enforceable and administrable manner.

Third, if the chosen Pillar One approach relies on financial reporting, the policy questions that arise out of relying on financial accounting to determine tax results must be addressed. The three most important questions revolve around:

- the potential for residence jurisdictions to change accounting principles in light of the Pillar One agreement;
- the level of comfort that market jurisdictions can achieve with private sector financial auditors in residence jurisdictions determining the amount of tax revenue being allocated to market jurisdictions;
- the concerns that might be raised by financial regulators with book-tax conformity that makes financial accounting standards (rather than legislated tax accounting rules) primary; and

Fourth, a minimum tax architecture to implement the new taxing right allocated to market jurisdictions substantially relieves pressure on any version of the Pillar One new taxing right relative to a final liability rule. In many cases, a minimum tax architecture would create incentives for MNCs to build transfer pricing structures that align with the new taxing right.

Conclusion

¹¹³ Note that this criticism would also extend to the so-called RPA-I proposal made by Devereux, Auerbach, Oosterhuis, Schön and Vella. Devereux et al, *supra* note 35.

One major stated goal of the current OECD work programme is to maintain or reestablish international tax order. The Pillar One effort to reallocate taxing rights raises important questions regarding whether this goal can be achieved. In 2019, the Inclusive Framework has committed to determining the general approach they wish to pursue under Pillar One. It is important that participating country delegates consider during that period, and not only thereafter, what legal and political instruments would be required to implement and stabilize any given Pillar One approach.

Six key structural decisions that can impact the ability to stabilize the international tax architecture are likely to be implicitly taken in choosing a general approach for Pillar One. The six key decisions with respect to the new taxing right allocated to market jurisdictions are:

1. Whether or not to attempt to impose a distinction between routine returns and non-routine returns in defining the new taxing right
2. Whether or not to attempt to impose a distinction between residual returns associated with market intangibles and other residual returns
3. Whether or not to include traditional transfer pricing concepts as a component of the Pillar One solution
4. Whether or not to rely on consolidated tax base (unitary) calculations
5. Whether and how to use financial reporting concepts
6. Whether or not to use a minimum tax architecture

The decisions reached along these six dimensions will determine what set of tools have any chance of stabilizing the agreed upon architecture.

The paper used two strawmen—the CE Method and the OM Method—to examine whether any set of answers to the six questions raised above can be successfully stabilized, and which tools would be required to do so.

First, I conclude that no version of the new taxing right of Pillar One can be stabilized using the G20 Soft Law Approach.

Second, I conclude that the simplest version of the OM Method might be implemented using the MLI+ Approach. That is to say, a combination of tools previously used multilaterally by the OECD in the international tax area could be used to stabilize the OM Method. It would, however, be less stable than implementing the same Pillar One concept through a true multilateral instrument. One important reason a multilateral treaty is preferable is that the MLI+ Approach is ill-suited to deal with MNCs with losses, and about 20% of MNC have negative EBIT every year. Moreover, using the MLI+ Approach to implement the OM Method would raise significant questions about the consequences of relying on book-tax conformity, and the issues raised there are not limited to issues of tax policy. Policymakers from other technical domains will have an important stake in such decisions.

Third, I conclude that as one moves further from the simplifying conventions of the OM

Method, a truly multilateral treaty becomes increasingly essential.

Fourth, even a Pillar One approach based on a true multilateral treaty will fail if the approach attempts to incorporate traditional transfer pricing principles within the new taxing right itself; the amount of the new taxing right must be defined without regard to facts and circumstances transfer pricing if there is to be any hope of stabilizing the regime.

Finally, determining the destination of sales is a gating issue for any Pillar One proposal. Although that problem is beyond the scope of this paper, it was addressed in detail in my earlier work.¹¹⁴ Absent a workable solution to the destination determination issue stabilizing Pillar One is not possible.

¹¹⁴ Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate*, TAXES 85-118 (Mar. 2019).