Pillar One and Pillar Two: A Confirmation of the Formulaic Apportionment and Anti-Avoidance Approaches of the Value Creation Functional DEMPE Formula Standard?

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The article discusses how the value creation standard creates a "universal" definition of source as well as an anti-avoidance instrument that allows for a more mechanical and fractional manner to allocate profits. Pillar One and Pillar Two will also be scrutinized to determine if such an approach has been validated.

1. Introduction

In order to align value creation with transfer pricing results, the OECD released Final Reports on Actions 8-10 of the BEPS Action Plan in 2015, prompting the present OECD Guidelines 2017, which provided interpretative revisions to previous statements of the arm's length principle (ALP). It has been attempted to give transfer pricing rules a prominent role in upholding international standards against abuse by a major emphasis on the conception of substance through the use of the "new" value creation concept. Despite this "mandatory criterion" for profit distribution in multinational corporations (MNEs) being vague, at least directionally it establishes some type of "universal" concept of source and an anti-avoidance tool in a more mechanical fashion to try to answer a question that has been to a greater or a lesser extent at the heart of the international tax debate for the last 100 years: where and how shall income from MNEs be allocated?

To the same extent, both the "Secretariat Proposal on a 'Unified Approach' under Pillar One"[1] and Pillar Two "Global Anti-Base Erosion or GloBE proposal"[2] demonstrate the same concern as transfer pricing to the extent that it is hard to achieve consensus on international income allocation. Pillar One verifies, as predicted with the functional (i.e. DEMPE) formula-based value creation criterion, the need for some type of fractional apportionment using in this case an explicit formula. In reality, the Pillar One proposal is similar to the benchmarks from BEPS Actions 8-10,[3] which are based on value-adding elements such as functions, assets and risks. In effect, Pillar One is expressing the same issue as the ALP in that since it is difficult to get legal or political agreement on worldwide income sharing, some formula must be imposed. To the same extent, Pillar Two revels the same issues as in BEPS Actions 8-10 and intends to "correct" its pitfalls by imposing a minimum global tax that could serve as a separate anti-avoidance measure – not in the strict sense – by ensuring that profits are taxed at a minimum tax rate, and therefore it could establish a floor for tax competition among countries that could reduce MNEs' incentives to shift profit to low-tax jurisdictions.

In this context, the main goal of this article is to acknowledge that Pillar One and Pillar Two in fact are based on the same concerns that have been restated by the OECD Guidelines 2017. There is a general dissatisfaction with the ALP as it customarily has been understood and applied to be able to function as a suitable income allocation device. This article the role and effects of the value creation standard as to whether its implementation would actually prevent the shifting of profits to low-tax jurisdictions, even though it might accomplish a tool for the international allocation of income based on a fractional approach, i.e. new normative functional (i.e. DEMPE) formula-based value creation standard. It also considers the fractional

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1. OECD, *Public Consultation Document, Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October 2019 – 12 November 2019* (OECD 2020); OECD/G20, *Tax Challenges Arising from Digitalisation: Report on Pillar One Blueprint – Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2020); OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 Oct. 2021).
2. OECD, *Public Consultation Document: Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two, 8 November 2019 – 2 December 2019* (OECD 2020); OECD/G20, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2021); OECD, *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (8 Oct. 2021).
3. OECD/G20, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), Primary Sources IBFD.

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approach given to the ALP reinforced by Pillar One and the anti-avoidance need of the ALP reinforced by Pillar Two what challenges the coexistence of two systems, one for transfer pricing purposes and another for the international allocation of income beyond transfer pricing lenses. The final purpose of this contribution is not to give a final answer but to plant the seed for future discussions on how both systems could coexist.

2. Is the Quest for the Holy Grail over? The Untold Truth of the Standard of Value Creation

Prior to the amendments proposed by measures arising from the Reports on BEPS Actions 8-10, the established transfer pricing guidance might lead to circumstances in which the allocation of benefits was not aligned with the economic activity that generated them, in the sense that, primarily, profits from assets were allocated where actions associated with the ascribed value were not carried out, and the "return" on intangible assets was taxed in low- or no-tax jurisdictions having reached those jurisdictions through charges and valuations that reduced the tax base of higher tax jurisdictions. In practice, the arm's length concept permitted or at least did not comprehensively mitigate or deter the contractual assignment of tasks, assets or risks at the expense of the parties' real economic behaviour.[4]

In response to this situation, the OECD introduced the notion of value creation through the mantra "align taxation with value creation",[5] despite the absence of a defined -concept. From the author's notion "without concept", the creation of value has a meaning or significance that aims to give a guide on how to distribute income to counteract the abusive use of transfer pricing rules, in particular the ALP.[6] However, this form of income distribution in a *quasi*-pre-established manner will result in a mechanical application of the ALP that may produce results contrary to those expected.[7] Actually, it is questionable how value creation could produce a different result when the OECD stated that the principles of international taxation should not be changed.[8]

