
Act of creation: the OECD/G20 test of “Value Creation” as a basis for taxing rights and its relevance to developing countries

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This paper examines the use of the “value creation” concept that plays a central role in current OECD/G20 and European Union taxation work as a way of determining the taxation rights of countries, especially in the increasingly digitalised economy. It examines the likelihood of a consensus on whether it is an appropriate test, particularly with a view to the interests of developing countries. It also notes the need for such countries to ensure that their “policy space” in corporate taxation that is based on the place of consumption is not unduly limited by these developments.

Keywords: BEPS, Base Erosion and Profit Shifting, developing countries, digital economy, multinationals, policy space, taxation of multinationals, tax treaties, transfer pricing, value creation

*“Anyone who writes on a complex subject must learn that he cannot aim one arrow at two targets.” —Arthur Koestler, *The Act of Creation**

1. Introduction

A central idea justifying the recent OECD/G20 Base Erosion and Profit Shifting (BEPS) project, designed to tackle tax avoidance and evasion by multinational enterprises (MNEs) in particular, has been to “ensure that profits are taxed where economic activities take place and value is created”. Among other appearances, it has been at the foundation of the OECD Action Plan initiating the BEPS Project,¹

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¹ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. <http://dx.doi.org/10.1787/9789264202719-en>.

the BEPS Final Report on Actions 8-10 dealing with transfer pricing (profit-shifting) issues² and, most recently, the 2018 Interim Report on Tax Challenges Arising from Digitalization (“the Interim Report”).³ It has also been taken up in the work of the European Union (EU) on taxation of the digitalised economy.⁴

The question of what the term “value creation” means is only now being investigated as closely as its importance warrants, however. Such an investigation is important to understanding the reach and impact of BEPS, but also, most immediately, in considering the possibilities for resolving differences over how to tax the increasingly digitalized economy. It is especially pressing, given that the OECD is seeking a consensus on this issue by 2020.⁵ The meaning of the term, and the level of shared understanding on the point, affect the likelihood of a consensus and the depth of any consensus that is reached. From the perspective of developing countries, important issues are whether the term sufficiently accommodates countries with differing situations and priorities, and how likely it is that the outcomes will have the common sense of ownership that is needed if countries are to adhere to them in practice.

These issues are especially important because there has been recognition as part of the 2015 BEPS Report on this issue that – as summarised by the 2018 Interim Report – “it would be difficult, if not impossible, to ‘ring-fence’ the digital economy from the rest of the economy for tax purposes because of the increasingly pervasive nature of digitalisation. Instead, it considered digitalisation as a transformative process affecting all sectors brought by advances in [information and communication technology]”.⁶

The work on BEPS thus has not focussed only on the Facebooks, Spotifys, Googles and the like of this world but rather on the increasingly digitalized economy more generally (an approach which has some merits in terms of practicality and realism). Thus, any norms emerging out of the work will affect taxation more broadly, not just the most digitalized businesses. As business models and consumer behaviours evolve, such norms will, for good or ill, likely be in place for a long time. This is all the

² OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241244-en>; e.g. p. 3: “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.”

³ OECD (2018), *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264293083-en>.

⁴ European Union (2018), “Fair Taxation of the Digital Economy”, 21 March 2018, https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en.

⁵ Interim Report, p. 20.

⁶ Interim Report, p. 18.

more reason why the norm-setting process should be scrutinised, including how it is likely to affect developing countries. This note seeks to give just such scrutiny to the current processes and interim outcomes.

Section 2 of the note addresses the OECD/ G20 Base Erosion and Profit Shifting Project and the new focus it has brought to the “value creation” concept, especially by referencing the Interim Report and its potential significance for developing countries. Section 3 examines similar but distinct European Union initiatives. Section 4 considers India’s “equalisation level” as a response to the digitalized economy, and the different concepts of “value creation” its history demonstrates, while Section 5 looks more generally at the tension between the needs for both practical solutions and the certainty of guidance. Section 6 considers the relationship of the value creation concept to the “consumption” side of the market – where a firm “captures” the demand in the market even when it has not (on the “supply side”) actively created that demand. Section 7 addresses the treatment of so-called “interim measures” in the BEPS context, and looks to their wider significance, including for the chances of a consensus outcome. Finally, Section 8 looks at the prospect for a consensus on the OECD / G20 digitalised taxation work, and whether and in what form such a consensus would be suitable for developing country official. It makes suggestions for outcomes that might best preserve appropriate “policy space” especially for developing countries.

