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An Octogenarian on Value Creation

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In this article, the author discusses the role of value creation in tax policy and legislation.

On May 18 the International Fiscal Association celebrated its 80th anniversary in Rotterdam, the city of its headquarters. The *plat de résistance* of this celebration was a panel presentation and discussion under the title, "Tax in a New Universe: The Role of Value Creation." The panel was experienced and well balanced, including representatives from North America (Peter Blessing), Europe (Wolfgang Schön), and Asia (Porus Kaka) under the neutral chairmanship of Robert Danon of Switzerland.

The presentations and debate raised many questions and criticisms on the role of value creation, a topic that has been dominating international discussions on tax policy and legislation since the release of the base erosion and profit-shifting reports. Basically, two questions were debated: (1) What is the function of the concept of value creation in international taxation; and (2) What is value creation? Although concern over double taxation was thick in the air, one issue that was not extensively debated was how the use of value creation as a tool to allocate income across tax jurisdictions will affect double taxation.

The chair started by pointing out a kind of contradiction within the concept of value creation. To the extent that it is indirectly relied upon to change the traditional allocation of taxing rights, value creation complicates the traditional distinction between residence and source. Initially the BEPS action plan stated that: "While actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income."[1] However, it now appears that the post-BEPS international tax system has become more "hybrid" and less coherent.

The Many Functions of Value Creation

Value creation seems to fulfill several functions in international taxation. In BEPS actions 8-10 (aligning transfer pricing outcomes with value creation), value creation is being used to align transfer pricing outcomes by using the functional analysis of transactions: "it is important to understand how value is generated by the group as a whole, the interdependencies of the functions performed by the parties with the rest of the group, and the contribution that the parties make to that value creation."[2]

BEPS action 7 (preventing the artificial avoidance of permanent establishment status) is mainly focused on the question of what is the minimal PE threshold. However, the final paragraph of the discussion draft makes the link to value creation: "While there are a number of different ways of approaching these issues, they cannot be addressed successfully without coordination between the work on the PE status . . .

[1] OECD, BEPS action plan (July 2013), at 12.

[2] OECD, "Public Discussion Draft: BEPS Actions 8, 9 And 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)" (Dec. 19, 2014), para. 16.

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and the work on . . . Action 8. . ., in particular the work aimed at ensuring that profits associated with the transfer and the use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation."[3]

Finally, BEPS action 6 (preventing the granting of treaty benefits in inappropriate circumstances), containing limitation on benefit rules and the principal purpose test (PPT), does not directly refer to value creation but clearly states in its introduction: "Existing domestic and international tax rules should be modified in order to more closely align the allocation of income with the economic activity that generates that income."[4] One could be excused for reading "economic activity that generates income" as a definition of value creation. The overall objective of the BEPS action was to "realign the value chain," which of course has to do with where and how much value was created in the chain.

In prof. Schön's opinion, value creation was originally about substance and tax avoidance with the purpose of cutting tax havens out of the international system. That corresponds more or less to the BEPS objectives stated in the preceding paragraph. But in the ensuing debate, value creation was used as a concept to allocate taxing rights not only between residence and source countries, but also among developed OECD countries, the BRIC (Brazil, Russia, India, and China) states, and developing countries.

That opinion was supported by Mr. Kaka, who asked whether value creation could be used as the basis for a new PE concept. As permanency is redundant in the metaphysical digital economy, the PE concept could be replaced by a new concept of significant economic presence for which he submitted a definition that could be inserted in the OECD model convention's article 5:

> where a person makes sales to or in a contracting State, exceeding an amount (to be negotiated) and has the following additional activity carried out within that State: collects data from users within such State or indirectly facilitates the sales, and/or has [the] number of users of its platform exceeding (to be negotiated), and/or carries out support activities such as after sales support services in relation to the sales; then it would be deemed to have a PE for the purposes of this convention.

That definition is not too far away from the significant economic presence proposed by the European Commission in its recent draft directive on digital presence (COM(2018) 147 final).

What Is Value Creation?