Indeed, the intention of the OECD is to restore the benefits from jurisdictions with low or no taxation – although not simply due to their preferential tax regime but also combined with their lack of economic activity – to countries considered as high taxation, mainly due to the mobility of intangibles. Emphasizing on contractual arrangements and the separate entity principle offered a relatively easy way to change the location of legal ownership of an intangible, which in fact attracts most of the routine and non-routine gains, regardless of if the jurisdiction of the legal owner really had the capacity to carry out such functions that it contractually performed, that is, non-routine functions (e.g. R&D, branding, design) that are what attract most of the benefits compared to routine functions (e.g. manufacturing, distribution). In fact, such effects are nothing new since they date back to the 1920s when transfer pricing rules were developed that in sum separated the residual profits not only from the market states, but also from the states of residence, where such residual earnings were expected to be taxed, to the detriment of countries with low or no taxation.[9] Indeed, the "synergistic effects" of belonging to a multinational group could flow freely to "efficient" jurisdictions from a tax point of view.[10]

In this context, the OECD introduced the DEMPE concept in order to establish which are the functions of high added value, and thus the "creation of value" assigns all the residual benefit to one of these countries. Therefore, the intention was that the higher the jurisdiction's degree of taxation, the more benefits will be allocated to it based on high value-added functions, for example, managerial or research and development.[11] In contrast, low value-added functions, for example, distribution, would

4. On the structures that gave rise to manipulations in the pre-BEPS phase, *see* M.S. Screpante, *Rethinking the Arm's Length Principle and Its Impact on the IP Licence Model after OECD/G20 BEPS Actions 8-10: Nothing Changed But the Change?*, 11 World Tax J. 3, sec. 2.3. (2019), Journal Articles & Opinion Pieces IBFD; M.S. Screpante, *Garantizar que los resultados de los precios de transferencia estén en línea con la creación de valor en las operaciones con intangibles (Acciones 8-10): ¿el cambio que nada cambia?*, in Braccia (ed.), *Aspectos Relevantes de la Reforma Tributaria en Materia de Tributación Internacional*, pp. 167-172 (Thomson Reuters La Ley 2018).
5. OECD, *BEPS Project Explanatory Statement: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, p. 4 (OECD 2016) [hereinafter *OECD BEPS Explanatory Statement*].
6. Haslehner argues that value creation is not meaningless in the sense that it has the function of aligning taxation with value creation; *see* W. Haslehner, *Value Creation and Income Taxation: A Coherent Framework for Reform?*, in *Taxation and Value Creation: 2020 EATLP Congress Vienna 18-20 June 2020*, p. 60 (W. Haslehner & M. Lamensch eds., IBFD 2021), Books IBFD.
7. On the same opinion about a mechanical application of the ALP, *see* J. Monsenego, *Value Creation and Transfer Pricing,* in *Taxation and Value Creation: 2020 EATLP Congress Vienna 18-20 June 2020* (W. Haslehner & M. Lamensch eds., IBFD 2021), p. 115, Books IBFD; A.J. Martín Jiménez, *Tax Avoidance and Aggressive Tax Planning as an International Standard – BEPS and the "New" Standards of (Legal and Illegal) Tax Avoidance*, in *Tax Avoidance Revisited in the EU BEPS Context: 2016 EATLP Congress Munich 2-4 June 2016*, p. 35 (A.P. Dourado ed., IBFD 2017), Books IBFD.
8. *OECD BEPS Explanatory Statement*, pp. 4-5, where it is established that the task of the OECD is the "renewal" and not the replacement of the existing international tax regulations.
9. A.J. Martín Jiménez, *Value Creation: A Guiding Light for the Interpretation of Tax Treaties?*, 74 Bull. Intl. Taxn. 4/5, sec. 3.1. (2020), Journal Articles & Opinion Pieces IBFD.
10. Martín Jiménez, *supra* n. 9, at sec. 3.1.
11. OECD, *Addressing Base Erosion and Profit Shifting* p. 29 (OECD 2013): "[F]rom an economic point of view, most of the value of a good or service is typically created in upstream activities where product design, R&D or production of core components occur, or in the tail-end of downstream activities where marketing

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be assigned to low-tax countries. In short, a priori the OECD did nothing more than reinforce the status quo of the allocation of residual benefits in favour of countries of residence or high taxation. That said, the OECD nevertheless acknowledged the legitimacy of "outsourcing" the conduct of activities associated with various aspects of the "development" and "exploitation" of intangibles, provided that the suitable direction and oversight was exercised by those who were contracted for the outsourced work to be done, who were expected to have the competence and resources to engage for that work and then exploit it.

