Digital Business and Corporate Income Taxation: Is Value Creation's Role Overstated?

by Jefferson VanderWolk

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In this article, the author discusses value creation and international corporate income tax policy.

International corporate income tax policy discussions are increasingly focused on the concept of value creation.[1] The OECD, the European Commission, and the U.N. have all used the term as a touchstone in recent policy documents.[2] Tax administration is also being affected.[3]

The OECD's March 2018 interim report on digitalization tax challenges starts:

> The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and *ensure that profits are taxed where economic activities take place and value is created*.[4] [Emphasis added.]

As indicated in Chapter 1 of the interim report, this language was drawn from the October 2015 final BEPS project reports:

> Launched in 2013, the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project consisted of 15 separate action areas targeting the gaps and mismatches in the international tax system that facilitated the shifting of profits by multinational enterprises (MNEs) away from *where the underlying economic activity and value creation took place.* Action 1 of the BEPS Project undertook to consider the tax challenges raised by digitalisation for both direct and indirect taxation.[5] [Emphasis added.]

It is worth noting that the OECD's formulation contains two concepts — economic activity being one and value creation being the other. The two would seem to be linked, at least insofar as economic activity results in the creation of value. Yet the focus of current discussions and analyses,

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[1] *See, e.g.*, Allison Christians, "Taxing According to Value Creation," *Tax Notes Int'l*, June 18, 2018, p. 1379; and materials cited below.

[2] OECD, "Tax Challenges Arising from Digitalisation — Interim Report 2018: Inclusive Framework on BEPS," (2018) (hereinafter "interim report"); and United Nations, "Report on the Fifteenth Session of the Committee of Experts on International Cooperation in Tax Matters" (Oct. 17-20, 2017), paras. 28-29.

[3] Ryan Finley, "'Value Creation' Cases Present Challenges for IRS APMA Program," *Tax Notes Int'l*, June 11, 2018, p. 1335 (quoting John Hughes of the IRS, speaking at the OECD-USCIB International Tax Conference in Washington on June 5, 2018).

[4] Interim report, Foreword.

[5] Interim report, Chapter 1, para. 12.

including the interim report, has been mainly on value creation, with little mention of economic activity. This preference is reflected in the title of the OECD's final report on BEPS actions 8-10: "Aligning Transfer Pricing Outcomes With Value Creation."

At the same time, however, the OECD's explanatory statement **[link provided doesn't work]** on the BEPS project final reports goes the other way: "Changes to the Transfer Pricing Guidelines will ensure that the transfer pricing of MNEs better aligns the taxation of profits with economic activity." This suggests that perhaps the OECD did not see any difference in the meaning of the two phrases. Nevertheless, "value creation" has been in the forefront of subsequent work.

The interim report's second chapter lays the groundwork for the rest of the report and makes its focus on value creation clear in the introductory paragraph:

> This chapter presents an in-depth analysis of value creation across different digitalised business models, with the aim of informing the current debate about international taxation. Section 2 describes the main characteristics of digital markets. Such characteristics shape the three different processes of value creation identified in Section 3 (value chain, value network and value shop) and analysed in detail in Section 4 through business case studies. Section 5 identifies three key factors that are prevalent in more highly digitalised businesses and it accounts for the related differing views of the members of the Inclusive Framework on BEPS.[6]

The problem with talking only about value creation, rather than economic activity, is that value creation is much more difficult to define as a practical matter. According to one commentator, "Part of the OECD's problem is the hopelessly vague standard it developed during the BEPS project: that profits must be taxed where value is created."[7] At a recent conference, a leading international tax academic "observed that deriving a correct definition of 'value creation' or its source in tax jurisprudence, is difficult."[8]

The interim report adopts an economist's view:

> Discussions of value creation tend to start with the value chain. Developed by Michael Porter in the mid-1980s, the value chain is a standard tool in academia and business applied to analyse a firm's competitive advantage. Value chain analysis divides a firm into discrete activities in order to understand how to create superior value, where superior value has two sources: by offering differentiated products which can justify a premium price or by reducing costs.[9]

In the context of income tax law, this approach is problematic for at least two reasons. First, it is premised on the concept of a unitary firm, regardless of whether that firm does its business as a single business entity or through a group of commonly controlled entities. Tax law does not have such a concept. Rather, the taxation of business income occurs in relation to individual business entities or groups of business entities whose tax attributes are consolidated through common ownership or control, regardless of whether they are all engaged in carrying on a unified business as a "firm."

Second, the taxation of a business's income is not based in any way on the value of the business. A business can have value but no income and no income tax liability. The expectation of future income may result in substantial value for a business that has not yet made a single sale. Business income taxation depends on the realization of net profits from operations of the taxpayer through its agents — that is, its employees, directors, and authorized contractors.

