

New Taxing Right in the Unified Approach: Old Wine in a New Bottle

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ABSTRACT:

The OECD's 'Unified Approach' (UA) features new taxing rights allocated to market jurisdictions irrespective of the existence of physical presence. While this new taxing right is intended to address tax challenges of a new economic pattern, i.e. the digitalisation of the economy, these authors note that similar challenges already existed even before the era of digitalisation, particularly with respect to the attribution of profit to the dependent agent permanent establishment (DAPE). The authorized OECD approach (AOA), which hinges the profit attributable to a DAPE upon the significant people function performed by the dependent agent (DA), has been heavily criticized. In this regard, the UA provides a more reasonable and simplified solution: the source state is entitled to tax at least a portion of the residual profit made by the non-resident enterprise from the business undertaken in that state through the DAPE regardless of the extent of the functions performed by the DA enterprise. This approach has indeed already been implemented by certain countries in their domestic tax practices regarding the DAPE profit attribution, albeit couched in traditional transfer-pricing terms. At the same time, these domestic tax practices on the DAPE profit attribution may enlighten the improvement to the UA that has been criticized for its complexity and uncertainty.

1. INTRODUCTION

Since October 2019, the OECD has developed a 'Unified Approach' (UA) under Pillar One, which concerns the allocation of taxing rights between jurisdictions in the context of digitalisation.¹ The UA features a 'new taxing right', i.e. taxing rights

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¹ OECD, *Secretariat Proposal for a 'Unified Approach' under Pillar One*, Public Consultation Document 9 Oct. 2019 – 12 Nov. 2019, 3-5 (OECD Publishing 2019).

allocated to market jurisdictions irrespective of the existence of physical presence.² The label of ‘new’ taxing right suggests that this novel approach targets the tax challenge of a new economic paradigm, i.e. the digitalisation of the economy, particularly with respect to the phenomenon of ‘scale without mass’.³

These authors, however, take the view that the traditional fiscal world in the absence of the digital economy has already been frequented and many times disturbed by scale without mass. This issue is most notably reflected in the debate on the attribution of profit to the dependent agent permanent establishment (DAPE), a situation in which a non-resident taxpayer has no physical presence of his own in a source state, and his business in that country is typically outsourced to a local enterprise in the country.⁴ The authorized OECD approach (AOA) hinges the profit attributable to a DAPE upon the significant people function performed by the DA enterprise, a method that has caused much confusion.⁵ In this connection, these authors will strive to demonstrate how the new taxing right under the UA may enlighten the DAPE’s profit attribution as well as the entire AOA, which has been heavily criticized for its complexity and lack of coherence.⁶ Indeed, as will be demonstrated in a later section, some domestic courts have already acknowledged, albeit in an unconscious and indirect manner, the rights of source states to tax non-resident enterprises with DAPEs within those states regardless of the function performed by the DAs.⁷ In this sense, both scale without mass and the new taxing right endorsed by the UA are rather ‘old wine in a new bottle’. At the same time, the domestic legal practice on DAPE profit attribution may also provide some useful insights to the refinement of the UA that has also been increasingly under criticism.⁸ Accordingly, the mutual enlightenment between the UA and the discussion on DAPE profit attribution is at the heart of this article.

² OECD, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Base Erosion and Profit Shifting Project, 8 (para.10) (OECD Publishing 2020).

³ Scale without mass denotes a phenomenon in which, owing to technological advances, businesses are able to increase substantially in size and reach with minimal increases in the number of personnel and other physical assets required to perform day-to-day operations of the businesses. See OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, 66 (para.158) (OECD Publishing 2015).

⁴ OECD Model Convention (2017), Art. 5 (5).

⁵ See Section 4.2 below.

⁶ P. Baker, *The League of Nations’ Draft Convention for the Allocation of Business Income between States – a New Starting Point for the Attribution of Profits to Permanent Establishments*, 5 *British Tax Review*, 514 (2018), 514; L. Oats, A. Miller & E. Mulligan, *Principles of International Taxation*, 264 (6th ed., Bloomsbury Professional 2017).

⁷ See Section 4.4 below.

⁸ A.P. Dourado, *The OECD Unified Approach and the New International Tax System: A Half-Way Solution*, 48 *Intertax* 1, 3 (2020); Y. Brauner, *Lost in Construction: What Is the Direction of the Work on the Taxation of the Digital Economy?* 48 *Intertax* 3, 270 (2020).

In what follows, an outline of the UA and the AOA will be laid out in Sections 2 and 3, respectively. Part 4 contains a critical analysis of the AOA to the profit attribution for the DAPE followed by a proposed solution informed by the UA. The part is concluded by a case study. Part 5 provides some critical comments on the UA, drawing on the insights from domestic practice on DAPE profit attribution. Part 6 concludes.

2. OUTLINE OF THE UA

The UA seeks to build a consensus-based approach that is based on various previous recommendations, which can be grouped into three major proposals: the ‘user participation’ proposal, the ‘marketing intangibles’ proposal, and the ‘significant economic presence’ proposal.⁹ In particular, the UA highlights a commonality of all of the three proposals, i.e. the acknowledgement that a market jurisdiction is entitled a taxing right no matter whether there is a physical presence within this jurisdiction.¹⁰ Nonetheless, the UA is only applicable to in-scope businesses, i.e. automated digital services and consumer-facing businesses.¹¹

The UA identifies three types of taxable profit that may be allocated to a market jurisdiction described as Amount A, Amount B, and Amount C, respectively.