However, the modification of the OECD Guidelines 2017 may yield results that may not necessarily coincide actually or directionally with the above-described intentions of restoring benefits to residence countries.[12] In fact, such modifications can contribute to a greater transfer of benefits to low-tax jurisdictions validated by the same value creation standards and DEMPE that are intended to provide a different result. In fact, whether BEPS Actions 8-10 exacerbate the risk that contractual arrangements, as the main allocation criterion, have ultimately been traded for value creation as the relevant paradigm for the profit sharing. In this vein, the OECD Guidelines 2017 could be viewed as effectively establishing a kind of new functional regulation, that is, a value creation standard based on the functional formula (i.e. DEMPE) for multinational companies to transfer benefits to jurisdictions of low or no taxation, provided that value is created there.[13] While it is true that such an approach reinforces the alignment of the taxability of profits with the place of economic activities, it does not prevent profits from ending up being taxed at low rates, despite improvements made with respect to the directional purpose. What is true is that there is no place for contractual agreements without substance in terms of functions, assets and risks in line with the ability of the parties to monitor the substance of said risks, that is, having the capacity and power to do so. In effect, value creation as defined in the OECD Guidelines 2017 entails a "new" source convention, i.e. an origin-based interpretation of source,[14] in order to adopt new common standards for how income should be earned that are applicable in a "universal" manner,[15] despite the fact that there is no universal source of income.[16]

Within the context of the OECD Guidelines 2017, in the authors' view, value creation operates primarily as some sort of anti-avoidance tool due to the significant emphasis that is given to the "substance" of a transaction in two inter-related phases, on the one hand, through the "as-accurately principle", and on the other hand, through the holistic commercial rationality test which became a standard for recognizing a transaction. The focus on relevant functions, e.g. DEMPE, control of risks and financial capacity to bear the risks legally assumed and in a lesser degree on the assets owned to generate profits with regard to intangibles, reinforces the need for legal substance[17] to avoid profit allocation as a mere consequence of a contractual arrangement. That, in the author´s opinion, constitutes an anti-avoidance function of the ALP,[18]'[19] having converted transfer pricing rules into some sort of SAAR.[20]

Returning to the question of this section as to whether the outcomes of BEPS Actions 8-10 have achieved their objective, we should say that the OECD claims that the concept of value creation via the functional notion of DEMPE would remedy the defects inherited from the international tax regime that was originated in the 1920s; however, the proposal has been only partially successful, as in its attempts to develop an objective test or approach based on specific relevant functional activities, i.e. DEMPE, aimed specifically at the alignment of value-generating activity and taxable earnings. In fact, the creation of value only serves to justify the transfer of benefits in terms of DEMPE functions with the approval of the OECD by creating a new

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or branding occurs. Knowledge-based assets, such as intellectual property, software and organizational skills, have become increasingly important for competitiveness and for economic growth and employment."

12. Screpante (2019), *supra* n. 4, at sec. 6.
13. Screpante (2019), *supra* n. 4, at sec. 7.
14. In this regard, Schwarz notes that "[i]f value creation is just the originating cause of income or profit, then the only real analytical task today remains the continuing examination of modern income and profit generation to identify its originating cause and the location of that cause", *see* J. Schwarz, *Value Creation: Old wine in new bottles or new wine in old bottles?*, Kluwer International Tax Blog (21 May 2018); with respect to the "originating cause" of income and the "location of that cause" of income, Kemmeren already 20 years ago established that the causal relationship between the production of income and the territory of a state is the predominant factor under the principle of origin, which justifies the taxation of cross-border income by a state when the income is created within the territory of that state, *see* E.C.C.M. Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models* (Pijnenburg 2001), at pp. 35-36; E.C.C.M. Kemmeren, *Source of Income in Globalizing Economics: Overview of the Issues and a Plea for an Origin-Based Approach*, 60 Bull. Intl. Taxn. 11, pp. 433-434 (2006), Journal Articles & Opinion Pieces IBFD.
15. J.S. Wilkie, *Policy Forum: BEPS One Year In – Taking Stock*, 62 Canadian Tax Journal 2, pp. 467-469 (2014).
16. Wilkie argues that there is no universal source of income since source is determined by legal factors, otherwise source would be relegated to unlimited dictates of substance, *see* Wilkie, *supra* n. 15, at p. 470.
17. Wilkie sustains that BEPS Actions 8-10 defend the idea of legal substance since the inquiry is into economics facts within a legal arrangement, *see* S. Wilkie, *Transfer Pricing Aspects of Intangibles: The License Model*, in *Transfer Pricing in a Post-BEPS World*, pp. 80-83 (M. Lang, A. Stork & R. Petruzzi eds., Kluwer L. Intl. 2016); also, similarly, with more emphasis on the effects of the legal substance theory for corporations after BEPS, *see* S. Wilkie, *New Rules of Engagement? Corporate Personality and the Allocation of "International Income" and Taxing Rights*, in *Tax Treaties After the BEPS Project: A Tribute to Jacques Sasseville*, p. 349 et seq. (B. Arnold ed., Can. Tax Fond. 2018).
18. In the same line of thinking, *see* Monsenego, *supra* n. 7, at pp. 107-108 and 115-116. However, the author does not categorically affirm that value creation acts as an anti-avoidance tool, but it is associated with an anti-avoidance dimension; *see* Martin Jiménez, *supra* n. 7, at pp. 33.
19. Das also sees value creation as a reinforcement of substance, *see* R.R. Das, *The Concept of Value Creation: Is It Relevant for the Allocation of Taxing Rights?*, 74 Bull. Intl. Taxn. 3, p. 135 (2020), Journal Articles & Opinion Pieces IBFD.
20. On the same opinion, *see* Monsenego, *supra* n. 7, at p. 122.

