NAVIGATING TRANSFER PRICING: ISSUES AND CHALLENGES IN THE ERA OF BEPS 2.0

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Abstract

The core value driver for Multi-National Companies (MNCs) that operate in different territories is the profit-making motive, and hence, it is a common presumption that an MNC would seek to reduce its tax liability to increase its after-tax profits. The principle against double taxation in international tax law ensures that no income is taxed more than once. However, this doesn't mean the income can go untaxed in any jurisdiction. As such, the transfer price of the transaction between the associated enterprises of the MNC, which takes place cross-jurisdictionally, can only be taxed in the territory that has more nexus than the others to which such income can be attributed. Sometimes, a sovereign nation, in an attempt to exercise its taxing rights with the intention of not losing its tax base, may impose tax at a lower rate than others, creating a favourable tax regime for the MNCs. This practice may serve as an incentive to the MNCs through their strategic tax planning to shift their income and profits to such low-tax jurisdictions. Transfer pricing is one such mechanism of profit shifting exploited by the MNCs. To address these issues, the Organisation for Economic Co-operation and Development (OECD) spearheaded the BEPS 2.0, which aims to curtail the erosion of tax base and shifting of profits for fair and effective taxation. Through its Action plans, the BEPS regime ensures that the income is taxed in the jurisdiction where value creation occurs through substantial economic activities and combats tax abuse. This research paper explores the relationship between transfer pricing and the OECD initiatives in the ever-evolving landscape of international taxation. The study will employ a doctrinal approach to critically analyse the interplay between the BEPS compliance guidelines and the tax planning strategies of MNCs, including restructuring inter-

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company transactions. Further, the research paper will also examine the implications of this effort of the OECD to curb tax avoidance on global tax governance through an interdisciplinary approach so as to offer insights on how to navigate the complex intersection of corporates, taxation, and technology to secure fiscal justice.

***Keywords**: Transfer Pricing, BEPS, Profit Shifting, MNCs, OECD.*

INTRODUCTION

"*The avoidance of taxes is the only intellectual pursuit that carries any reward.*"

- *John Maynard Keynes.*

Tax is an obligatory payment for everyone's gain in a nation's interest, and the common gain is the responsibility of the government of every nation. Hence, tax is the rightful want of the government to fulfill its duties as a welfare state and to run its administration. Taxing rights can be seen as a government exercising its sovereignty, and it is therefore important for a sovereign nation not to lose its tax base. In the era of globalization, where Multinational companies (hereinafter referred to as MNCs) have branches, subsidiaries, holdings, and divisional offices that operate across the globe, it then becomes natural for them to make transactions worldwide, that is, the transfer of goods and services, between the countries or tax jurisdictions. One of the associated enterprises can be in one jurisdiction while the others operate in other jurisdictions. It is pertinent to note that the tax jurisdictions are not necessarily similar and can have distinct tax systems. It can be high-tax or low-tax jurisdictions, based on the domestic rates of tax that they impose on the taxpayers having a connection (either in the form of territorial nexus or a business connection in the nature of significant economic presence) to their jurisdiction. Then again, with globalization, it is difficult to design domestic tax policies in isolation from other jurisdictions.

In the case of Multinational enterprises (hereinafter referred to as MNEs) that operate globally across many tax jurisdictions, a nation cannot lose its right to tax the income attributable to its territory. The income of the corporate group that relates to a particular transaction can sometimes have its economic value spread across multiple nations involved in the transaction. In that case, rules have to be decided multi-laterally to attribute the extent of the income or profits appropriately to each taxing state.

One of the tax avoidance methods adopted by the MNEs is when the associated enterprises (hereinafter referred to as AEs) reallocate the profits and costs between the entities, known as profit shifting. *Jennison V. Baker*[1] clearly held that "The law should not be seen to sit by limply, while those who would defy it go free and those who seek its protection lose hope." As such, curbing the ways in which tax avoidance and tax evasion happen became a prominent issue in international taxation that needed to be addressed on an immediate basis, as not only the revenue of the states could be reduced, but the trust that the people may have on a welfare state would erode along with its tax base. Thus, the Organization for Economic Co-operation and Development (hereinafter referred to as OECD)[2] took upon itself the responsibility to address the issues pertaining to international taxation.

This research paper seeks to analyze the measures adopted by the countries of the globe in curbing any shifting of profits and subsequent tax avoidance through aggressive tax planning strategies. The advent of the Base Erosion and Profit Shifting (BEPS) project to the contemporary implementation of the Inclusive Framework with the two-pillar approach and the issues raised and discussed by various countries are also examined to deliberate the future course of action pertaining to mitigating the effects of transfer pricing.

