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Dr. Han's Comments on the OECD's Unified Approach Proposal

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Dr. Han's Comments on the OECD Secretariat Proposal for a Unified Approach under Pillar One[1]

October 21, 2019

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[1] Special thanks to JK Lim who gave me a help.

ABSTRACT

The OECD publicly requested the comments for the Secretariat Proposal for a "**Unified Approach**" under Pillar One for the resolution of digital service tax problems. For the Unified Approach, the OECD classified MNEs' digital service business' profit into 3 types of taxable profit: i) Amount A, ii) Amount B and iii) Amount C. Current digital service tax problems mostly occur due to **i)** the permanent establishment ("PE") rule, **ii)** the intellectual property immigration practice between related parties and **iii)** the character of remote control business. Accordingly, we need to exactly understand the current situation in order to make out an exact solution to these problems. Otherwise, we might make issues more complex and exacerbate the current situation.

The **first cause** of digital service problems in terms of taxation is the location of a server.

Commentary 125 of Article 5 of 2017 OECD Model Tax Convention provides "Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. *In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1*."

A digital service company can shift its server easily from one place to another place. Also, as a server can be operated by remote control, it is possible not to have a server manager in the country where a server is located. Thus, it is not reasonable to determine a PE only based on the location of a server from the standpoint of business functions and risk burdens. Accordingly the current Commentaries shall be revised.

The **second cause** of digital service problems is IP immigration.

R&D activities are very important to MNEs. MNEs which require a technology for their business cannot survive in the market without R&D activities. Thus, most of MNEs actively get involved in R&D activities. A patent is an output of R&D activities. MNEs often shift their patent into tax heaven areas in order to save related taxes. For that purpose, they conclude a contract between related parties for migration of a patent. Thus, it would be desirable for the international community to prevent this kind of transaction between related parties unless there is a justifiable reason.

The **third cause** of digital service problems is remote business activity.

A remote business enterprise has no business entity in a State in which sales activities occur and thus it looks like having no physical nexus with that State. Nevertheless, sales activities are taking place in a remote sales way in a State in which users (or customers) receive a digital service. So we could say that it has nexus with that State in terms of taxation. The tax law has priority over the general law in terms of taxation. Accordingly, it would be possible to treat the remote business enterprise as having a deemed PE in that State and tax the related profit case by case according to the existing principle of transfer pricing (including intra-group service charge principle).

The OECD's Unified Approach does not provide the exact solutions to current issues and thus can cause problems as follows:

First, the OECD's unified approach does not make any comment concerning the existing PE rule. If the OECD leaves the current e-commerce PE rule alone, it can conflict with the OECD's unified approach. Thus, the OECD should carefully handle this matter.

Second, the OECD intends to use a kind of residual profit split method. If a MNE wants to use the residual profit split method, first of all it should prepare a segmented financial statement per business line and type of transaction. Thus, it is necessary for a MNE to divide its Group financial statement per business line or type of transaction for the purpose of applying the residual profit split method. It would require a lot of time and money. What is more, in case where the OECD requires MNEs to insert a detailed segmented financial statement in their annual report, they must pay much more audit consulting fee to accounting firms. Thus, the OECD should introduce a cost-effective method for MNEs.

Third, for the purpose of residual profit split method, a MNE should divide its Group financial statement into several business lines such as "distribution activity", "marketing activity" (sales support activity) and "administrative activity" (intra-group service). And then it determines the routine profit of each entity by using an allocation key such as cost-plus 5% or 10% markup. By doing so, it can minimize the "routine profit" that is allocated to the countries in which its subsidiaries are located.

Under the OECD's unified approach, the quantum of the fixed return could be determined in a variety of ways: it could be i) a single fixed percentage; ii) a fixed percentage that varies by industry and/or region; or iii) some other agreed method. However, it would be very difficult for every related tax authority to agree upon such an allocation key. For example, let's assume that a digital service MNE has 80 subsidiaries in 50 countries. In that case, would it be possible for 50 tax authorities to agree upon a fixed percentage? Perhaps it is not.