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way of distributing benefits in such a way that structures are apparently seen as "genuine" based on the fact that there is "substance" in terms of DEMPE functions and ability to control risks.[21]

Consequently, the objective formulation of the creation of value may end up achieving or at least legitimizing the same kinds of effects that a priori the "new" outlook on transfer pricing's ALP – with DEMPE – seemingly seeks to avoid, namely the dissociation of the place where the economic activity would "genuinely" take place from the place to which the income is allocated in two significant ways that affect the nexus and the distribution of benefits, which is what happened in the 1920s, and still happens today, not only in terms of transfer pricing, but also with BEPS 2.0. and the taxability of the digital economy.

3. Is the End of the Arm's Length Principle, as Known, Closer Than Thought?

The modifications introduced in the OECD Guidelines 2017 show that there is a general dissatisfaction with the ALP since it alone cannot function adequately for the allocation of income, and eventually, of the benefits of economic groups. The comparative nature of the principle has been diluted in recent years due to deficiencies in its application, especially in relation to the availability of comparables.[22] However, the ALP has managed to overcome its shortcomings and is still today the principle used to set the price of intercompany transactions, mainly due to its flexibility and adaptability to changing economic circumstances and business practices.[23] However, the ALP has been modified too much to the extent that one of the most used methods is not a method based on a mere comparability with unrelated parties, but on a combined profit division method, that is the profit sharing method (PSM).[24] Although the PSM deviates from traditional transaction-based methods, it better addresses the problems of allocating the benefits of integration and synergies between the different parts of a multinational group. However, fractional approaches or forms for income distribution originated almost 100 years ago with the work of the ICC and the League of Nations in the 1920s,[25] which have been adapted to the new times, not only in the field of transfer pricing but also with regard to the debate on the imposition of the digital economy by the OECD/G20 and the Inclusive Framework.

This new form-type approach in transfer pricing rules, that is, closer to being a prescriptively and even mechanically functional (that is, DEMPE) formula-based value creation standard, although it is recognized as a fractional type to avoid some type of association with the notion of "formulary apportionment", has the same purpose as the jurisdictional allocation of benefits that is under debate today. Even though formulary approaches are not something new in the international tax system,[26] the worldwide tax community has always been hostile to the term "formulary", which has been more mythological, and mainly unfounded.[27] However, in terms of forms, the fractional method (without a precise algorithmic or other mathematical configuration) goes a bit beyond that goal because it aims to ensure that the allocation or distribution of income is conducted in line with the DEMPE concept's substantive requirements.[28] That mechanical application of the ALP in light of the functional (i.e. DEMPE) formula-based value creation standard reveals the vulnerability of the hypothetical and comparability nature of the ALP on how to agree on the distribution of the international income. In brief, to a lesser or a greater degree the ALP as it has been conceived originally and is used today is closer to the formulary apportionment rather than to a merely comparability-based principle, even though on a conceptual basis is referred to as fractional rather than formulary.[29] To this extent, it is valid to question whether the utility and viability of the ALP should definitely be adapted to this formulaic standard to prevent its peril. However, in *stricto sensu* such approach would not be consistent with the nature of the ALP. This has been reinforced, or, rather, confirmed by the