Amount A: A share of residual profit allocated to market jurisdictions irrespective of the existence of physical presence. This amount is derived by using a formulaic approach applied at a multinational enterprise (MNE) or business line level.¹² The so-called residual profit is the profit that would remain after allocating arm’s length remuneration to all routine activities performed in relation to the business concerned.¹³

Amount B: A fixed remuneration based on the arm’s length principle for baseline distribution and marketing functions that occur in the market jurisdiction.¹⁴

Amount C: Any additional profit for in-country functions that exceed the baseline activity covered by Amount B.¹⁵

⁹ OECD, *Secretariat Proposal for a ‘Unified Approach’ under Pillar One*, *supra* n. 1, at 3 (para. 4).

¹⁰ OECD, *Secretariat Proposal for a ‘Unified Approach’ under Pillar One*, *supra* n. 1, at 4 (paras 7, 10).

¹¹ OECD, *Secretariat Proposal for a ‘Unified Approach’ under Pillar One*, *supra* n. 1, at 7 (paras 19, 20).

¹² OECD, *Secretariat Proposal for a ‘Unified Approach’ under Pillar One*, *supra* n. 1, at 6 (para. 15).

¹³ OECD, *Secretariat Proposal for a ‘Unified Approach’ under Pillar One*, *supra* n. 1, at 9 (para. 30).

¹⁴ OECD, *Secretariat Proposal for a ‘Unified Approach’ under Pillar One*, *supra* n. 1, at 6 (para. 15).

¹⁵ OECD, *Secretariat Proposal for a ‘Unified Approach’ under Pillar One*, *supra* n. 1, at 9 (para. 30).

As the UA recognizes, Amounts B and C are based on the existing transfer pricing (TP) rules.¹⁶ Only Amount A embodies the aforementioned new taxing right, and there are nexus requirements for its application. Specifically, for automated digital businesses, the revenue threshold will be the only test required to create nexus. For consumer-facing businesses, nexus showing a sustained interaction with the market jurisdiction by the MNE is further required in addition to the revenue threshold.¹⁷ This scope limitation reinforces the impression that the new taxing right is only intended for the new economic paradigm.

The UA further recognizes that a strong emphasis on dispute prevention and resolution is integral to each of the above three amounts.¹⁸ An improved dispute-resolution process is of particular relevance for the determination of Amounts A and C, both of which may ‘eat into’ the profit of non-routine activities related to the business and hence overlap with each other.¹⁹

3. OUTLINE OF THE AOA

Pursuant to Article 7 (1) of the OECD Model, the basic principle of allocating tax rights over business income between contracting states works as follows: unless a non-resident enterprise has a permanent establishment (PE) in the host country, the business profit of that enterprise may not be taxed by the host country.²⁰ Conversely, once an enterprise has a PE in the host country, it is then necessary to determine what, if any, are the profits that the host country may tax.²¹ The AOA to the attribution of profits to the PE is epitomized in the *2010 Report on the Attribution of Profits to Permanent Establishment* (2010 Report) and Article 7 of the OECD Model.²² The basic idea of the AOA is to hypothesize a PE as a separate and independent enterprise so that the Transfer Pricing Guidelines (TP Guidelines)²³ developed in connection with Article 9 of the Model Convention can be extended to the circumstance of PEs.²⁴

¹⁶ OECD, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*, *supra* n. 2, at 8 (para. 11).

¹⁷ OECD, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*, at 13 (paras 38, 39).

¹⁸ OECD, *Secretariat Proposal for a ‘Unified Approach’ under Pillar One*, *supra* n. 1, at 13 (para. 50).

¹⁹ OECD, *Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalisation of the Economy*, *supra* n. 2, at 8 (para.10), 16 (paras 56, 57).

²⁰ OECD Model Convention (2017): Commentary on Article 7, paras 1, 2.

²¹ OECD Model Convention (2017): Commentary on Article 7, paras 1, 2.

²² OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD Publishing 2010);

OECD Model Convention (2017): Commentary on Article 7, paras 21-22.

²³ OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing 2017).

²⁴ R. Couzin, *The OECD Project: Transfer Pricing Meets Permanent Establishment*, 53 *Canadian Tax Journal* 2, 401, 402 (2005).

Specifically, the AOA recommends a two-step analysis in this regard.