If that is the case, we cannot understand why the OECD tries to use this kind of inefficient and unreasonable approach. If there is no possibility of compromise between related tax authorities, this kind of approach should be discarded. If the OECD continues to insist upon this kind of approach, it would just substantially increase tax disputes between related tax authorities.

Fourth, under the OECD's unified approach, only in case where a MNE meets a certain revenue threshold in a specific country, may the tax authority of that country have taxing right over "Amount A" or "Amount B" relating to the revenue in issue. Is it reasonable from the standpoint of equity? Of course it is not. Under the principle of taxation equity, if there is income, there must be tax on it. Thus, the OECD's unified approach is not reasonable from the standpoint of equity.

Fifth, in case where there is a traditional nexus in the market jurisdiction under the OECD's unified approach, first of all, taxpayers and tax authorities should determine the applicable fixed return (**"Amount B"**). And then in case where tax authorities consider that a MNE performs activities exceeding the fixed return arrangement, taxpayers and tax authorities should once again determine an additional taxing right (**"Amount C"**).

Further in case where a MNE is making remote sales and thus has no in-country physical presence, taxpayers and tax authorities should determine a portion of the deemed non-routine profits (**"Amount A"**) of MNE Group. But the OECD does not explain how to calculate that portion of the deemed non-routine profit. Is this process efficient? Of course it is not. Thus, the OECD should adopt a more efficient approach in order to minimize the tax disputes and MNEs' compliance expense.

The OECD does exist for the development of the international community. Accordingly the OECD should handle the pending issues in a way which can promote a peaceful relationship between states. The current OECD's proposed "Unified Approach" **does not provide the exact solutions to current issues and as a result** there is a high possibility that international taxation disputes between states increase substantially. Accordingly, the OECD should propose the tailor-made and feasible solutions to the causes of problems.

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I. Introduction

In the OECD Secretariat Proposal, the OECD stated "Interested parties are invited to send their comments no later than **Tuesday, 12 November 2019, noon Paris time**, by email to TFDE@oecd.org in Word format (in order to facilitate their distribution to government officials) for the public consultation meeting."

Thus, as a head of the BEPS International[2] (BEPS division of a leading Korean law firm which provides BEPS service to multinational enterprises), I send my comments on the OECD Secretariat Proposal.

I had published the article "**Undesirable Google Digital Tax & Tax War**[3]" in January 2019 in both English and Korea. It handles most of current BEPS related issues in detail. Thus, I present my comments based on this article once again. Most of my comments was excerpted from the article.

II. Current Problems of Digital Service Tax

Current digital service tax problems mostly occur due to **i)** the permanent establishment ("PE") rule, **ii)** the intellectual property immigration practice between related parties and **iii)** the character of remote control business.

Accordingly, we need to exactly understand the current situation in order to make out an exact solution to these problems. Otherwise, we might make issues more complex and exacerbate the current situation.

1. Permanent Establishment Rule

a. General PE Rule

Under Article 5 of the OECD Model Tax Convention, if there is a fixed place of business through which the business of an enterprise is wholly or partly carried on, it constitutes a permanent establishment. That is, it is subject to taxation as a taxable entity.

Paragraph 5, Article 5 of the OECD Model Tax Convention provides "Where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State."

That is, under this Paragraph 5, where an enterprise has a person exercising an authority to conclude contracts in the name of the enterprise in a Contracting State, although the enterprise does not have a fixed place of business in that State, the enterprise has a deemed PE in that State.

However, Paragraph 7, Article 5 of the OECD Model Tax Convention provides "The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a

[2] The BEPS International has a business partnership relationship with the Thompson Reuters since the year 2016 for the provision of BEPS service to multinational enterprises.

[3] Han, Sung-Soo, Undesirable Google Digital Tax & Tax War, 2019. Available at: https://works.bepress.com/sung_soo_han/85/

permanent establishment of the other." Accordingly, it is possible for MNEs to make a tax planning under these two rules as follows:

A U.S. MNE 'X' is a digital service enterprise. X wants to sell its digital service product to Korean customers (users). But X does not want to have a PE in Korea as the PE can be taxed by the resale price method (RPM) or the operating margin method (TNMM) based on the total sales amount in Korea.