TRANSFER PRICING AND SHIFTING OF PROFITS

The tax planning strategies employed by the MNEs on their tax attributes generally involve those strategies that help secure, increase, and/or accelerate tax relief or other tax incentives. They are very country-specific as they rely on their domestic rules. An OECD report[3] on how tax planning on tax attributes occurs was released, describing a number of aggressive tax planning schemes on losses. The objective of these very schemes varies from the recognition or treatment of losses (to reduce the tax payable), shifting of losses to a party making profits, or shifting of profits to a party making losses (to the constituent entity in an MNE group), circumventing any limitations placed on the carry forward of losses, creating artificial losses in a jurisdiction and ensuing multiple use of the same loss in different jurisdictions.

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[1] *Jennison* v. *Baker*, [1972] 1 All ER 997.

[2] The Organization for Economic Co-operation and Development is an international, inter-governmental organization headquartered in Paris. It was set up in 1961 to provide guidance for economic growth and promote policies for sustainable economic development with the expansion of world trade.

[3] OCED, *Corporate Loss Utilisation through Aggressive Tax Planning* (OECD Publishing, Paris, 2011), *available at*: https://doi.org/10.1787/9789264119222-en (last visited on: 30.11.2024).

Identified to be the most pressing among the ways to shift the profits, transfer pricing (hereinafter referred to as TP) is when the MNE tries to redistribute their profits through inter-company[4], intra-group transactions. The transaction between two related parties within the MNE group can be overpriced or underpriced so as to shift the substantial economic value between the parent and subsidiary or two subsidiaries situate in two different countries. As a general rule, these transactions must take place at the market price level as though they occur between two unrelated parties so that the prices are not manipulated[5]. However, when it happens within the group, it serves as a technique to reallocate the income of the MNE by themselves, thus leading to tax avoidance through internal profit shifting by erosion of the tax base of the country. Transfer pricing manipulation became so rampant that the OECD had to step up in the 1970s, more so because the increasing number of member countries may subject the tax base to double taxation. With interconnected issues cropping up, the OECD released a report on 'Transfer Pricing and Multinational Enterprises'[6] in 1979 that analyzed the problems and practices from the point of view of a taxing state. After the 1995 Transfer Pricing Guidelines[7] for the MNEs and subsequent 2010 guidelines, the OECD called for the Base Erosion and Profit Shifting Action Plan (BEPS project) in 2013[8]. Thus began the process of rendering the methods of profit shifting ineffective.

OECD Action Pathway

When the OECD set out in 1979 to examine the transfer pricing mechanism to secure the taxing rights of its members, it propounded the principle of Arm's Length Pricing (ALP) as its standard to assess the price involved in the transaction, imbibed in Article 9[9] of the OECD Model Tax Convention while rejecting the global method of profit allocation. Attention is to be drawn to the fact that these Transfer Pricing guidelines serve as a focal point that is followed by most nations of the world (including the non-OECD member states) through

[4] The inter-company transactions, here, means those transactions between the associated enterprises of the MNE, which shift profits between tax jurisdictions under the pretext of aggressive tax planning.

[5] Eric J. Bartelsman and Roel M.W.J. Beetsma, "Why Pay More? Corporate Tax Avoidance through Transfer Pricing in OECD Countries" 87 *Journal of Public Economics* 2225–2252 (2003), *available at*: https://www.sciencedirect.com/science/article/abs/pii/S004727270200018X (last visited on: 17.09.2024).

[6] OECD, *Transfer Pricing and Multinational Enterprises* (OECD Publishing, Paris, 1979).

[7] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing, Paris, 1995).

[8] OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, Paris, 2013), *available at*: http://dx.doi.org/10.1787/9789264202719-en (last visited on 12.12.2024).

[9] *"Where a Contracting State includes in the profits of an enterprise of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State..."*

self-enforcement, even if not legally binding (as it is a soft law having quasi-legal status)[10]. The ALP principle treats the inter-company transaction in the same manner it should have been treated had it occurred between two independent, unrelated parties. Here, the benchmark for redistribution of revenue and expenses becomes the behavior of unrelated parties in such a scenario. Thus, the entities of the same corporate group are treated as distinct, separate companies for the purpose of taxation despite falling under the same central command. Further, it was recommended by the OECD that the FAR analysis (functions, assets, and risk analysis) be done before choosing which method of ALP to apply to compute the transfer price.