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21. On DEMPE, assets and risks as source of income where an enterprise conducts economic activities by means of production factors, i.e. employees, assets and capital, *see* V. Chand & G. Lembo, *Intangible-Related Profit Allocation within MNEs based on Key DEMPE Functions: Selected Issues and Interaction with Pillar One and Pillar Two of the Digital Debate*, 3 Intl. Tax Stud. 6, at sec. 6.1. (2020), Journal Articles & Opinion Pieces IBFD; V. Chand, *Allocation of Taxing Rights in the Digitalized Economy: Assessment of Potential Policy Solutions and Recommendation for a Simplified Residual Profit Split Method*, 47 Intertax 12 (2019); J. Becker & J. Englisch, *Taxing Where Value Is Created: What's "User Involvement" Got to Do with It?*, 47 Intertax 2, pp. 163-164 (2019); and R. Collier, *The Value Creation Mythology*, in *Taxation and Value Creation: 2020 EATLP Congress Vienna 18-20 June 2020*, p. 137 (W. Haslehner & M. Lamensch, IBFD 2021), Books IBFD.
22. On the practical and theoretical problems encountered in the application of the arm's length principle, *see* R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle after BEPS*, pp. 123 ss. (Oxford University Press 2017).
23. J. Owens, *Should the Arm's Length Principle Retire?*, 12 Intl. Transfer Pricing J. 3, p. 101 (2005), Journal Articles & Opinion Pieces IBFD.
24. *See* H.-K. Kroppen, R. Dawid & R. Schmidtke, *Profit Split, the Future of Transfer Pricing? Arm's Length Principle and Formulary Apportionment Revisited from a Theoretical and a Practical Perspective*, in *Fundamentals of International Transfer Pricing in Law and Economics, MPI Studies in Tax Law and Public Finance*, pp. 270-271 (W. Schön & K.A. Konrad eds., 2012).
25. S. Wilkie, *Policy Forum: The Way We Were? The Way We Must Be? The 'Arm's Length Principle' Sees Itself (for What It Is) in the 'Digital' Mirror*, 47 Intertax 12, pp. 1091-1094 (2019).
26. *See* Wilkie, *supra* n. 25, pp. 1097 ss.
27. S. Wilkie, *More on "Minimum Tax", BEPS, the Pillars, CFC Rules and Trade Law*, Osgoode Hall Law School (10 June 2021), available at https://tax.osgoode.yorku.ca/2021/06/more-on-minimum-tax-beps-the-pillars-cfc-rules-and-trade-law/ (accessed 13 Nov. 2021).
28. On the formulaic approach, *see* J. Scott Wilkie, *Reflecting on the "Arm's Length Principle": What is the "Principle"? Where Next?*, in *Fundamentals of International Transfer Pricing in Law and Economics*, pp. 137-156 (W. Schön & K.A. Konrad eds., Springer 2012).
29. Wilkie, *supra* n. 25, at p. 1097.

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"digital" debate, which has prompted a more thorough examination of the ALP to the extent that its fundamentals have been challenged to fractional apportionment and minimal taxation.

4. Is the International Tax System Heading towards a True Non-Transactional Evolution of Fractional/Form Apportionment? The Emergence of Pillar One

Pillar One's essence is to replace long-standing notions of tax jurisdiction and taxable presence with something else that holds an appropriate degree of source country taxation for "value created" in source countries, especially for so-called "customer facing" and "automated digital services" businesses. In effect, as mentioned above, Pillar One represents some type of worldwide fractional apportionment of revenue, notably for the profits from "intangibles", notwithstanding the international tax community's aversion to the term "formulary". Proposals advocating profit splitting and formulaic apportionment of profits are not something new. They have been part of the international tax debate since the work of the ICC and the League of Nations back in the 1920s and 1930s.[30]

If so, this perhaps gives new urgency to developing the concepts in the recently expressed Pillar One to recalibrate the transfer pricing analysis with a more developed orientation around fractional apportionment as a deliberate regime and not merely an incidental outcome of the ALP as such. The intrinsic implication is that, if you locate at least competent supervision and direction associated with each of the DEMPE functions, the associated income with those functions is allocated where you prefer. In the end, BEPS turns out to be an instruction manual on how to allocate profits that are supposedly valuable activities (i.e. DEMPE) via, in the author's terms, a *functional (i.e. DEMPE) formula-based* standard.

Nevertheless, the fact that legal fragmentation still exists indicates that there is a need to allocate enterprise profits in a "fractional apportionment split" – in effect to reconstitute the economic unity that is an MNE for tax purposes despite common respect for and reliance on separate entities and the discrete transactions they undertake or that are attributed to them for tax purposes. That fractional apportionment has been reinforced by the proposal for the taxation of the digital economy launched by the "Secretariat Proposal on a "Unified Approach" under Pillar One"[31] and the Report on the Pillar One Blueprint[32] which speaks of "people, tangible assets, or sales and market/users, in which the latter are conceived as value adding factors with value being created by users and customers". This proposal resembles the benchmarks from BEPS Actions 8-10 based on value adding factors with value being created by functions, assets and risks. The difference lays in "markets/users" or "sales" as splitting or allocating factor which does not mean the abandonment of the concept of value creation as understood in BEPS Actions 8-10,[33] even though the express mention of it was indeed excluded from Pillar One due to the diverging objectives.[34] While the former attributes taxing rights based on the physical performance of relevant functions, the latter attributes taxing rights irrespective of the physical presence of the supply-side factors, however limnited to manifestations of intangible contributions or presence for digital and customer-facing businesses and consumer-facing businesses. Notwithstanding that, value creation is still the underlying notion of the demand-side factor proposed by Pillar One.