It is odd, therefore, that the OECD and many international tax policy specialists have opted to focus on value creation, rather than on economic activity, in the effort to address the tax challenges

[6] Interim report, Chapter 2, para. 31.

[7] Mindy Herzfeld, "A Post-Truth Tax World," *Tax Notes Int'l*, June 18, 2018, p. 1369.

[8] Frans Vanistandael, "An Octogenarian on Value Creation," *Tax Notes Int'l*, June 18, 2018, p. 1385 (referring to a comment by prof. Wolfgang Schoen at the 80th anniversary of the International Fiscal Association panel discussion on "Tax in a New Universe: The Role of Value Creation," Rotterdam, May 18, 2018).

[9] Interim report, Chapter 2, para. 66.

of digitalized businesses. As the interim report shows, an economist's analysis of value creation does not lead to any clear conclusions regarding what ought to be done in the corporate income tax area to address perceived problems resulting from digitalization. Perhaps an approach based on economic activity, rather than value creation as defined in the world of economics, would be more fruitful.

Nexus and Profit Allocation

The interim report concludes that:

> [M]embers of the Inclusive Framework agree that they share a common interest in maintaining a single set of relevant and coherent international tax rules, to promote, inter alia, economic efficiency and global welfare. As such, they have agreed to undertake a coherent and concurrent review of the two key aspects of the existing tax framework, namely the profit allocation and nexus rules that would consider the impacts of digitalisation on the economy.[10]

Following a brief summary of the nexus and profit allocation standards embodied in the OECD's model tax convention articles 5 and 7 (regarding the definition of permanent establishment and the attribution of profits to a PE) and the OECD transfer pricing guidelines, the interim report states:

> [T]he taxation of a non-resident enterprise depends on rules that are strongly rooted in physical presence requirements to determine nexus and allocate profits. The principal focus of the existing tax framework has been to align the distribution of taxing rights with the location of the economic activities undertaken by the enterprise, including the people and property that it employs in that activity. This conceptual approach was recently reinforced by the BEPS Project, which sought to realign the location where profits are taxed with the location where economic activities take place and value is created. However, the effectiveness of these rules may be challenged by the ongoing digitalisation of the economy to the extent that value creation is becoming less dependent on the physical presence of people or property.[11]

For the reasons noted earlier, the words "value creation" in the last sentence of the above passage ought to be replaced by "profit realization" or words to that effect. Nevertheless, the passage appropriately recognizes the importance of the "location of the economic activities undertaken by the enterprise" and "the location where economic activities take place."

In essence, the tax problem posed by digitalized businesses is that they are able to penetrate the market in a jurisdiction and earn profits from regular and continuing sales to customers located in that jurisdiction without needing to have a traditional taxable presence — that is, an office or dependent agent with authority to conclude sales in the jurisdiction. The internet has created this problem. Before the internet, a remote seller could make some sales in a jurisdiction where it had no office or dependent agent by means of print advertising or other forms of marketing, or by concluding sales over the telephone or on paper through the mail, but this did not result in remote sellers making so many local sales that local suppliers of similar goods or services were undermined by tax-advantaged competition. Also, the local tax authorities did not perceive any significant threat to their income tax base from the activities of remote sellers.

Now, however, thanks to the internet, remote sellers are competing successfully with local sellers everywhere, reducing the local business income tax base. The questions that need to be addressed are how can the definition of PE in article 5 of the OECD model tax convention be amended to permit the relevant jurisdiction to impose income tax on remote sellers; and how can the rules for the attribution of profits to a PE under article 7 of the model tax convention be amended to achieve appropriate results?

[10] Interim report, Chapter 5, para. 373.

[11] Interim report, Chapter 5, para. 379.

Tweaking the Tax Rules

To address these questions, it is not necessary to analyze a business's value creation. Rather, we need to consider the ways in which the existing tax rules are falling short of achieving the desired results and the options for tweaking the rules to achieve those results without causing new problems.

The nexus issue is relatively easy to deal with. The PE definition in article 5 already contemplates a deemed taxable presence based on the activities of a dependent agent that habitually concludes sales or habitually plays the principal role leading to the conclusion of sales by the remote seller.