OECD has always supported the 'comparable uncontrolled price' method (CUP), the 'resale price method' (RPM), and the 'cost plus method' (CPM). The Transactional Profit Methods gained significance only after the 1995 guidelines, following the issues of availability of comparable data. Critics highlight the fact that implementation issues are not the dominant problem of transfer pricing regulations but rather the ALP that evaluates an MNE based on the behaviour of the independent, unrelated parties[11]. The fallacy is at the very core of the Arm's length standards (ALS) in its assumption based on the centralization of the management of an MNE that defies reality.[12] Moreover, finding sector-specific comparable entities is highly unlikely. The independent parties who provide the 'uncontrolled comparable' do not even exist in most sectors.

The period between 1995 and 2010 saw the evolution of TP regulations as reports were issued on intangible assets, intra-group services, and business restructuring of the MNEs, which gave an insight into how transfer pricing can take various forms. They had to be incorporated into the TP guidelines to give rise to the 2010 version. The primary change in this version was that the OECD finally adopted the 'most appropriate method' approach rather than blindly supporting only the traditional methods of transfer pricing. The 2022 TP guidelines[13], which replaced the previous 2017 edition, dealt with the hard-to-value

[10] Alberto Vega, "International Governance Through Soft Law: The Case of the OECD Transfer Pricing Guidelines", *Working Paper of the Max Planck Institute for Tax Law and Public Finance No. 2012-05* (2012), *available at*: http://dx.doi.org/10.2139/ssrn.2100341 (last visited on: 01.12.2024).

[11] Michael Durst, "It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws" *Tax Notes*, Jan. 18, 2010, at 247-256.

[12] Reuven Avi-Yonah & Ilan Benshalom, "Formulary Apportionment - Myths and Prospects", *University of Michigan Law School Public Law and Legal Theory Working Paper Series*, Paper 28 (2010).

[13] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing, Paris, 2022), *available at*: https://doi.org/10.1787/0e655865-en (last visited on: 12.11.2024).

intangibles, the application of transactional profit split methods, and the pricing of intra-group financial transactions.

BEPS ACTION PLAN

The OECD BEPS initiative sought to address, through its 15 Action Plans, the shifting of the profits of the MNE to a low tax jurisdiction where it performs little to no substantial economic activity in the name of 'tax planning' so as to reduce the group's tax liability. The BEPS project began in 2013, and the OECD and G20 countries released consensus reports in 2015. The main concern of BEPS was that the multinational groups were separating the taxable income from the economic activities that generate such income in an artificial manner. Action Plans 8 to 10 and 13 talk about transfer pricing, particularly to align the price with value creation and the documentation requisites. Action 13[14] focused on country-by-country reporting (CbCR) for information on the allocation of profits and the revenue from the economic activity performed in each tax jurisdiction. Even the taxes paid by each constituent entity must be disclosed in the master and the local file to assess the fiscal position of the group[15]. This supposedly increased the financial transparency of the MNEs.

Action Plans 8 - 10[16] sought to align the transfer price of the associated enterprise with the economic value it creates. The functional analysis would actually affect the price of the transaction as it signifies the choice of the TP method and the tested party. This means that the comparability analysis will be done from the point of view of the tested party. However, the 'tested party approach' is not followed by most countries, including India, as it analyzes the transaction from the other party rather than from the point of view of the MNC in question. Action 8 deals with intangibles - their definition, ownership, and who is entitled to the returns from the unique transactions. In line with this, India also suggests using the 'Profit Split Method' (PSM) for such R&D related to intangibles.[17] Nonetheless, in practice, the Indian judiciary always over-utilized the 'transactional net margin method' (TNMM) for testing the Indian taxpayer. This is a fundamentally flawed approach because both the tested

[14] Transfer Pricing Documentation: Improving tax transparency with country-by-country reporting.

[15] Ioana Ignat & Liliana Ionescu-Feleagă, "Short History of the Transfer Pricing Concept and Interesting Concerns in Relation to It", in *Transfer Pricing in Manufacturing: Contributions to Finance and Accounting* (Springer, Cham, 2022).

[16] Transfer Pricing: Guidance for applying arm's length principle.

[17] CBDT, Circular No. 6/2013 dated 29.06.2013, *available at*: https://www.pwc.in/services/tax/news_alert/2013/pwc_news_alert_1_july_2013_cbdt_issues_revised_guidance_on_contract_r_and_d_centres.pdf(last visited on: 30.11.2024).

parties are risk contributors. The routine profits must be distributed according to their activities, and the non-routine profits should then be allocated in accordance with their unique contributions based on a profit-split analysis.