Step 1: Functional and factual analysis

This first step aims to hypothesize the existence of a PE as a separate and independent enterprise since otherwise, in a legal sense, a PE is always an integral part of its headquarter enterprise. Essentially, the analysis delineates the ‘boundary’ of a PE – i.e. its rights and obligations, economic ownership of assets, attribution of risks, attribution of capital, etc. – by reference to significant people functions performed in the PE.²⁵

Step 2: Comparability analysis

Under this step, the dealings of the PE will be compared to transactions of independent enterprises that have the same or similar characteristics in terms of, inter alia, functions, assets, and risks. In particular, the internal dealings between the PE and the other part of the non-resident enterprise will be examined on an arms’ length basis.²⁶

The AOA has been heavily criticized for its complexity. Indeed, the method “has not found many supporters, and has been rejected by a large group of countries”.²⁷ Part of its complexity concerns Step 2, which involves the application of the Guidelines. Nevertheless, the difficulties of applying the Guidelines are common to all types of TP cases (although the PE context does complicate the situation further).²⁸ In contrast, the most difficult part of the AOA relates to the first step that rests the boundary of a PE upon the concept of significant people function. It could be seen that the AOA together with Article 7 establish the physical presence, either being a fixed place or some significant people functions, as the foundation of nexus and profit allocation rules with respect to business income. This ‘brick-and-mortar’ approach is in accordance with the benefit principle underlying the PE regime, i.e. taxes should be paid where the business would typically avail itself to a significant degree of public goods provided by the state.²⁹ However, as will be argued in the following section,

²⁵ OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22, at 14-20 (paras 13-38); OECD Model Convention (2017): Commentary on Article 7, para. 21.

²⁶ OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22, at 20 (paras 39-43); OECD Model Convention (2017): Commentary on Article 7, para. 22.

²⁷ Oats, Miller & Mulligan, *supra* n. 6, at 264; Baker, *supra* n. 6, at 514.

²⁸ See OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22, at 14 (para. 14); Couzin, *supra* n. 24, at 404-405.

²⁹ J. Becker & J. Englisch, *Taxing Where Value Is Created: What’s ‘User Involvement’ Got to Do With It?* 47 *Intertax* 2, 161, 162 (2019); see also K. Holmes, *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application* 20-21 (2nd ed., IBFD 2014).

this conventional approach to profit allocation regarding business income and the narrowly construed benefit-principle are questionable even for the traditional fiscal world absence of digitalisation. The issue becomes particularly acute when the DAPE's profit attribution is concerned.

4. PROFIT ATTRIBUTION TO THE DAPE: INSIGHTS FROM THE UA

4.1 Single-taxpayer vs. dual-taxpayer approach

Pursuant to paragraph 5 of Article 5, if a non-resident enterprise carries on its business in a source state through a person situated in that state and that person acts as a dependent agent (DA) of the enterprise, then it is deemed that the enterprise has a PE, typically known as the DAPE, in the source state. It should be noted that, although the DA acts on behalf of and is contractually dependent on the principal, it is *per se* a separate enterprise conducting its own businesses with a view to profit.³⁰ Therefore, the DA will be rewarded for the services it provides to the non-resident taxpayer, and the profit of the DA will be taxed by the source country. In this connection, some commentators contend that, in all circumstances, the payment of an arm's length reward to the DA should fully extinguish the profit attributable to the DAPE.³¹ Accordingly, the only taxpayer in the source country with respect to the cross-border business is the DA, which is usually a resident enterprise to the source country. This proposal is known as 'the single-taxpayer approach'.³²

The flaw of the single-taxpayer approach is evident. Among others, this approach 'would mean that there would never be profit consequences resulting from the finding of a dependent agent PE, thereby making Article 5 (5) largely redundant'.³³ In this connection, the AOA maintains that a DAPE is different from a DA. In addition to the reward to the DA, further profit may be attributable to the DAPE if the DA performs significant people functions relevant to the assumption of risks, the economic ownership of assets, etc.³⁴ This method can be referred to as 'the dual-taxpayer approach'. For example, if the DA performs significant people functions relevant to the development of a market intangible in the source country, then the economic ownership of the intangible will be attributed to the DAPE proportionally – though,

³⁰ Holmes, *supra* n. 29, at 186.

³¹ OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22, at 60 (para. 235).

³² OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22.

³³ OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22, at 61 (para. 239).

For other criticisms of the single-taxpayer approach, see 61 (paras 236-238).

³⁴ OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22, at 60 (para. 232).

legally, all of the tangible or intangible assets will be owned by the non-resident enterprise – and profits associated with the intangible will accordingly be assigned to the DAPE. Likewise, as the 2010 Report provides, if the DA performs a significant people function relevant to the management of inventory risks, then the profit or loss associate with such risks – such as the appreciation or depreciation of the inventory value – will be attributable to the DAPE.³⁵ It could be seen that the AOA maintains its consistency between the DAPE’s profit allocation and that of other PE types, both of which rely on the concept of the significant people function.