It should not be too difficult to amend the PE definition to deem a remote seller to have a taxable presence in a jurisdiction if it has actively marketed its goods or services to customers located in the jurisdiction, whether through digital means such as a local-language website and online advertising or through one or more service providers located in the jurisdiction; or if its sales to these customers exceed a stated revenue or number-of-sales threshold during the tax year, or both.[12] The fact that the remote seller does not have any physical presence in the jurisdiction should not by itself prevent the jurisdiction from asserting the right to tax if the stated conditions are met. The U.S. Supreme Court's recent decision in the *Wayfair* case supports this proposition.[13]

The more difficult issue is profit attribution to a deemed taxable presence. Attribution of profits to a PE has never been consistently done internationally, and the OECD's attempt to spell out an agreed approach in its 2010 Report on the Attribution of Profits to Permanent Establishments has not in practice resulted in consistency. Nevertheless, all Inclusive Framework countries have been able to agree on this principle:

> Under Article 7 of the [OECD Model Tax Convention], the profits to be attributed to a PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that cause it to be a PE. [T]his principle applies regardless of whether a tax administration adopts the authorized OECD approach as explicated in the 2010 Report on the Attribution of Profits to Permanent Establishments.[14]

In other words, a PE should be taxed on the profits attributable to the activities conducted by the PE, taking into account the assets used by the PE and the risks assumed as a result of the PE's activities. The basic approach prescribed by article 7 of the model tax convention deems the PE to be a separate and independent enterprise transacting with its head office, or other parts of the enterprise of which it forms a part, at arm's length. This implicates the OECD transfer pricing guidelines, which relate to arm's-length pricing under article 9 of the model tax convention. The core of the guidelines is the requirement to analyze each transacting party's functions, assets, and risks as a matter of practical reality, in determining what an arm's-length result (or the range of possible arm's-length results) would be.

On reflection, it should be possible to take a common-sense approach, consistent with the agreed principle and based on the relevant activities of the taxpayer, to the attribution of profits to a remote seller's deemed PE where the taxpayer has no physical presence or dependent agent in the taxing jurisdiction. The PE would be based on two requirements: an active marketing requirement and a revenue/sales threshold requirement. The revenue from sales to customers located in the jurisdiction should be the starting point for the computation of attributable profits. Costs to be deducted from the revenue should include all costs of marketing to those customers,

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[12] At the time of writing, the Indian government had launched a public consultation, related to its new "significant economic presence" test of business connection in India giving rise to a taxable presence in India, on what the thresholds should be for both total receipts of a nonresident from sales to customers located in India and the number of users located in India solicited or otherwise engaged by the nonresident through digital means.

[13] *South Dakota v. Wayfair Inc.*, No. 17-494 (2018). Although the case was concerned with sales taxes, it is nevertheless relevant to taxing rights more generally, as the issue was whether a nonresident seller had availed itself of the privilege of carrying on business in South Dakota by virtue of having more than $100,000 in revenue from sales to customers located in the state or more than 200 transactions with such customers during the year. *See* Squire Patton Boggs discussion.

[14] OECD, "Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7" (2018), para. 6.

regardless of where those costs were incurred, as well as all costs related to the purchase or production of the goods or services sold to those customers (including, for example, research and development costs).

This would require a country-by-country allocation of certain costs that are not directly related to any one country, such as the compensation costs of a global or regional marketing team, or the cost of a global or regional marketing campaign. Directly related costs, such as the cost of creating and maintaining a website in a language spoken only in one country (for example, Hungarian), or the service fees paid to one or more marketing services providers in a country, would be wholly allocated to the PE deemed to be in that country.

If after-sale services are provided to customers without charge, the cost of such services should also be deducted, regardless of where the cost is incurred (for example, a global customer service center in India), using an appropriate method of allocation to individual countries.[15]

Attributing profits to a deemed PE in this way would be consistent with the principle that taxation of business income should be aligned with the economic activities giving rise to that income. Existing transfer pricing methodologies would not be disturbed. The value of both production intangibles and marketing intangibles would be reflected in the pricing of the relevant transactions (or hypothesized transactions between the PE and other parts of the enterprise of which it is a part). The substance-based transfer pricing guidance that emerged from actions 8-10 of the BEPS project could continue to be implemented as intended by all the countries that participated in formulating it.

Nor would this approach require acceptance of a simplistic destination-based taxation of business income, which gives a jurisdiction the right to tax a resident's business income solely because customers located in that jurisdiction bought goods or services from the nonresident. Income taxes, unlike consumption taxes, should be based on the activities and attributes of the taxpayer, not on the mere fact that customers have chosen, for whatever reason, to buy particular goods or services from a particular supplier.

In conclusion, the current focus on value creation in discussions of the tax challenges posed by digitalized business models appears to be misplaced. Value creation is an economic concept that does not fit well with corporate income taxation in the global arena. The focus ought to be on the activities of taxpayers regarding the various markets in which they make their sales. ■

[15]This discussion is concerned only with fact patterns in which the remote seller conducts no production-related activities in the jurisdiction. Clearly, if a remote seller was conducting production-related activities in a jurisdiction in which its active marketing and sales operations created a "virtual" PE as discussed in this article, a portion of its profits would have to be attributed to the production-related activities as well. A transactional profit-split method might be appropriate in such a case unless the particular facts supported the use of another method.