Developments In BEPS Framework

Owing to the mobility of the risks and assets and the corresponding tax structurization by the countries to attract finances and investment, separate entity principles strengthen the tax competition. Expanding the reach of the existing nexus rules may help address the mobility issues. The nature and location of the management of risks, research and development functions, and further classification of the functions as routine or high value-addition would determine the ALP more appropriately. Such in-depth information on the operations of the MNC is now possible through Action 13 of the BEPS.

With increasing global mobility, the manner in which profits are attributed to a subsidiary and a permanent establishment (PE) significantly varies. As pointed out by 'Manuel de los Santos, Head of the Transfer Pricing Unit, OECD Centre for Tax Policy and Administration', "We need to pause and see whether the core OECD instruments, i.e., the Chapter 1 of OECD Transfer Pricing Guidelines relating to ALP, are still fit for purpose[18]." India, like other OECD members, follows the 'Significant People Functions' approach to attribute the profits to the PEs as it seeks to identify the economic ownership to address the disconnect between economic activity and profits. Action 10 particularly clarified the use of profit split methods in 'global value chains'. The profit generated must be equivalent to the value generated by the transaction[19]. It specifically spoke of the low value-adding services that are performed intra-group, which can be categorized as high risk.

Based on these action plans, a discussion draft to amend the TP guidelines was produced, which led to the amendments of 2017. The 2017 guidelines were a toolkit to help developing countries analyze transfer pricing. The evolving research on this resulted in two other reports

[18] Ralf Heussner, *et. al.*, "Deloitte OECD Interview Series – Part Two: Attribution of Profit to PEs and the Authorised OECD Approach" *Deloitte*, Feb. 15, 2024, *available at*: https://www.internationaltaxreview.com/article/2cuif1o2nxo7h1938sf7k/sponsored/deloitte-oecd-interview-series-part-two-attribution-of-profit-to-pes-and-the-authorised-oecd-approach (last visited on: 09.12.2024).

[19] OECD, *Aligning Transfer Pricing Outcomes with Value Creation*, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, Paris, 2015), *available at*: https://doi.org/10.1787/9789264241244-en (last visited on: 06.11.2024).

in 2018[20] that discussed using the transactional profit split methods and when to use the same. In 2018, additional guidelines were issued under Action 7 for attributing profits to permanent establishments (PEs). The outcomes of these actions came to be placed under the 'common approaches' category as they form the foundational principles for nations such that there is convergence in the domestic transfer pricing practices. Despite all this progress, issues still continue to exist relating to the criteria for attribution of profits in accordance with value creation and application of profit split methods. BEPS requires not only continuous coordination but also multi-lateral consensus to be implemented.

Paving The Pathway To BEPS 2.0

The problems associated with BEPS include not just the inability to agree to the criteria for profit allocation but also the unilateral measures undertaken by the sovereign nations like that of Digital Services Tax (hereinafter referred to as DSTs) and interpretations of significant presence in the taxable territory. As such, the OECD charted the tax on the digital economy based on user-created economic value in the market countries where businesses operate[21]. A value chain analysis for the varied business models that would determine the contribution of users to the multi-sided platform of the digital business is an economically sound approach for allocating taxing rights. This is the stand of OECD taken to build consensus to avoid unilateral measures to the multi-lateral international taxing issues. BEPS sought to look beyond the arm's length principle, and hence, work continued on the digital economy front as it was widely accepted that the market-based countries were denied an appropriate share of their tax base. A pure destination-based model would not be appreciated, and at the same time, addressing tax competition requires the participation of low-tax jurisdictions. This again called for a system that would have the ALP as a foundation upon which to build, and thus, any formula-based approach was out of the equation. With the broad consensus that profits should be taxed rather than revenues on a 'net basis'[22], an improved international tax system

[20] OECD, *Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, Paris, 2018), *available at*: https://www.oecd.org/tax/beps/revised-guidance-on-the-application-of-the-transactional-profitsplit-method-beps-action-10.pdf (last visited on: 20.11.2024).

[21] Vladimir Starkov and Oceana Wang, "What is the Value of Users, Anyway? How to Value the User Contribution to Digital Enterprises" *Tax Notes International*, Jan. 20, 2020, *available at*: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3586419 (last visited on: 16.10.2024).

[22] Joseph L. Andrus & Richard S. Collier, "Transfer Pricing and the Arm's-Length Principle After the Pillars" *Tax Notes*, Jan. 31, 2022.

needs to be implemented quickly to increase the global economy, including a global minimum tax (GMT).