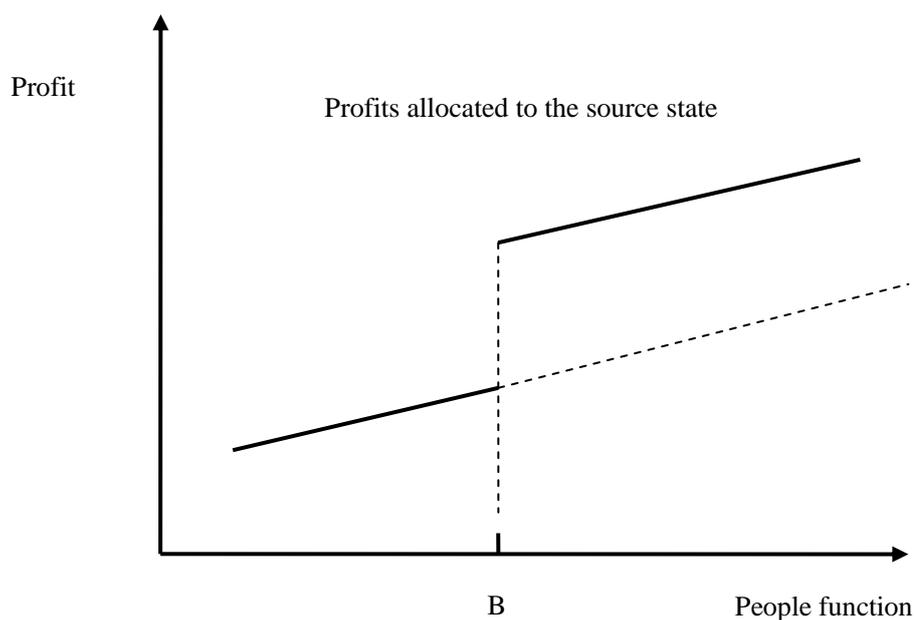
Compared with the single-taxpayer approach, the dual-taxpayer approach represents a more effective option in preserving the integrity of the DAPE regime and enabling the source country to acquire a fairer slice of the tax cake related to cross-border business income. It is true that a DA would usually be rewarded for any extra people functions above baseline activities, such as its development of market intangibles. Nevertheless, this reward would typically be significantly less than the entire proceeds generated from such people functions.

4.2 Deficiencies of the significant-people-function approach in profit attribution

Despite the above advantages of the dual-taxpayer approach, its reliance on the significant people function is, at best, insufficient. The people function performed by a DA enterprise lies within a spectrum from baseline activities to full-fledged sales functions. Additionally, considering the typically arm’s-length relationship between the DA and its principal, any extra functions undertaken by the DA would be remunerated by the principal. However, under the AOA, it seems that certain points of people functions are so ‘significant’ that they would attribute a further portion of the principal’s profit to the source country. This ‘cliff’ effect in profit allocation can be illustrated in the following graph where the horizontal axis denotes the spectrum of the people function performed by a DA, and the vertical axis denotes profit level. The broken line illustrates the profit allocated to the source state under the AOA. It can be seen that the line makes a sudden leap at Point B. Before B, the only taxable income in the source state is the arm’s length reward to the DA whereas, after B, further profit of the non-resident taxpayer is allocated to the source state as the income of the DAPE.

³⁵ OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22, at 62 (para. 243).

Graph 1: Profit allocated to the source state under the AOA



Given this ‘cliff’ effect on profit allocation, it becomes critical for the non-resident enterprise and the DA to prove that the function performed by the DA is insignificant. As a result, the identification of a significant people function, or the B point in the above graph, may become highly contentious. Imagine a DA person who is skillful in soliciting orders and negotiating contracts, who actively manages inventory level and sales credit, yet does not play a role in developing brand names and an overall market strategy for the non-resident enterprise. According to the AOA, it seems that the sales skill would only be allocated an arm’s length reward while the management of inventory and credit risks could be attributed some profit of the principal generated from these management activities. However, it is difficult to understand why managing inventory and credit risks are more significant in the profit allocation than soliciting orders and negotiating contracts which are at the core of the business. In

addition, it could be difficult, if not impossible, for taxpayers and tax administrations to foresee all of the types of significant people functions that may vary from business to business. Complexity may also arise for parties to compute profit attributable to each type of significant people functions. For example, how much of the profit should be allocated to a significant people function related to the assumption of credit risk? Last but not least, although the significant-people-function approach can be traced back to the benefit principle, as was discussed in section 3, the application of this approach to the DAPE situation may indeed contradict the benefit principle. This is because all of the people functions performed in the source country, significant or insignificant, are undertaken by the DA rather than the non-resident enterprise. Accordingly, if the source state has provided any benefits of public goods in relation to the business income concerned, they are physically consumed by the DA enterprise which is typically a resident in the source state. Therefore, it seems the source state is only entitled to tax the income of the DA enterprise.

The problem of the AOA becomes particularly acute regarding a PE of simple functions. As the 2010 Report recognizes, a DA may not perform any significant people function that is relevant to the economic ownership of assets and/or the management of risks. In that case, ‘profits to the dependent agent PE is correspondingly reduced or eliminated’. An example provided by the report is a mere sales agent that ‘may well be unlikely to represent the significant people function’.³⁶ It seems that the AOA returns to the single-taxpayer approach to profit allocation in the situation of simple-function PEs. The problem, however, is that simple-function PEs such as mere sales agents constitute the most typical DA type. Indeed, one of the most critical yardsticks in distinguishing the DA from an independent agent, which will not give rise to a DAPE, is that an independent agent bears a commercial degree of entrepreneurial risks whereas a DA complies with detailed instructions from the non-resident enterprise.³⁷ If no further profit – in addition to the reward to the DA enterprise – would be attributed to such DAPEs with insignificant functions, then perhaps a significant part of the DAPE regime will be rendered meaningless.

The above problem related to simple-function DAs can also be viewed in the context of a sales commissionaire arrangement. A commissionaire company is usually a subsidiary that performs a very limited range of business functions, bears only

³⁶ OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22, at 60 (para. 233).