Thus, X determines to set up a sales support 100% ownership subsidiary 'Y' in Korea. Y performs only sales support activities on behalf of X and is compensated cost plus 10% mark-up from X.

Y's sales support activities are to help Korean users communicate with X in relation to the digital service contract between Korean users and X. But Y does not directly conclude a contract with Korean users in order to avoid a PE issue.

Y is an independent agent and thus cannot be X's PE in Korea under Paragraphs 5 and 7, Article 5 of the OECD Model Tax Convention. Accordingly, Y does not have to recognize the Korean sales amount in its accounting book but recognizes just its sale support commission revenue (e.g., cost plus 10%).

X's sales revenue in Korea is US$1 billion and Y's operating expense in Korea is US$0.1billion. Thus, Y is compensated US$0.01billion (US$0.1billion x 10%) from X and it becomes Y's taxable income in Korea.

However, where Y can be deemed as X's PE in Korea, the Korean tax authority might use the resale price method (e.g., 20% gross margin[4]) or the operating margin method (e.g., 5% operating margin[5]). In case of using 5% operating margin approach, Y's taxable income becomes US$0.05billion (US$1billion x 5%).

That is, there is a gap of US$0.04billion (US$0.05-US$0.01) taxable income in Korea depending upon whether or not Y is an independent agent or a deemed PE. Accordingly, most of MNEs want to make such a tax planning in order to avoid a PE issue.

b. Electronic Commerce PE Rule

Commentary 125 of Article 5 of 2017 OECD Model Tax Convention provides "Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. *** *In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1*."

Accordingly, in the above case, X does not set up its server in Korea in order to avoid the PE taxation under Commentary 125.

c. Loophole of PE rule

The current PE rules were made a long time ago and thus do not properly reflect the current business circumstance. Most of MNEs are now enjoying a chance of tax planning with a help of tax consultants. Thus, the OECD should take a proper measure such as the revision of PE rules in order to prevent the profit shifting activities.

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[4] Gross profit / Sales revenue
[5] Operating profit / Sales revenue

2. Case Analysis[6]

'X' is a multinational enterprise which provides digital service to EU customers. When it comes to electronic commerce under the e-commerce rule of the OECD Model Tax Convention, a permanent establishment exists at the place where the server is located. Thus, if X UK (digital service multinational company) had its server for its **sales activity** only in the UK, X UK can become a permanent establishment and all income relating to **sales activity** is subject to taxation.

On the other hand, if X puts its server in Ireland and provides sales service to the UK customers, X Ireland becomes a permanent establishment and its income derived from the UK is allocated between UK and Ireland according to their function and risk burden.

[Case 1] For example, let's assume that X UK has a server in the UK and realizes the sales revenue of US$0.1billion from only the UK customers in 2018. It also incurs a total US$ 0.05 billion of operating expense (including royalty payment) for its business in the UK in 2018. In that case, its P/L is as follows:

Unit: US$

	UK	Ireland
Revenue (Sales)	100,000,000	-
Operating expense	50,000,000	-
Taxable income	50,000,000	-

Thus, if there is no additional expense, X UK can realize US$0.05 billion of taxable income in the fiscal year 2018.

[Case 2] What if X UK shifts its server to Ireland? Let's assume that X Ireland has a server in Ireland and earns US$0.1billion from Ireland customers and US$0.1billion from the UK customers in 2018. X Ireland incurs a total US$0.105billion of operating expense for its business in both the UK and Ireland in 2018. Then, X Ireland compensates "cost[7] plus 10% mark-up" to X UK in a consideration of **sales supporting activities** for X Ireland. In that case, P/Ls of X UK and X Ireland are as follows:

Unit: US$

	UK	Ireland
Revenue	55,000,000[8]	200,000,000
Operating expense	50,000,000[9]	50,000,000[10]+55,000,000[11]
Taxable income	5,000,000	95,000,000

Thus, if there is no additional expense, X UK can realize US$0.005 billion of taxable income and X Ireland US$0.095billion of taxable income in the fiscal year 2018.