BEPS INCLUSIVE FRAMEWORK

The era of Transfer Pricing is undergoing changes in the global scenario with the advent of the BEPS 2.0 initiative addressing the digitalization of the economy, which introduced the Two-Pillar approach over which political and geographical concerns ensue. The original timeline to reach a political multi-lateral consensus was targeted towards the end of 2020, but disagreements on critical issues caused failure to adhere. This has led to the timeline for implementation being shifted over and over again, making the BEPS initiative a work in progress. While the feasibility of such a Transfer Pricing regime needs to be discussed, Pillar One redistributes the profits of the MNE in such a manner that the jurisdictions wherein there is a 'significant economic presence' with a substantial market and user participation. Pillar Two, which is the GloBE rules, designed a global minimum tax regime that prevents the shifting of profits to tax havens/ low-tax jurisdictions[23].

Two-Pillar Approach

The BEPS 2.0 was introduced by the OECD to dampen profit shifting by the MNEs as a two-pillar approach with the unilateral measures by the various countries in mind. To put it simply, Pillar One would tax the digital economy while Pillar Two would impose a minimum tax, which would help resolve a few transfer pricing issues. Pillar 1, in its Amount A, reallocates 25% profits in excess of 10% for companies having turnover over €20 billion to a market jurisdiction in which the group derives more than €1 million[24] in revenue. This is done on the basis of the sales factor to prevent double taxation. Here, profits (in turn, taxes) are reallocated to where the markets are rather than where the economic activities are. The attribution of residual profits to market states and a safe harbor mechanism for the marketing and distribution activities work hand-in-hand as part of the pillar one mechanism. Amount B of Pillar 1 is a critical component that applies ALP to the in-country baseline marketing and distribution activities focusing on low-capacity countries in order to avoid double taxation[25].

[23] Erika Scuderi & Raphael Holzinger, "Global Transfer Pricing Developments", in Michael Lang and Raffaele Petruzzi (eds.), *Transfer Pricing Developments Around the World 2021* (Wolters Kluwer, 2021).
[24] "The domestic currency equivalent will be computed in the corresponding tax jurisdiction."
[25] OECD, *Outcome Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* (July 11, 2023), *available at*: https://www.oecd.org/tax/beps/outcome-statement-

Pillar 2 operates for MNEs with turnover exceeding € 750 million[26] through the 'Global Anti-Base Erosion' (GloBE) Model Rules, imposing 15%, which may create a secondary taxing right[27]. The GloBE rules implement a top-up tax in case of excess profits if taxed below the 15% rate through the 'Income Inclusion Rule' (IIR) and 'Undertaxed Profits Rule' (UTPR). The 'Ultimate Parent Entity' (UPE) would pay the top-up tax in its resident jurisdiction. However, if the UPE has not adopted the IIR, the UTPR will deny deductions or similar measures for the group entities to adjust the unpaid top-up tax. The 'Effective Tax Rate' (ETR) is computed for the qualifying taxes for the determination of top-up tax, and tax is imposed domestically through the 'qualified domestic minimum top-up tax' (QDMTT) mechanism[28]. Together, both pillars were seen as a hybrid model combining different income allocation methods, and hence, integrating them to form a single unified tax system was of utmost importance.

PROGRESS IN THE TRANSFER PRICING WORLD

More countries have introduced the Digital Services Tax levy to tax the 'digital presence' in their jurisdictions, which doesn't require a physical nexus to the state. However, these DSTs have a hybrid character with features of both income tax and sales tax, raising the question of whether tax treaties against double taxation are applicable[29]. Amount A of Pillar One creates a taxing right to those market jurisdictions where the residual profits are located, and this, in turn, not only reduces the complex compliance burdens but prevents the proliferation of these DST-like measures unilaterally. However, a Multi-Lateral Convention (MLC) must be designed to allocate a defined portion of the profits to those members having a nexus.

5.1 The Arguments Surrounding BEPS 2.0

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on-the-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2023.pdf (last visited on: 01.12.2024).

[26] "The equivalent of €750 million will be computed as per the domestic currency of each tax jurisdiction."

[27] Carolyn Wright, "OECD and Country Officials Discuss BEPS 2.0 Pillars One and Two and Other OECD Tax Work" *Ernst & Young Tax News Update: Global Edition*, Nov. 6, 2023, *available at*: https://www.ey.com/en_gl/tax-alerts/oecd-and-country-officials-discuss-beps-2-0-pillars-one-and-two- (last visited on:15.12.2024).

[28] KPMG, "Global Minimum Tax: Complexities Abound" *KPMG Global Tax and Legal – Hot Topic*, May 25, 2023, *available at*: https://kpmg.com/kpmg-us/content/dam/kpmg/frv/pdf/2023/hot-topic-global-minimum-tax.pdf (last visited on: 24.12.2024).