³⁷ Oats, Miller & Mulligan, *supra* n. 6, at 247-248.

minimal risks, and owns few assets.³⁸ In the case of a sales commissionaire, the business risk is borne by the associated supplier company rather than the commissionaire, and the function of the commissionaire is limited to pure sales. Accordingly, the commissionaire only earns a commission fee for the distribution service rather than the profit from the sale. With such commissionaire arrangements, an MNE manages to minimize the amount of group profit that must be allocated to the commission that is typically located in a high-tax jurisdiction.³⁹ One way of tackling this tax planning method is to deem a sales commissionaire as a DAPE of the non-resident supplier company so that further profit in addition to the commission fee could be allocated to the source country.⁴⁰ However, this anti-avoidance measure would largely be nullified, or at least made less effective, by the significant-people-function approach because a critical feature of a sales commissionaire is its limited people function compared with a full-fledged distributor.

4.3 Applying the new taxing right to the DAPE

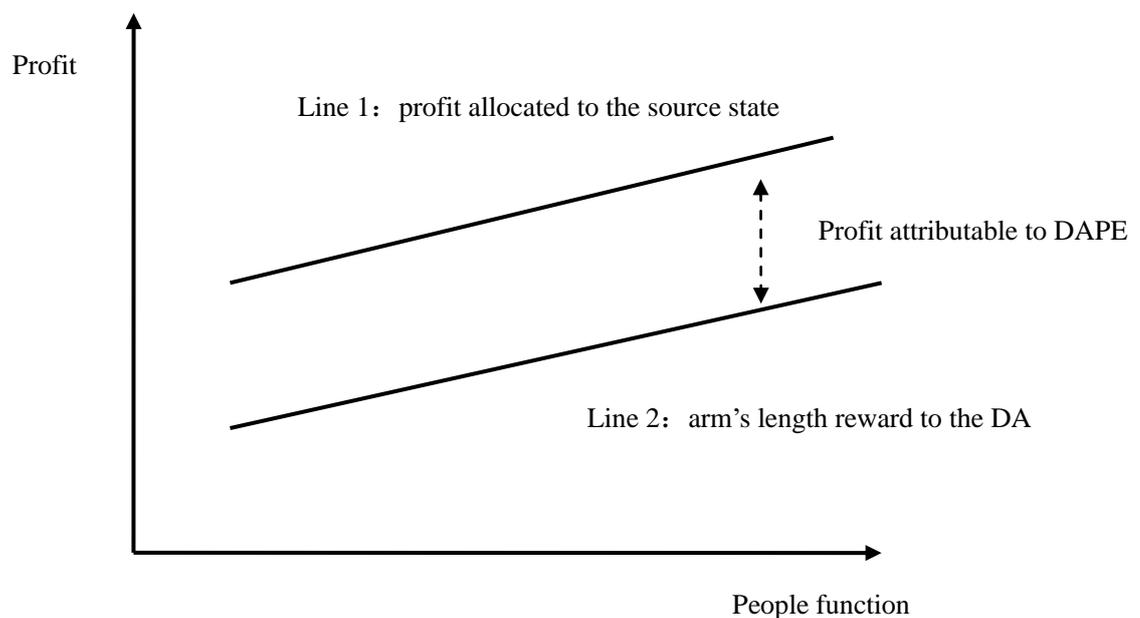
Considering the shortcomings of the AOA in fulfilling the dual-taxpayer approach to the profit attribution regarding the DAPE, the question remains on what grounds further profit of the non-resident enterprise can be attributed to the DAPE in addition to the arm's length reward paid to the DA. In this regard, the UA provides a simpler and better option: the DAPE would be further allocated a sum equivalent to Amount A, i.e. part or all of the residual profit earned by the non-resident enterprise from the business in question. Amount A will be a constant percentage – 100% or less – of the residual profit regardless of the magnitude of the people function performed by the DA. Accordingly, any people function, significant or routine, that is performed by the DA will be covered by the arm's length reward to the DA. This reward is actually equivalent to the aggregation of Amounts B and C or only Amount B if the DA only undertakes baseline activities. Indeed, the DAPE presents a perfect situation in which Amount A will never be overlapped with Amounts B and C because any B and C will automatically be covered in the reward to the DA and will be deducted as an expense from the income of the enterprise in deriving Amount A attributable to the DAPE. The UA approach to the DAPE's profit attribution can be depicted in the following graph:

³⁸ Oats, Miller & Mulligan, *supra* n. 6, at 248.

³⁹ Oats, Miller & Mulligan, *supra* n. 6, at 249.

⁴⁰ OECD, *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)*, 33-36 (paras 106-112) (OECD Publishing 2012).

Graph 2: Profits allocated to the source state under the UA



Compared with Graph 1, the cliff effect of the profit level allocated to the source country has been settled as the profit attributable to the DAPE – denoted by the gap between line 1 and line2 – becomes a constant value, which is Amount A. In this way, the dual-taxpayer approach can be maintained while, at the same time, the shortcomings related to the reliance on the significant people function can largely be avoided.