In case where X shifts its server from the UK to Ireland, X UK's revenue decreases from US$0.1billion to US$0.055billion because X UK is compensated by "cost plus 10% mark-up" method from X Ireland. As a result, its taxable income decreases from US$0.05billion to US$0.005billion. X UK does not recognize its **sales revenue** because it is not a permanent establishment from the standpoint of OECD electronic commerce rule.

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[6] Refer to supra note 2, at pp.25~28

[7] Operating expense

[8] 50,000,000 (X UK operating expense) x 1.1

[9] We assume that server management expense is minimal compared to other expenses. Thus, we don't consider it in our P/L.

[10] X Ireland's operating expense in Ireland

[11] Compensation expense for X UK

On the other hand, X Ireland can realize a substantial taxable income and save a lot of taxes since Ireland's tax rate is very low compared to the UK's tax rate. Through the above example, we can understand why MNEs would try to shift their server to a tax heaven state. Is it reasonable that the mere shift of a server has a significant effect on taxing right of each state from the standpoint of international tax principle?

Thus, European Commission ("EC") had proposed **3%** of digital service tax in order to prevent such an unreasonable result. EC states "The tax will apply to revenues created from activities where users play a major role in value creation and which are the hardest to capture with current tax rules, such as those revenues: 1) created from selling online advertising space, 2) created from digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them, 3) created from the sale of data generated from user-provided information.[12]

3. Causes of Digital Service Problems In Terms of Taxation[13]

a. Server

The first cause of digital service problems in terms of taxation is the location of a server.

Commentary 125 of Article 5 of 2017 OECD Model Tax Convention provides "Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. *In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1*."

Also Commentary 127 provides "Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. *This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources*."

Thus, according to Commentaries 125 and 127, a server becomes a permanent establishment regardless of whether or not there is a person who manages the server.

A digital service company can shift its server easily from one place to another place. Also, as a server can be operated by remote control, it is possible not to have a server manager in the country where a server is located. Thus, it is not reasonable to determine a PE only based on the location of a server from the standpoint of business functions and risk burdens.

A server is a kind of by-product of R&D activities. Once a digital technology is completed by R&D activities, a digital service company can install its completed server anywhere all over the world. R&D expenses can be allocated between related parties by cost sharing. A server of itself cannot do business but certainly needs persons who operate it for the business.

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[12] European Commission, https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en (Last visit on 10 January 2019)

[13] Refer to supra note 2, at pp.28~30

The business activities of a digital service company consist of “R&D activity” and “Sales activity” broadly. Thus, it is appropriate that its whole business income should be allocated between R&D activity entities and sales activity entities on a reasonable basis considering their functions and risk burdens.

A server is currently being used as a conduit for tax avoidance because the current OECD commentaries relating to electronic commerce acknowledge it. Accordingly the current Commentaries shall be revised.

Also, these rules treat a server (computer equipment) in the same way as automatic pumping equipment. Is it reasonable from a substantive perspective? Of course it is not.

A server can be installed in a place where business activities are not performed because it can be operated by remote control. Thus, it is possible that a digital service company avoids a PE issue by installing a server in a state where active business activities are not performed. That is, a digital service company which does business in the UK can avoid a PE issue by installing a server in a tax heaven country.

What about a company using automatic pumping equipment in the exploitation of natural resources? A company using automatic pumping equipment should install its equipment in a location where there are natural resources. That is, in case where a company exploits natural resources in the UK, it wouldn’t be feasible that the company installs the automatic pumping equipment in Germany for the purpose of exploiting natural resources in the UK.