[29] Isabel Verlinden, *et. al.*, "Chapter 2: Transfer Pricing Developments in the European Union", in Michael Lang and Raffaele Petruzzi (eds.), *Transfer Pricing Developments Around the World 2021*(Wolters Kluwer, 2021).

Following the rudimentary explanation of the pillars of BEPS 2.0, it can be understood that the ALP will still serve as the exclusive method for those MNCs below the revenue threshold and entities engaged in specific sectors like mining and financial services. At the same time, while there is material uncertainty on how the pillars will pan out, the question of whether a shared timeline for the implementation of the pillars or a decoupled implementation would be fitting needs to be considered. Pillar 1 Amount A reallocates the profits to the market country

irrespective of any taxable presence or resident entity, which means that those countries with smaller markets but higher economic presence will actually lose out on their taxing rights. A loss carry-forward regime and simplified administrative process are required, coupled with a double taxation avoidance mechanism. The profit re-attribution to ensure tax certainty necessitates a dispute resolution approach by applying a formula to a newly defined tax base with business line segmentation. In order to ensure that the entity is paying the tax liability on the relevant profits, pillar 2 needs to leverage by providing an incentive through its jurisdictional top-up tax[30]. If pillar 2 can fix the partial reallocation of the profits to the market jurisdiction, then the MNC will not be motivated to avoid tax as it will be forced to pay an additional tax of the same amount in another jurisdiction. This requires consensus on the designs for the different tax systems and business models that ensure a level playing field[31].

What this means for the countries is another question altogether, as discussed extensively. This is because, for international cooperation to be achieved, the costs that each country has to pay are of varying degrees for both the Pillars and how it will impact the tax revenue, and the subsequent response of the country will vary.

Issues In Amount B for Simplification of TP Rules

Amount B of Pillar 1 is subject to the in-scope intercompany transactions[32] for the distributors, sales agent, or commissionaire as tested party where a one-sided Most Appropriate Method (MAM) of transfer pricing can be applied. However, a distributor with

[30] Heyden Wardell-Burrus, "A Pillar One Design Proposal: Leveraging Pillar Two", *Oxford Centre for Business Taxation Working Paper* No. 22/06 (2022).

[31] Erika Scuderi & Raphael Holzinger, "Chapter 1: Global Transfer Pricing Developments", in Michael Lang and Raffaele Petruzzi (eds.), *Transfer Pricing Developments Around the World 2021* (Wolters Kluwer, 2021).

[32] OECD, *Release of New Tools for the Implementation of Amount B Relating to the Simplification of Transfer Pricing Rules* (OECD Publishing, Paris, 2024), *available at*: https://www.oecd.org/en/about/news/announcements/2024/12/release-of-new-tools-for-the-implementation-of-amount-b-relating-to-the-simplification-of-transfer-pricing-rules.html (last visited on: 26.12.2024).

unique contributions or assuming economically significant risks cannot be a qualified party. The exclusion of non-distribution activities and non-tangible goods and services/ commodities from the ambit of Amount B again brings with it the challenges posed by the ALP method in identifying whether TNMM or CUP is most appropriate. Suppose unilateral adjustments are to be made to the returns computed (in case of 'net risk adjustment' or 'net operating asset intensity percentage') due to an insufficient global dataset. In that case, the tax administrations may lose or gain their tax base as MNEs can undertake business restructuring to fall in or out of the scope. Amount B is the only approach that doesn't have a revenue threshold (unlike Amount A and Pillar 2)[33]. It can be made widely applicable for those transactions if it can potentially have a positive impact. The Pillar One exclusion of extractive businesses and regulated financial services when the intention is to cover the highly digitalized business models is another issue, as the technical complexities remain despite simplifying the assessment procedures.

Challenges in Implementing Pillar Two

In the implementation of Pillar Two, the variations in the accounting standards of the consolidated financial statements do create differences in basis. Also, the impact of deferred taxes for such differences needs to be accounted for. The rules prohibit any deferred tax accounting as part of the top-up tax as a temporary relief measure[34]. Suppose no consensus on pillar two is reached. In that case, a unilateral minimum tax levy within the scope of the bilateral treaties is still possible, but multi-nationally, it complicates and damages the taxing bodies. It would be sensible to say that Pillar 1 and Pillar 2 need to be implemented in the same timeline as they back each other up because not only does there need to be a multilateral agreement for treaty ratification, but it also requires the countries to roll back their unilateral levy of DSTs. Efforts are being made around pillars 1 and 2, especially with regard to the interaction of the ALP approach with the destination-based approach of the amounts A and B of pillar 1. Hence, it can be said that any delay in reaching a political agreement on the implementation is undesirable.