This proposal pertains to the design of what amount to new formulary non-transactional profit allocation rules despite the historical reluctance of the OECD to acknowledge the legitimacy and utility of "formulary apportionment" in deference to prevailing comparative and profit-oriented methodological analysis still being the backbone of the OECD Guidelines, i.e. Amount A, based on predetermined formulas associated with people, tangible assets, or sales and market/users as a whole, rather than on an individual entity and individual country basis.[35] This approach clearly departs from the transactional view or separate approach embedded in the ALP and introduces a global approach departing both from the 100-years old tradition

30. Wilkie, *supra* n. 27; Martín Jiménez, *supra* n. 9, at sec. 4.2; Collier & Andrus, *supra* n. 22, at sec. 3, p. 260.
31. OECD, *Public Consultation Document, Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October 2019 – 12 November 2019* (OECD 2020). For Tavares, the ALP is a middle ground between the 2017 OECD Guidelines, i.e. ALP, and formulary apportionment; *see* R.J.S. Tavares, *Multinational Firm Theory and International Tax Law: Seeking Coherence*, 8 World Tax J. 2, pp. 273-274 (2016), Journal Articles & Opinion Pieces IBFD.
32. OECD/G20, *Tax Challenges Arising from Digitalisation: Report on Pillar One Blueprint – Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2020).
33. On the contrary *see* Martín Jiménez, *supra* n. 9, at sec. 5. The author affirms that "the old debate on allocation of tax bases between residence and source countries made a comeback in the context of BEPS Action 1 and the OECD/G20 Inclusive Framework with such an intensity that it meant the abandonment of the concept of value creation as understood in BEPS Actions 8-10 and incorporated in the OECD Transfer Pricing Guidelines (2017). Before having an opportunity to be tested, the concept was already left behind in the definition of a "new international tax order" (for some multinational groups only)".
34. Monsenego, *supra* n. 7, at p. 127; in the same line of thinking, *see* Martin Jimenez, *supra* n. 9, at sec. 3.4. The author states that the "Unified Approach" only pointed out that the new taxing right, i.e. Amount A, is based on the possibility of businesses to interact with "their consumer base and create meaningful value without a traditional physical presence in the market". *See also* OECD, *Public consultation document: Secretariat Proposal for a "Unified Approach" under Pillar One, 9 October 2019 – 12 November 2019*, p. 19 (OECD 2019).
35. V. Chand, *Achieving Certainty in an Uncertain Profit Allocation Environment*, 47 Intertax 12, p. 1001 (2019); OECD/G20, *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 – January 2020*, p. 15 (OECD 2020).

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of separate entity approach which has been also reinforced by Pillar Two, also referred to as the Global Anti-Base Erosion or GloBE proposal,[36] and the recent Report on Pillar Two Blueprint.[37]

In the author´s view, the international tax system is moving towards a fractional non-transactional allocation of profits and it might not take long until it reaches beyond the digitalized business models. However, the approach proposed by Pillar One has diverging objectives, which will have to coexist where there are different allocation rules for MNEs for transfer pricing purposes and for general income tax purposes, even though both are based on value creation. While the former is based on a supply approach only, i.e. DEMPE functions, the latter is based on a supply-demand approach, i.e. people, tangible assets, or sales and market/users.

Within this context, it is valid to question how to reconcile both diverging objectives to achieve a coherent international tax system. One might argue that, having concluded in this thesis that value creation is a redefinition of source and as it has been foreseen almost 40 years ago that the demand jurisdictions ought to receive parts of the "international income",[38] formulary apportionment is a potential option for that. As it has been established some time ago, on the one hand, the supply approach of source entails that income has its source where the factor services or functions that generate that income operate or perform, that is in today´s OECD terms DEMPE functions. On the other hand, source also has a supply-demand approach which holds the market value created through the interplay of the supply-demand, that is in today's OECD terms the "location of consumers or users".

The "new" era of source taxation – namely some generalized notion of "source"– that the international tax "system" seemingly is aiming towards, reflects that source – or possibly more broadly "origin". On the one hand, it denotes the notion that income is attributed geographically to a jurisdiction where income arises, i.e. DEMPE functions from BEPS Actions 8-10 (OECD Guidelines 2017). On the other hand, it denotes that income might have a specific link other than to for example the geographical location where income arises, i.e. location of consumers and/or users from Pillar One. In this vein, it seems formulary apportionment is an option for that, as above mentioned. Furthermore, under a supply-demand approach the separate accounting principle would not be applicable because it would need something similar to a PE to allocate income from sales. That would mean that a fictional PE would have to be created on a transactional basis in a discretionary process that would represent the demand, which would be inapplicable from a practical point of view.[39] This is the reason why the proposal on Pillar One departs from the transactional view or separate approach and adopts an overall profit or group approach; this approach is also reinforced by Pillar Two. The fact that the functional (i.e. DEMPE) formula-based value creation standard is still based on the separate accounting principle demonstrates that the current formulaic approach to allocate income would need to move to a real formulary approach. As a matter of fact, as it has been seen in practice due to the interconnectedness of operations, the difficulty to obtain comparables and have access to information has led over time to the use of more formulary approaches that have been introduced in the OECD Guidelines 2017, i.e. profit split methods. This demonstrates that sooner rather than later the moving towards a fractional approach would be inevitable, moreover if it is considered that the supply-demand approach has arrived here to stay.