The million-dollar question is, of course, whether value creation can fulfill all these functions. To find the answer, we must know what we mean by value creation. Apparently, value creation is not identical to profits. Paragraph 1 of the preamble to the EU anti-tax-avoidance directive (Council Directive (EU) 2016/1164), which aims at implementing BEPS, states: "The current political priorities in international taxation highlight the need for ensuring that tax is paid where profits and value are generated." We know that profits are subject to income tax, but value or value creation, which is apparently something different from profits, is not mentioned in income tax acts.

In the international taxation of business income, traditionally there were two questions to be answered: (1) Where is the taxpayer subject to tax; and (2) What amount of his income is subject to tax in that jurisdiction? The answer to the first question was the taxpayer's state of residence, absent a PE outside that state; and then, of course, whether its business presence qualified as a PE.

The answer to the second question was to be found in the rules for the allocation of income. Traditionally these were the market rules, balanced by tax treaty and transfer pricing rules supporting the market rules.

The rules defining the tax jurisdiction and those allocating the taxable income between two jurisdictions fulfill two very different functions. The two major international tax questions are unchanged. But because of evolving economic and technical conditions, there is now a consensus that existing rules no longer function properly.

The functional analysis standards used in the BEPS action plan to identify value creation are

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[3]OECD, "Public Discussion Draft — BEPS Action 7: Preventing the Artificial Avoidance of PE Status" (Oct. 31, 2014), para. 44.

[4]OECD, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report" (Oct. 5, 2015), para. 2.

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gradually eroding the difference between these two old questions as we attempt to find a new approach. Functional analysis determines the jurisdiction where the income is taxed based on the physical location where a function is carried out. On the other hand, it also determines the amount of income that market rules, or their proxies, indicate should be allocated to that function. The distinction is being blurred because within the concept of value creation, new elements have been identified as potential contributors to taxable profits, especially those concerning digital activities. Peter Blessing suggested that value creation was a concept that derived from the growing recognition of the importance of intangible assets, and that the word "creation" could be considered to emphasize production inputs, in particular research and development.

The location of the "establishment" is extended to "significant economic presence" based on the number of users, the volume of sales, and the number of times databases have been accessed. In classical economic theory, these elements were not considered to be production factors contributing to business profits and therefore were never taken into consideration for defining either the location of an economic establishment or the amount of profit to be allocated to that establishment.

This new value creation idea allows the allocation of profits to tax jurisdictions where there is no or almost no physical taxpayer presence. Ironically, it originated in some economic powers' dissatisfaction with the huge gap between the effective but minimal presence of a taxpayer in a particular jurisdiction and the huge amount of profits realized that are subject to tax in that jurisdiction.[5]

The idea was to solve this problem by searching for a certain proportional relationship within a jurisdiction between the taxpayer's economic presence and the amount of income generated. By widening the concept of economic activity beyond the concept of an "establishment," let alone a "permanent establishment," source-country tax jurisdiction was extended to all significant types of income-generating activity performed, even without any tangible presence. At the same time, similar indices were used to calculate taxable income allocation to the extended jurisdiction. The value was to be determined in accordance with market rules, thereby reducing the contracting parties' discretionary power to distribute profits in accordance with their business objectives.

What About International Double Taxation?

Needless to say, the introduction of value creation's new elements into the minimal economic presence that justifies source taxation and the value chain functional analysis that allocates income between jurisdictions has had an unsettling effect. The new elements of value creation are rather vague, and will create instances of double taxation. This is illustrated by allocation rules presented by Kaka for the digital economy's deemed PE. In the case of a deemed PE, the determination of profits shall be made after deduction of expenses, incurred directly or indirectly in earning the profit-related income, including an allocation of executive and general administrative expenses, whether incurred in the state where the PE is situated or elsewhere. If the correct amount of profit attributable to a PE cannot be determined, or the determination presents exceptional difficulties, the profits may be estimated "on a reasonable basis."