So there is a big difference between server and automatic pumping equipment in terms of tax avoidance. That is, a server can be used as a conduit but the automatic pumping equipment cannot. Therefore, it is not proper to treat a server and automatic pumping equipment in the same way in terms of international taxation.

b. Patent & IP Immigration[14]

R&D activities are very important to MNEs. MNEs which require a technology for their business cannot survive in the market without R&D activities. Thus, most of MNEs actively get involved in R&D activities. A patent is an output of R&D activities. MNEs often shift their patent into tax heaven areas in order to save related taxes. For that purpose, they conclude a contract between related parties for migration of a patent.[15]

For example, let’s assume that a US MNE ‘X’ invested US$1billion on R&D activities and acquired a patent (output of R&D activity). X wants to migrate its patent into a tax heaven area for tax saving and sets up a 100% subsidiary ‘Y’ in a tax heaven state. X invests US$1billion as a paid-in capital on Y and again Y buys a patent from X at US$1billion. The patent is necessary for business activities. Then Y sells its products within Europe region. Thus, European customers should pay a price which contains a consideration of R&D to Y. Y is in a tax heaven state and as a result can save taxes.

If X didn’t sell its patent to Y, Y should pay royalties to X since Y has no patent necessary to its business activity. Thus, X should report its royalty income to the US tax authority. However, X sold its patent to Y, and Y reports the royalty income in a tax heaven state. The intellectual property transaction between X and Y does not affect X’s taxable income because X’s investment amount is not expense to X. Both related parties shifted IP to a tax heaven area with ease by just a paper work.

[14] Refer to supra note 2, at pp.33~34
[15] Contracting activity is just a paper work.

Is this kind of IP immigration reasonable from the standpoint of international taxation principle and equity? The answer would be no. Thus, it would be desirable for the international community to prevent this kind of transaction between related parties.

III. Simple and Easy Solution to Current Problems

1. Server Problem and its Solution

A server is currently being used as a conduit for tax avoidance because the current OECD commentaries relating to electronic commerce acknowledge it. Accordingly the current Commentaries shall be revised.

The business activities of a digital service company consist of "R&D activity" and "Sales activity" widely. Thus, it is appropriate that its whole business income should be allocated between R&D activity entities and sales activity entities on a reasonable basis considering their functions and risk burdens regardless of the location of a server.

That is, the current e-commerce rule must be revised to ensure that the whole business income of digital service should be allocated between R&D activity entities and sales activity entities on a reasonable basis considering their functions and risk burdens regardless of the location of a server.

It is not a difficult and complex job to revise the current e-commerce rule since e-commerce PE has been treated separately from other business and thus its revision does not affect other kinds of business.

For example, it might be possible to simply provide as follows:

"Notwithstanding the provisions of paragraphs 1 and 2 of Article 5, an e-commerce enterprise shall be deemed to have a permanent establishment in the State in which its users (or customers) are located."

2. Patent & IP Immigration Problem and its Solution

The intellectual property transaction between related parties is being used a means of tax avoidance as set forth above. Both related parties can shift IP to a tax heaven area with ease by just a paper work. Especially digital service enterprises actively use this approach. Thus, it would be desirable to prohibit this kind of transaction between related parties especially in case of a digital service enterprise.

If a subsidiary in a tax heaven state were a joint venture, it would be possible to use a 50% ownership threshold because such a planning is not possible unless an enterprise in issue has a majority ownership.

3. Remote Business Activities

Another issue relating to digital service business is how to handle the remote business activities. A remote business enterprise has no business entity in a State in which sales activities occur and thus it looks like having no physical nexus with that State. Nevertheless, active and continuous sales activities for unspecific many customers are taking place in a remote sales way in a State in which users (or customers) receive a digital service. So we could say that it has **electronic nexus** with that State in terms of taxation.

The tax law has priority over the general law in terms of taxation. Accordingly, it would be possible to treat the remote business enterprise as having a deemed PE in that State and tax the related profit

according to the existing principle of transfer pricing (including intra-group service charge principle). For example, a MNE performs digital service business in two countries X (resident country) and Y (non-resident country). The MNE provides remote sales service to the users of Y. The MNE realizes US$1 billion of sales revenue respectively in both countries. The employees of the MNE in X work for the users of both countries X and Y. Thus, the MNE Group may make an intragroup transaction arrangement of compensating 3% of operating margin (e.g., assuming that 3% is arm's length operating margin) to X and Y. In that case, X and Y respectively have taxing rights over US$0.03 billion of operating income.