One might argue whether the inclusion of the demand side in the supply approach for transfer pricing purposes could be accomplished by adding a factor to the functional (i.e. DEMPE) formula-based value creation standard that includes the market jurisdiction, for example: DEMPES; where the "S" represents sales. This approach would require an analysis of whether the sales factor has already been taken into account in any of the other relevant factors to avoid double taxation issues. Moreover, the formulary approach would solve determining the amount of profits to be allocated to a jurisdiction which BEPS Actions 8-10 has not addressed.

5. What If the ALP Is Not the Problem? The Emergence of Pillar Two and Global Taxation

BEPS Actions 8-10 became the forum for studying international corporate income and income tax base allocation by revealing the foundational concern that profits were shifted from high to low-tax jurisdictions instead of addressing that profits were taxed low without substance. Actually, the fact that profits were taxed low without creating any constructive economic activity provided as a rationale to address the issue of "low-tax countries" in some way. In other words, the goal of BEPS Actions 8-10 was not to address substance – in the sense of alternate formulations of the same economic outcome. In reality, as one

36. OECD, *Public Consultation Document: Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two, 8 November 2019 – 2 December 2019* (OECD 2020).
37. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2020).
38. N.P. Musgrave, *Principles for Dividing the State Corporate Tax Base, The State Corporation Income Tax: Issues in Worldwide Unitary Combination (1984)*, p. 234 (McLure ed. 1984), available at https://www.tib.eu/de/suchen/id/BLCP:CN004156365/Principles-for-Dividing-the-State-Corporate-Tax?cHash=c8d9682e78be8a236cedf9304639ba2e (accessed 13 Nov. 2021).
39. Id., at p. 234.

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of the elements used to resolve challenges of tax competitiveness, substance has been used to limit the position of low-tax nations in the international tax mainstream. One solution would be the harmonization of tax systems, namely tax base or tax rates, but considering there is no political support for such harmonization, the OECD focused on one of those factors as proxy for a harmful tax competition such as "substance" that in fact was already part of the OECD Guidelines 2017 and could accommodate it to its expectations. Despite this, BEPS Actions 8-10 have their merits considering that the kind of reproachable tax avoidance of "cash-box" entities has been successfully deterred. However, there is a new form of reprehensible tax avoidance that is nonetheless permissible. In reality, as previously stated, the functional (i.e. DEMPE) formula-based value creation criterion encourages profit shifting to low-tax countries, albeit this is not necessarily a cause for concern, unless the move is not genuine. As a result, the functional (i.e. DEMPE) formula-based value creation norm not only does not prohibit true profit shifting, but it further supports it through the use of the ALP mechanically.

As a result, tax competition is likely to rise as nations compete to attract mobility factors (people functions combined with money) by lowering corporate tax rates or establishing preferential tax regimes to encourage innovation and investment, for example. Indeed, the OECD has indicated that several nations have increased or implemented new tax incentives, including modified nexus-based IP boxes to encourage innovation.[40]

In that context, it's debatable whether Pillar Two will be able to curb tax competitiveness and the "race to the bottom", given that it targets tax arrangements that are seen as allowing multinational corporations to move profits to countries with no or low taxes.[41] And, this does not account for Pillar Two's limited scope in any event – there are many MNEs that are substantial but not to the degree necessary to bring them within Pillar Two's scope. Because Pillar Two tries to settle on a worldwide "average" tax rate, the author believes that the "race to the bottom" and "bad" tax competition that the international tax system is now experimenting with will become a "race to the average".[42] This would lead to a "return to the beginning place", which is, after all, the core of any competition, including tax. In reality, competition is beneficial when it is viewed as a tool for encouraging a country's progress rather than an aim in itself. This also applies to governments and the tax policies that underpin revenue collection.

With this in mind, one could question if Pillar Two, by guaranteeing that earnings are taxed at a minimum tax rate and therefore establishing a basis for tax competitiveness among nations, could solve the shifting of profits that the OECD Guidelines 2017 failed to tackle. In this regard, the OECD already stated that Pillar Two "could reduce the differences in effective tax rates across jurisdictions, which are one of the main drivers of profit shifting. *Reducing these tax rate differentials would reduce MNEs' incentives to shift profit to low-tax jurisdictions*".[43] One might not forget that the OECD not so long ago in BEPS Action 11 expressly mentioned that "if economic functions, assets and risks are effectively relocated to another country to take advantage of a low tax rate or tax credit, this does not constitute BEPS."[44] It appears that the OECD either changed its mind in a short period of time after seeing that the BEPS approach was really triggering more BEPS than predicted, or it refuses to acknowledge that BEPS Project 1.0's methodology was inherently flawed.