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[33] EY Global, "OECD Releases Final Guidance on Pillar One Amount B on Baseline Distribution" *EY Global*, Feb. 22, 2024, *available at*: https://www.ey.com/en_gl/technical/tax-alerts/oecd-releases-final-guidance-on-pillar-one-amount-b-on-baseline- (last visited on: 22.12.2024).

[34] KPMG, "Global Minimum Top-Up Tax: Relief from Deferred Tax Accounting" *KPMG Global Tax and Legal – Insights*, Sept. 29, 2023, *available at*: https://kpmg.com/xx/en/our-insights/ifrg/2024/beps-proposed-amendments-deferred-tax-ias12.html (last visited on: 24.12.2024).

Advancing The Design To Protect Tax Base

Further, the requirement of an MLC to give effect to Pillar 1 causes the time difference in the implementation of the two pillars, which in turn has separated the pillars 1&2. If you look at it from the perspective of the countries, the Pillars provide for relatively little gain compared to the unilateral DSTs. Moreover, the effect of double taxation that must be eliminated also falls on the tier-1 countries, which are smaller. Such issues have resulted in the search for alternatives to Pillar One, viz., models resembling Value Added Taxes (VAT), Digital services tax (DST), Significant economic presence (SEP), or options for withholding the taxes in case of digital supply. One distinct feature of these alternatives is that they concentrate on taxing turnover, not profits and taxing supplier, rather than the consumer or the market state.

Another question would be concerning 'value creation' for the splitting of profits. While examining the term from the viewpoint of operational contributions of the business, its limitation, whether to include only the functional contributions or the other capital and risk contributions, is relevant as the right approach for quantifying the value of the contributions is not spelled out in the OECD guidelines. The potential allocation keys and their weightage are not specified to identify the economically relevant characteristics to perform functional analysis for profit splitting[35]. While BEPS has attempted to answer the 'what?' and 'when?' here through its extensive discussions, the question of 'how?' has been neglected, especially in the wake of digitalization concerns[36].

Repercussions of the Inclusive Framework

Suppose someone is of the opinion that pillars 1 and 2 are going to curb profit shifting entirely. In that case, it is better to understand that the pillars would not effectively reduce tax competition, and in effect, tax planning would take a different form than what is in existence. However, the tax differentials would be reduced, and the transfer pricing would become less aggressive as the incentive to shift profits becomes miniscule. This is owing to the fact that there is less difference in tax when the transaction is taxed at 15% and, say, 20% than when it

[35] OECD, *Aligning Transfer Pricing Outcomes with Value Creation*, Actions 8-10 Final Reports (OECD Publishing, Paris, 2015).

[36] Andrew Hickman, "Arm's Length Principle Mutations: Control of Risk in the OECD Guidelines and Variations in Practice", *MNE Tax* (2021).

is taxed at zero (assume tax havens) and 20%. The primary objective of the Inclusive Framework is to create a level-playing field for tax jurisdictions such that the stimulant for profit shifting is not solely tax arbitrage. In a theoretical construct, the tax advantages shrink and lessen the incentive to shift. However, as pointed out by Herzfeld[37], a comparison with the Anti-inversion law of the US that sought to curb paper profit shifting resulted in the shifting of real substance instead. Real economic behavior is unpredictable, and any regulations may end up incentivizing a different kind of profit shift and consequent tax competition altogether.

CONCLUSION AND SUGGESTIONS

The income of an MNE is easier to ascertain, and as such, a model of income allocation that is based on revenue is preferable over the one based on its expenditure. It may so be possible that a model based on outflows might disregard the quality of the expenditure. As a revenue-based solution, whether the Inclusive Framework under the BEPS project can ameliorate the tax avoidance situation is a worthy discussion. MNEs benefitting from the tax arbitrage offered by the low-tax jurisdictions or the tax havens can diminish to a large extent following the implementation of BEPS 2.0[38], but having ALP as the core foundational principle still doesn't address the concerns of the complex model vis-a-vis treatment of risks and capital. The paucity of information was an important concern of the ALP, which can be overcome by BEPS Action 13.

However, when it comes to the two-pillar approach, Amount B of Pillar 1, which seeks to reallocate a proportion of the profits to the demand jurisdiction, seems more generalized, while there is potential for a specific approach. The doubts raised and issues that arise can always be settled without leading to tax uncertainty through Advance Pricing Agreements (APAs) and Mutual Agreement Procedure (MAP) arrangements. This would further enhance predictability both to the tax payers and the tax jurisdictions in whether any dispute is subject to review or otherwise reassessment[39]. Amount A of Pillar 1 applies fractional apportionment

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[37] Chip Harter, *et.al.*, "Hashing Out the Pros and Cons of a Global Minimum Tax: Transcript Print" *Tax Notes*, Sept. 30, 2021, *available at*: https://www.taxnotes.com/featured-analysis/hashing-out-pros-and-cons-global-minimum-tax-transcript/2021/09/30/79gr0 (last visited on: 29.11.2024).