Going forward, the UA can be extended to fixed-place sales PEs. Specifically, the people function of the PE will be covered by Amount B or the sum of B and C, depending on whether the PE performs any non-routine activities. Independent of such rewards of people functions, the PE will be further attributed a profit equivalent to Amount A. Otherwise, the AOA to the profit allocation regarding fixed-place PE would face the same challenges as with the DAPE: the cliff effect of profit allocation, the difficulty of distinguishing significant people functions from those that are insignificant, and the complexity of matching profit to any particular type of people function.

Indeed, the taxing rights of market jurisdictions have been touched upon lightly in the 2010 Report. In the discussion regarding the attribution of assets to the PE, the report warns that the process also depends upon the type of asset and the type of business for which the asset is used.⁴¹ For example, the fact that a PE economically owns a tangible asset that is used in a manufacturing process does not necessarily mean that this asset can be attributed income from selling goods even though the goods are manufactured by the asset.⁴² With this statement, the report actually admits that the factor of significant people function alone is insufficient for determining the profit attributable to the PE and that reference must also be made to the type of the PE – whether or not it is a sales branch. The 2010 Report does not further explain why sales activities are so unique compared with manufacturing processes. A speculation is that, had the drafters of the report elaborated on this point further, they might have developed a different path that is more in accordance with the UA.

It might have been noticed that a fixed-place sales PE located in market jurisdictions is indeed a typical scenario covered in the UA in which Amounts B and C cover the physical presences – including fixed-place PEs – of MNEs in market jurisdictions. Nonetheless, the UA only applies to in-scope businesses and is subject to nexus threshold whereas other business types remain being covered by the AOA. In this sense, the above argument also demonstrated that, at least for MNEs having physical sales presences in marketing jurisdictions, the UA's differentiation between in-scope business and out-of-scope business leads to nothing but unnecessary inconsistency.

By far, two questions remain unanswered regarding the UA to the PE's profit attribution. The first question concerns the policy rationale of the proposal, which will

⁴¹ OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22, at 16 (para. 19).

⁴² OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, *supra* n. 22.

be addressed in this paragraph; and the second pertains to the quantum of Amount A, which will be covered in the next section in conjunction with a case study. The issue of policy rationale becomes particularly prominent when the situation of simple-function DA is concerned: given that the significant people function in relation to the business has been performed by the non-resident enterprise outside the source state, why should some or all of the residual profit be allocated to that source state? The question can be enlightened by the marketing intangibles proposal and the significant economic presence proposal. According to the marketing intangibles theory, there is an intrinsic link between the market-related people function, regardless of its performing place, and the source jurisdiction. For example, some marketing intangibles, such as brand and trade name, ‘are reflected in the favourable attitudes in the minds of customers’.⁴³ Based on the significant economic presence theory, it could be said that the significant people function performed by the non-resident enterprise has been projected to the source country via the channel of the DA. In this way, the non-resident enterprise has projected a significant economic presence in the source country.⁴⁴ Both accounts can be incorporated into a benefit narrative: market-related people functions benefit from the customer bases of the source jurisdiction. In this context, the traditional benefit principle needs to be expanded to encompass not just physical utilities such as infrastructure and public service but also customer bases of the source country.⁴⁵ The difference between this expanded version of benefit principle and the traditional version is qualitative rather than merely quantitative. Specifically, unlike those physical benefits that necessitate some geographical proximity between a beneficiary (an enterprise) and a service provider (the host country), market benefits can be exploited remotely. It is this expanded benefit principle that justifies the new taxing rights allocated to market jurisdictions irrespective of the existence of physical presence.

4.4 ANALYSIS OF THE SET SATELLITE CASE

This Indian case involves a Singapore company, SET Satellite, that conducted advertising businesses in India through its DA, SET Satellite India. The tax return of the Singapore company showed that it had no tax liability in India as the DA was

⁴³ OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy*, Public Consultation Document 13 Feb. 2019 – 6 March 2019, 12 (paras 30-31) (OECD Publishing February 2019).

⁴⁴ OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy*, *supra* n. 43, at 16 (paras 50, 51).

⁴⁵ A. J. Cockfield, *Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test*, 38 Can. Bus. LJ 400, 403 (2003).

already remunerated on an arm's length basis. The position was challenged by the Indian tax authority, and an appeal was made to the Income Tax Appellate Tribunal (ITAT) of Mumbai.⁴⁶ The case concerned the debate about the choice between the single-taxpayer and dual-taxpayer approaches.

The ITAT supported the dual-taxpayer approach, arguing that the alternative option would render the entire concept of DAPE meaningless.⁴⁷ The ITAT particularly opined that the profit attributable to the DAPE should be decided on the basis of the foreign company's *revenue* from the business performed in the source state through the DA. To illustrate this point, the tribunal provided an imaginary case as follows:⁴⁸

Sing Co is an electronic equipment distributor based in Singapore. It sources electronic equipment from all over the globe and sells the same to the Indian market through a local DA called Ind Co. The consideration received by Ind Co is agreed to be 30 per cent on sales plus reimbursement of expenses. Sing Co procures electronic equipment from China, ships the products directly to India and sells them in India after a mark up of 200 per cent. The handling costs of Sing Co for sourcing the merchandise are 60 per cent on cost. In a particular year, Sing Co sells goods worth USD 3 million in India. Ind Co incurs a cost of USD 899,000 to earn the agency remuneration.