As previously stated, the OECD Guidelines 2017 reinforce profit shifting through the formulaic DEMPE concept, and Pillar Two aims to eliminate or at the very least mitigate this effect by proposing two different approaches to determining an effective tax rate (ETR), namely global and jurisdictional blending, as well as the consideration of a substance-based approach that could exclude certain activities that are less susceptible to BEPS risks. It's debatable whether a substance-based carve-out would be consistent with BEPS Action 5 or Actions 8-10 in this sense. Substance-based carve-outs, in the author's opinion, are not recommended since the "new" reproachable profit shifting that enabled BEPS Actions 8-10 via the functional (i.e. DEMPE) formula-based value creation standard would be triggered. The Blueprint's contemplation of a formulaic substance-based carve-out based on payrolls and assets components would have a similar effect. Furthermore, if profit shifting to low-tax jurisdictions is to be resisted, jurisdictional blending would be the ideal complement. This would ensure that both high and low tax rates are not blended to establish the ETR.

Having that in mind and recalling that there is reproachable tax avoidance when the transaction that results in that outcome is unreasonable or non-genuine because there is a tax benefit other than for bona fide purposes, it is questionable whether such transactions should be carved out given that they have passed a test where their susceptibility to BEPS is almost non-existent. This differs from the carving-out of transactions merely in accordance with BEPS Actions 8-10 since these transactions might be exploited for non-genuine objectives.

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40. OECD, *Tax Policy Reforms 2019 OECD and Selected Partner Economies*, sec. 3.2 (OECD 2019).
41. OECD/G20, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy – Inclusive Framework on BEPS*, p. 25 (OECD 2019).
42. *See* Chand & Lembo, *supra* n. 21, at sec. 6.2.1.
43. OECD/G20, *Tax Challenges Arising from Digitalisation: Economic Impact Assessment – Inclusive Framework on BEPS* sec. 1.2.2 (OECD 2020).
44. OECD/G20, *Measuring and Monitoring BEPS – Action 11: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, p. 82 (OECD 2015).

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6. Concluding Remarks

The main question addressed by this article is whether the main thrust of Pillar One and Pillar Two constitutes a confirmation of the formulaic apportionment and anti-avoidance approach of the value creation functional (i.e. DEMPE) formula standard. The answer is yes.

From a transfer pricing perspective, value creation develops, invites and reveals a fractional apportionment as a new normal standard to allocate profits based on the performance of earning-income activities, which can be interpreted as a new universal source rule. As such, value creation, in the OECD's understanding, is an expression of substance in terms of functions that are exemplified in a formulaic (though not expressly arithmetic) way in DEMPE functions, assets and risks. In this sense, value creation determines the countries that are allowed to tax an enterprise's cross-border business income provided in that state where an enterprise conducts economic activities by means of production factors, i.e. employees, assets and capital. That approach constitutes a mechanical approach that will continue to permit an acceptable "outsourcing" of significant activities, i.e. DEMPE functions, but aligned with value creation, in other words, with substance. This approach leads to a two-fold redefinition of source rule, i.e. positive and negative source.[45] While the positive source rule seeks to allocate economic activities income, however in very abstract terms – the certainty that something must occur –, the negative rule aims to counter illegitimate or reproachable tax avoidance based on where it is not reasonable for income to have been earned if there are no commensurate functions, assets or risks that give substance to them. In that regard, the formula-based value creation standard reinforces also the anti-avoidance approach of the OECD Guidelines 2017 to the extent that profits could not be allocated to jurisdictions where, mainly, functions are not performed.

From the perspective of taxation of the digital economy, Pillar One and Pillar Two are effectively connected with the issues revealed by the OECD Guidelines 2017. Pillar One to the same extent confirms and adheres to the rationale that formulary proposals only serve as a mechanical tool to allocate benefits in a results-driven manner that instructs MNEs on how to organize their transactions. Pillar Two is a way of admitting that there is a global legal system, therefore some form of global anti-abuse rule could also be implemented, as has been attempted from a transfer pricing perspective when the OECD universally defined what a source of income means with the notion of value creation in the Guidelines. From a different angle, Pillar Two would serve as a "safe harbour" for those transactions that despite being aligned with substance would allow the shifting of profits to low-tax jurisdictions, guaranteeing that at least profits will be taxed at a minimum level.

45. In the same line of thinking, *see* Martin Jimenez, *supra* n. 9, at sec. 2.2.; A. Martín Jiménez, *Tax Avoidance and Aggressive Tax Planning as an International Standard – BEPS and the 'New' Standards of (Legal and Illegal) Tax Avoidance*, in *Tax Avoidance Revisited in the EU BEPS Context: 2016 EATLP Congress Munich 2-4 June 2016* (A.P. Dourado ed., IBFD 2017), Books IBFD; Wilkie also argues that value creation operates as negative source rule, *see* Wilkie (2016), *supra* n. 17, at p. 84.

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