If that is the case, MNEs would not try to perform a remote business for the purpose of tax avoidance. On the other hand, MNEs would try to have an entity in Y and shift employees in X to Y from the standpoint of economic efficiency. That is to say, if we should change an unreasonable rule, we could normalize cross-border transaction between related parties.

Last, Transfer pricing is not an exact science. Thus, it would be reasonable to resolve the remote business problem case by case through functional & risk analysis. In case where there is a dispute, it should be resolved through mutual agreement procedure and arbitration procedure.

4. Necessity of Use of Automatic Data Base

Transfer pricing (TP) has become a hot issue to the international community since the 1990s as it significantly affects the taxing right of each country. TP very often leads to a functional, legal and statistical analysis issue, and the analysis process makes the TP issue more complex because transfer pricing is not an exact science. The reason why transfer pricing lacks exactness is that the comparable analysis is normally done through an atypical statistical approach and performed by an inexact manual work. Accordingly, in order to decrease the unnecessary dispute between tax authorities and between taxpayers and tax authorities, the international community needs to introduce the automatic data base for the transparent administration of transfer pricing. For details concerning the fact analysis, the legal analysis, the statistical analysis and the necessity of automatic data base, refer to "**Undesirable Google Digital Tax & Tax War**" at pp. 36~47.

5. Sub-Conclusion

The **first** cause of current problems relating to the digital service tax is a server PE rule of the OECD Model Tax Convention, and the **second** cause is IP immigration of MNEs. Thus, the OECD should abolish the current e-commerce server rule and prevent the paper work IP immigration of digital service business unless there is a justifiable reason from now on. **Last**, it is necessary to apply a deemed PE rule to the remote digital service business in order to prevent tax avoidance activities. It is a very efficient and easy approach to the current digital service problems.

IV. OECD's Inefficient and Complex Approach to Current Problems

1. OECD's Proposed Unified Approach

The OECD proposed a new unified approach for the resolution of digital service tax problems. For that purpose, the OECD classified MNEs' digital service business' profit into 3 types of taxable profit: i) Amount A, ii) Amount B and iii) Amount C.

"**Amount A**" is <u>a portion of the deemed residual profit</u> of a multinational business to market jurisdictions irrespective of the location and/or residence of that business, consistent with the creation of a <u>new nexus</u> unconstrained by physical presence requirements.
"**Amount B**" is a fixed return (or fixed returns, varying by industry or region) for certain "baseline"

or routine marketing and distribution activities taking place in a market jurisdiction. The quantum of the fixed return could be determined in a variety of ways: it could be i) a single fixed percentage; ii) a fixed percentage that varied by industry and/or region; or iii) some other agreed method.

"**Amount C**" is an additional profit which taxpayers and tax authorities may retain when the marketing and distribution activities taking place in the market jurisdiction go beyond the baseline level of functionality and therefore warrant a profit in excess of the fixed return contemplated under Amount B, or when the MNE group or company perform other business activities in the jurisdiction unrelated to marketing and distribution.

Group X	P Co	Q Co
Digital business MNE	Parent company of Group X	Subsidiary of P Co
	Country 1	Country 2: Marketing & distribution
	Owns Group intangible asset	Country 3: Remote digital service

- Country 2 is allowed a right to tax a portion of the deemed non-routine profits of Group X ("**Amount A**") against marketing & distribution activities if it meets "revenue threshold". Country 2 may tax that portion directly from P Co with the possibility of Q Co held jointly liable for the tax due.

- Q Co is a taxpayer for the only applicable fixed return for marketing & distribution activities ("**Amount B**")

- If Country 2 considers that Q Co should have additional profits in addition to fixed return because Q Co performs activities exceeding the fixed return arrangement for marketing & distribution activities, Country 2 may request an additional taxing right.

- If Q Co is making remote sales in Country 3 and it meets the revenue threshold, Country 3 is allowed a right to tax a portion of the deemed non-routine profits of Group X ("**Amount A**"). As Group X does not have an in-country presence in Country 3, "**Amount B**" would not apply.