The tribunal computed the profits that are taxable in India as follows:

Dependant agent's income:

Commission earned	\$ 9,00,000
Less: Deductible expenses incurred	(\$ 8,99,000)
Taxable income	\$ 1,000

DAPE's income:

Sales consideration	\$ 30,00,000
Less: Agent's commission	(\$ 9,00,000)
Less: Cost of purchase	(\$ 10,00,000)
Less: Handling charges	(\$ 6,00,000)
Attributable profits	\$ 5,00,000

⁴⁶ IN: *Deputy Director of Income-Tax vs. Set Satellite (Singapore)*, 2007 106 ITD 175 Mum (2007).

⁴⁷ *Deputy Director of Income-Tax vs. Set Satellite (Singapore)*, *supra* n. 46, at para. 31.

⁴⁸ *Deputy Director of Income-Tax vs. Set Satellite (Singapore)*, *supra* n. 46, at para. 11.

The tribunal noted that there was a prominent difference between the DA's income and the DAPE's income, both of which were subject to the source tax.

This example not only demonstrates the difference in profit allocation between the single-taxpayer and the dual-taxpayer approaches but also elucidates Amount A. First, the tribunal attributed almost all of the profit of Sing Co in relation to the business in India to the DAPE and hence little has been left to the Singapore company. This computation is somehow problematic since Sing Co performs, at the very least, some baseline activities such as the procurement and handling of the goods. Nevertheless, even if such baseline activities are attributed an arm's length remuneration, the residual income would still be allocated to the DAPE by the tribunal. Consequently, Amount A in the above example constitutes 100 per cent of the residual income in relation to the business. To be sure, the fact of the imaginary case seems to suggest that Ind Co is a full-fledged sales agent whereas Sing Co only undertakes routine activities. Nevertheless, nowhere in the judgment did the tribunal make any reference of the significant people function in determining the profit attributable to the DAPE. This confirms the point that a market jurisdiction is entitled to a tax right for its own sake. Accordingly, it is reasonable to infer that, even if Sing Co performs significant people functions in carrying on the business, such functions would only be attributed an arm's length reward that is somehow equivalent to Amounts B and C while the residual income would still be allocated to the destination country. This destination-based approach is in accordance with the expanded benefit principle enunciated in Section 4.3: people functions that target a market jurisdiction should be regarded as having benefited from that jurisdiction even if such functions are performed outside the jurisdiction.⁴⁹

Secondly, in deriving the profit attributable to the DAPE, the tribunal did not focus on the DAPE directly but began from the total revenue of the non-resident enterprise from the business. The revenue was then subtracted by the cost of the non-resident enterprise in relation to the business, including the remuneration to the DA enterprise. This indirect approach is most beneficial when a fixed place PE performing full-fledged sales functions is concerned. For such PEs, not only Amount A but also B and C are all difficult to determine considering their performance of non-routine activities. In contrast, under the indirect approach, once the costs of and the

⁴⁹ For the link between the taxing rights of market jurisdictions and a destination-based transfer pricing method, see Brauner, *supra* n. 8, at 272.

remuneration for the activities of the non-resident enterprise are determined, the aggregation of amounts A, B, and C that are attributable to the PE can automatically be derived. There is no need to further isolate each of the three amounts since all three together constitute the taxable income of the fixed-place PE payable to the source country.

It is true that the tribunal's position in the SET Satellite case has not been universally accepted. Indeed, the case was then appealed before the Bombay High Court, which subsequently set aside the ITAT's decision.⁵⁰ Nevertheless, the ITAT's position has increasingly been defended by scholars.⁵¹

5. COMMENTS ON THE UA: INSIGHTS FROM THE SET SATELLITE CASE

Despite the UA's merit in protecting the fiscal interests of market jurisdictions in the context of digitalisation and its advantages in addressing the issue of attributing profit to sales PEs, the approach is not free from challenge. Like the AOA, one major criticism of the UA concerns its complexity.⁵² In these authors' view, much of this complexity is related to the UA's hybrid feature: while it was originated to address the tax challenge of scale without mass, it also covers the traditional situation where MNEs have physical presences in market jurisdictions, and the latter situation has traditionally been covered by the conventional TP rules. It is true that the UA is essentially a variant of the profit-split method.⁵³ However, profit split is only one, and usually the last, resort of TP methods. Imagine the following example which is adapted from an example provided in the consultation document on UA.⁵⁴

P Co, resident in Country 1, is the parent company of Group X, which manufactures a type of widgets. Q Co, a subsidiary of P Co, resident in Country 2, plays a pivotal role in developing market intangibles in relation to the widgets. Q Co sells products to customers in Country 2. It has also begun selling products remotely to customers in Country 3 where it does not have any taxable presence under the current rules.

For the sales in Country 2 where Q Co, a full-fledge distributor subsidiary, is located,

⁵⁰ IN: *SET Satellite (Singapore) Pte Ltd v. DDIT* (2008-TIOL-414-HC-MUM-IT).

⁵¹ R. Sharma, *Attribution of Profits to a Dependent Agent Permanent Establishment: An Analysis of the Indian Approach*, 37 *Intertax* 8/9, 493 (2009).

⁵² Dourado, *supra* n. 8; M. F. de Wilde, *On the OECD's 'Unified Approach' as Frankenstein's Monster and a Dented Shape Sorter*, 48 *Intertax* 1, 9 (2020).