[38] Felix Hugger, *et. al.*, "The Global Minimum Tax and the Taxation of MNE Profit", OECD Taxation Working Papers, No. 68 (OECD Publishing, Paris, 2024), *available at*: https://doi.org/10.1787/9a815d6b-en (last visited on: 19.11.2024).

[39] OECD, *Pillar One - Amount B: Inclusive Framework on BEPS* (OECD Publishing, Paris, 2024), *available at*: https://doi.org/10.1787/21ea168b-en (last visited on: 25.12.2024).

by properly excluding the intangible assets, and the implementation of it will eliminate double taxation rules. Since it doesn't seem to generate more revenue than individual digital taxes, many countries have rejected Pillar One from a tax revenue perspective[40]. The alternatives presented for Pillar One need the development of a formula that depends on the profit margin of similar businesses and also needs to be a model that taxes the consumers. There is one other proposal that imposes a two-stage tax model, which suggests taxing the net profits by withholding tax in the product line as well as taxing the revenue source, i.e., the location of the customers. The indicators from Amount A of Pillar One can be used to identify the final adjustments. Irrespective of the propounded alternatives, a transfer pricing approach that secures a stable, coordinated international tax system, ensuring tax equity for all businesses alike, is the need of the hour, and any failure to deliver would result in a patchwork of unilateral measures. Unilateral measures by any country are not only mutually damaging but may cause an international tax war[41].

The domestic incorporation of the Pillar Two compliance and filing obligations necessitates a safe harbor provision that provides for penalty relief for non-compliance during the transitional period if reasonable measures had been taken in good faith and can be made inapplicable to fraud, tax avoidance, or abuse of tax treaties. The non-qualifying and stateless constituent entities that escape taxation under the IIR or UTPR rules must be addressed through such a safe harbor mechanism. The STTR rule and the implementation of an MLI allow 'taxing back' the profits that were subject to minimum or no tax in their jurisdictions. The Inclusive Framework of the OECD has made substantial progress through the impact assessment of pillars 1 and 2, wherein over 130 tax jurisdictions have agreed upon implementing the pillar two solution[42] to protect the tax base of the countries where the MNEs operate. The Pillar Two solutions come into effect on 1st January 2025, and will change the global tax landscape when it comes to tax avoidance through transfer pricing. Countries like India are moving towards the implementation of the two-pillar solution

[40] Reuven Avi-Yonah & Ajitesh Kir, "Building the Gateway: Why the Two Pillars Need Each Other", *University of Michigan Law & Economics Research Paper* No. 24-023 (2024), *available at*: https://dx.doi.org/10.2139/ssrn.4766111(last visited on:14.11.2024).

[41] Daniel Bunn, "Chaos to the Left of Me. Chaos to the Right of Me." *Tax Foundation*, May 5, 2020, *available at*: https://taxfoundation.org/blog/pascal-saint-adams-oecd-digital-tax-negotiation-timeline/ (last visited on: 23.12.2024).

[42] OECD, *Action 1: Tax Challenges Arising from Digitalization* (OECD Publishing, Paris, July 11, 2023), *available at*: https://www.oecd.org/tax/beps/beps-actions/action1/ (last visited on: 30.10.2024).

through the withdrawal of the equalization levy[43]. It is important for the countries to incorporate the UTPR and STTR rules in their domestic legislation as soon as possible to facilitate the mitigation of the incentives and tax competition provided by the tax havens. On the other hand, non-advanced developing economies that may lose out on their investments post-implementation will have to provide tax incentives that are expenditure-based (for instance, in India, the CSR initiatives under section 135[44] of the Companies Act, 2013 can be given deductions). Expenditure-based incentives rely upon the investments made, irrespective of profitability, and can serve as a tax structure to retain foreign investments while aligning with the pillars of the Inclusive framework. However, the questions surrounding the integration of the pillars with the existing model of ALP and transfer pricing hinder the progression to swiftly adopt the new model with no delay because, after everything, the OECD intends to stick with the path of the arm's length principle for the time being.

[43] The Union Budget 2024-25 proposed the withdrawal of the 2% equalization levy on non-resident e-commerce operators with effect from Aug. 1, 2024.
[44] The Companies Act, 2013 (Act 18 of 2013), sec. 135 (5).