Experience has shown that tax administrations may have different opinions on what constitutes a reasonable basis. Yet the question of the concept's resulting double taxation was not discussed in this panel, except for a unanimous rejection of the European Commission's new proposal for a digital services tax (DST) (COM(2018) 148 final), in the form of an equalization turnover tax. The tax was seen as an additional layer of taxation that would be difficult to integrate into either the income tax or the VAT/goods and services tax systems.

In addition, there were objections that the equalization turnover tax would violate the basic WTO rule on nondiscrimination of products of

[5] One example of this gap was the case of *Cadbury Schweppes*, C-196/04 (CJEU 2006). The U.K. tax administration sought to tax all the profits of the Cadbury Schweppes subsidiary established in the International Financial Services Center in Dublin by applying the controlled foreign corporation legislation in the United Kingdom, because there was a disproportion between the size of the physical presence of the office in Dublin and the amount of profits realized in Ireland.

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foreign origin, because the tax was seen as mainly aimed at the services of major digital service providers established outside the EU. Yet there is already 50-year-old Court of Justice of the European Union case law on a turnover equalization tax (Umsatzausgleichsteuer) in Germany.[6] In that case, the Court decided that an internal turnover tax on imported products (green peppers) did not constitute a quantitative restriction or a measure having equivalent effect when there were no similar products supplied in the domestic market.

The Court also held that any internal tax that imposes a higher charge on imported products than on competing domestic products, even when not similar, constitutes discrimination under the old article 90 of the EC Treaty, which is a carbon copy of the national treatment rule in Article III of the General Agreement on Tariffs and Trade. The only question is whether the DST would provide indirect protection to internally provided digital services within the EU. However, if the DST would be applicable in law as well as in fact to digital service suppliers established inside the EU, the indirect protection argument probably would not apply.

The Need for an Open Political Debate

During the discussion, Schön observed that deriving a correct definition of "value creation," or its source in tax jurisprudence, is difficult. Kaka, while agreeing, commented that perhaps the reason behind the inclusion of value creation in the BEPS agenda is more a derivative of political convenience and consensus than a specific term that has tax jurisprudential history to which one could ascribe a definition. There is no objective definition available and one cannot overlook the political context in which the term "value creation" has been introduced in the tax lexicon. It means different things to different governments, especially in the context of the digital economy. On this the panel agreed.

In the end, not surprisingly, the conclusion was unanimous. The main issue is which country is entitled to tax and how much tax is it entitled to levy. This is not a question that can be resolved by introducing new technical rules, because it is a political issue that should be resolved in an open political debate. During the last century, that debate was conducted within the framework of the League of Nations, resulting after World War II in the OECD model convention.

Global changes in the economic relationships and fundamental changes in technology require a reassessment of the basic rules. But the core relationship between source and residence countries, and the common claim of source and residence countries to share the tax base, will remain unchanged. Prima facie, such open political debate looks like mission impossible. The conflicting interests of the three groups of countries identified by Schön — developed OECD countries, the BRIC countries, and developing countries — seem insurmountable. Furthermore, there is the question of this debate's appropriate forum.

None of the three groups on its own has the power to impose its view on the others. All three groups need each other not only for increasing economic growth and welfare within their own group, but also for meeting global challenges like climate change and immigration. Fora for discussion already exist: the OECD and its inclusive group of countries, the U.N. working parties on taxation, and the G-20. Cooperation among these fora may facilitate an open debate.

Also, the relative positions of major countries in the world pecking order are changing rapidly. These changes modify the outlook of countries' economic interests. Countries may rapidly change from source to residence countries and vice versa. That means that in less than a generation the economic interests of these countries may be quite different. In establishing new rules, these rapid changes should be taken into account.

It is a sign of vitality that an octogenarian like the IFA is in the forefront of conducting the debate on the future of international taxation. While the panel did not provide a satisfactory final solution, it did raise useful questions on the use of value creation as an instrument for ordering the new tax universe. Not only the panel members of the anniversary seminar, but the whole IFA organization deserves tribute for this effort. ■

[6] *Firma Fink Frucht GmbH v. Hauptzollamt München*, Case 27/67 (CJEU 1968).

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