⁵³ OECD, *Secretariat Proposal for a 'Unified Approach' under Pillar One*, *supra* n. 1, at 13 (para. 52).

⁵⁴ OECD, *Secretariat Proposal for a 'Unified Approach' under Pillar One*, *supra* n. 1, at 11 (para. 41).

it seems the most straightforward way of allocating profits among associated companies is to apply the comparable uncontrolled price (CUP) of the widget. In particular, if it is found that P Co's function is more routine, the CUP would ensure that P Co is attributed no more than an arm's length reward for its manufacturing activities. Accordingly, most of the residual income will be allocated to Q Co. It is true that a direct CUP is usually difficult to find and hence a profit-oriented method would be a more practical alternative. Nevertheless, as was discussed in the above case study (Section 4.4), a profit-based method could start with P Co, or the supply side of the business, rather than with Q Co. Again, if P Co only performs routine activities, the use of the profit-based method beginning with P Co, such as the cost-based transactional net margin method (TNMM), would also allocate full residual income to Q Co.⁵⁵ The profit method based on the supply side also promotes administrative efficiency, particularly when the supply side performs functions that are more routine. This is because once the arm's length remuneration for P Co is calculated, the profit attributable to Q Co, including Amounts A, B, and C, will automatically be determined. By contrast, working on Amounts A, B, and C directly, as is shown in the UA, may lead to repeated efforts and double counting. Repetition means administration inefficiency, and double counting implies disputes. The separation between A and C could be particularly controversial as both 'eat into' the profit above the remuneration for baseline activities. Indeed, the fact that the UA also features a notable emphasis on strengthened dispute prevention/resolution mechanisms may suggest the inherent volatility of the approach.

These authors do not necessarily deny the benefits of the UA. Indeed, two scenarios of profit attribution could be particularly amenable to the approach. The first is the scale without mass, such as the sale in Country 3 in the above example. Since this situation only involves Amount A allocated to the source country, the UA could be the most straightforward method to apply. The second scenario is when the supply side of an MNE, e.g. P Co in the above example, also engages in significant non-routine activities. In this situation, even the traditional TP regime would recommend the profit-split method as the most appropriate option.⁵⁶ Nevertheless, the authors cannot see any solid grounds to confine the method of profit allocation regarding a sales

⁵⁵ The TNMM examines the net profit relative to an appropriate base (e.g. costs, sales, assets) realized by the taxpayer from a controlled transaction; see OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, *supra* n. 23, at 117-132.

⁵⁶ OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, *supra* n. 23, at 133-134.

presence – be it a subsidiary or a PE – to the UA instead of allowing the parties a margin of freedom to employ a wider array of TP tools. As is discussed in the case study in section 4.5, the fiscal interests of market jurisdictions can be well entertained by the conventional TP rules even with respect to the DAPE where the MNE does not have any physical presence of its own in the source country. It is true that, for situations where significant people functions are all performed at the supply side, conventional TP rules may lead to too much profit being allocated to the supply side instead of the market jurisdiction; thereby appearing less attractive than the UA. However, even in such cases, Amount A for market jurisdictions can still be preserved by making the TP rule more destination-based, at least with respect to those market-related functions.

Therefore, these authors submit that the UA can take a more general and flexible form; it only needs to articulate the basic principle that market jurisdictions should be allocated at least a portion of residual income from cross-border businesses irrespective of the existence of any taxable presence in those jurisdictions. This goal can largely be achieved through conventional TP rules although, where significant market-related people functions are performed outside a market jurisdiction, some destination-based TP rules are more desirable. Only if and when parties are unable to attain any satisfactory result through usual TP methods should the three-tier profit allocation mechanism (i.e. Amounts A, B and C) currently endorsed in the UA serve as the last resort.

6. CONCLUSION

Digitalisation of the economy leads to the prevalence of scale without mass which subsequently poses challenges to the international tax regime, particularly with respect to nexus and profit allocation rules over business income. The UA addresses these challenges by conferring new taxing rights to market jurisdictions irrespective of the existence of any ‘mass’. This article noted that, even before the era of digitalisation, scale without mass and the resulting tax nuisances had already been manifested in the situation of the DAPE where a non-resident taxpayer has no physical presence of its own in the market jurisdiction. Considering that all of the people functions performed by the DA are remunerated at an arm’s length price and all other people functions are performed outside the market jurisdiction, the question remains on what basis a DAPE should be attributed further profit of the non-resident

enterprise. The AOA hinges the profit attributable to a DAPE on the significant people function undertaken by the DA, an approach attracting much criticism. Drawing on the UA, the authors argued that what is attributable to a DAPE is indeed the residual income of the business concerned, i.e. Amount A under the UA. Going forward, the UA can apply to not only DAPEs but also fixed-place sales PEs. At the same time, some domestic practice on the DAPE's profit attribution may also shed useful light on the refinement of the UA. In particular, for the situation where there is a marketing and distributing presence in the market jurisdiction, conventional TP rules with some destination-based modification can achieve the same goal of ensuring tax concession to market jurisdictions. Therefore, it is recommended that the UA take a more flexible approach rather than restricting itself to the three-tier profit allocation mechanism.