Simply speaking, the OECD proposed a kind of "modified residual profit split method". The residual profit split method identifies the routine profit for an entity as a **first step**. And **then**, any remaining profit is split based on each party's contribution to the earning of the non-routine profit such as the ownership of intangibles and what they contributed or own.

2. Problems of OECD's Unified Approach

a. E-commerce PE Rule

The OECD's unified approach does not make any comment concerning the existing PE rule. If the OECD leaves the current e-commerce PE rule alone, it can conflict with the OECD's unified approach. Thus, the OECD should carefully handle this matter.

b. Segmentation of Financial Data

If a MNE wants to use the residual profit split method, first of all it should prepare a segmented financial statement per business line and type of transaction. Thus, it is necessary for a MNE to divide its Group financial statement per business line or type of transaction for the purpose of applying the residual profit split method. It would require a lot of time and money. What is more, in case where the OECD requires MNEs to insert a detailed segmented financial statement in their annual report, they

must pay much more audit consulting fee to accounting firms. Thus, the OECD should introduce a cost-effective method for MNEs.

c. Difficult Compromise Process Concerning Profit Split Key

For the purpose of residual profit split method, a MNE divides its Group financial statement into several business lines such as “distribution activity”, “marketing activity” (sales support activity) and “administrative activity” (intragroup service). And then it determines the routine profit of each entity by using an allocation key such as cost-plus 5% or 10% markup. By doing so, it can minimize the “routine profit” that is allocated to the countries in which its subsidiaries are located.

Under the OECD’s unified approach, the quantum of the fixed return could be determined in a variety of ways: it could be i) a single fixed percentage; ii) a fixed percentage that varies by industry and/or region; or iii) some other agreed method.

However, it would be very difficult for every related tax authority to agree upon such an allocation key. For example, let’s assume that a digital service MNE has 80 subsidiaries in 50 countries and allocates its unequal profit applying a different way to each country. In that case, would it be possible for 50 tax authorities to agree upon a fixed percentage? Perhaps it is not.

If that is the case, we cannot understand why the OECD tries to use this kind of inefficient and unreasonable approach. If there is no possibility of compromise between related tax authorities, this kind of approach should be discarded. If the OECD continues to insist upon this kind of approach, it would just substantially increase the tax dispute between related tax authorities.

d. Revenue Threshold

Under the OECD’s unified approach, only in case where a MNE meets a certain revenue threshold in a specific country, may the tax authority of that country have taxing right over “Amount A” or “Amount B” relating to the revenue in issue. Is it reasonable from the standpoint of equity? Of course it is not. Under the principle of taxation equity, if there is income, there must be tax on it. Thus, the OECD’s unified approach is not reasonable from the standpoint of equity.

e. Inefficient and Complex Calculation Mechanism

In case where there is a traditional nexus in the market jurisdiction under the OECD’s unified approach, first of all, taxpayers and tax authorities should determine the applicable fixed return (**“Amount B”**). And then in case where tax authorities consider that a MNE performs activities exceeding the fixed return arrangement, taxpayers and tax authorities should once again determine an additional taxing right (**“Amount C”**).

Further in case where a MNE is making remote sales and thus has no in-country physical presence, taxpayers and tax authorities should determine a portion of the deemed non-routine profits (**“Amount A”**) of MNE Group. But the OECD does not explain how to calculate that portion of the deemed non-routine profit.

Is this process efficient? Of course it is not. Thus, the OECD should adopt a more efficient approach in order to minimize the tax dispute and the related compliance expense.

V. Conclusion

The OECD does exist for the development of the international community. Accordingly the OECD

should handle the related problems in a way which can promote a peaceful relationship between states. The current OECD's proposed "Unified Approach" **does not provide the exact solutions to current issues and as a result** there is a high possibility that international taxation disputes between states increase substantially. Accordingly, the OECD should make out the tailor-made solutions to the causes of problems in issue as set forth above. [**THE END**]

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- PricewaterhouseCoopers Korea [2000 through 2004] – International Tax & Transfer Pricing
- Ernst & Young Korea [2004 through 2006] – International Tax, Transfer Pricing and Customs Valuation
- Lee & Han International - Managing Partner [2007 through 2017]
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