2. The BEPS context

2.1. Some areas of agreement

To understand the term “value creation” as used in current tax debates, we should first consider the context of its use in the BEPS Action Plan.⁷ It seems intended to be a term that could be understood broadly and would speak to the political imperative that was such a driver for the BEPS Project. As the Action Plan itself said: “Political expectations are very high in most countries and the results and impact of the BEPS work must be in line with these political expectations”.⁸

The term “value creation” in this sense is employed particularly in connection with the use of tax havens, where activities exist but no value is considered to be created. Not just transparency, but also substance requirements, were seen as key to tackling so-called harmful tax practices, and the term “value creation” reflects this

⁷ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264202719-en>.

⁸ *Idem.*, p. 26.

perception.⁹ The term was seen as addressing the use of legal structures regarded as lacking economic substance, such as the use of “shell companies that have little or no substance in terms of office space, tangible assets and employees”.¹⁰ In this sense, the term “value creation” is the tip of the BEPS arrow against “practices that artificially segregate taxable income from the activities that generate it”, as the Action Plan puts it.¹¹

2.2. Transfer pricing and value creation

The BEPS Action Plan noted the concept’s relevance to the BEPS transfer pricing work:¹²

In the area of transfer pricing, the rules should be improved in order to put more emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits.

The specific value creation issues identified for transfer pricing include “adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital”.¹³ The clear intent, as elaborated in the 2015 Final Report on transfer pricing aspects of the BEPS,¹⁴ was to exclude from the calculation mere ownership of intangibles¹⁵ as well as formal acceptance of risks which really constitutes only funding, without other activities.¹⁶

2.3. The digitalized economy and value creation

The issue of taxation of the digitalized economy draws some of these other BEPS threads together and shows why we need to probe the term’s perceived meaning more closely. The Action Plan originating the still unfinished work related to the digitalised economy noted that¹⁷

⁹ See for example, p. 18 on Action 5: “Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime.”

¹⁰ Action Plan, pp. 13-14.

¹¹ Action Plan, p. 10.

¹² *Idem.*, p. 14.

¹³ *Idem.*, p. 20.

¹⁴ OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241244-en>.

¹⁵ *Idem.*, p. 10.

¹⁶ *Idem.*, p. 11.

¹⁷ *Idem.*, p. 110.

The spread of the digital economy also poses challenges for international taxation. The digital economy is characterised by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs. This raises fundamental questions as to how enterprises in the digital economy add value and make their profits, and how the digital economy relates to the concepts of source and residence or the characterisation of income for tax purposes. It is important to examine closely how enterprises of the digital economy add value and make their profits in order to determine whether and to what extent it may be necessary to adapt the current rules in order to take into account the specific features of that industry and to prevent BEPS.

2.4. Some areas of disagreement?

There are particularly important areas of disagreement on what value creation means for a digitalized economy, as noted in part by the Interim Report itself. Speaking of the features it identified in digitalized business (scale without mass, increased reliance on intangibles, and the importance of data and user participation) the Report says:

Among members of the Inclusive Framework, the existence of these three frequently observed characteristics of digitalised businesses is generally acknowledged but there is no consensus on their relevance and importance to the location of value creation and the identity of the value creator. There is general agreement that cross-jurisdictional scale without mass and the increased reliance on intangible assets can be highly relevant to the value creation of digitalised businesses, however, there is also agreement that these factors are not exclusive or unique to digitalised businesses.

While there is general agreement that data and user participation are common characteristics of digitalised businesses, there are differences of opinion on whether and the extent to which data and user participation represent a contribution to value creation by the enterprise.

This passage is important, as in recognising differences in the roles of data and user participation in value creation it assumes consensus that taxation in a digitalized environment should be based on value creation *by the enterprise*. Thus, the only debate would appear to be whether the user data that can be monetized or the user participation that adds value – such as by participation in a network, e.g. bringing in friends – is in fact value creation by the enterprise. There is probably far less agreement that the fundamental issue is what value the enterprise creates

than might appear from this passage, and far less agreement on what that means in any case.

2.5. Relationship to substance over form?

Although the BEPS outcomes generally avoid using the phrase “substance over form” other than when referring to domestic law rules, the concept imbues the BEPS work and its understanding of where value is created, as noted in the Transfer Pricing Report: “[A] realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments”.¹⁸ The promise is that better alignment with business models will ensure the taxation of MNEs where substantial activities occur.

The implied promise is that better alignment will also allow proper taxation of new business models. One risk of the current emphasis on “value creation” as the foundation stone for this new taxation edifice is that if there is no consensus on what it means, then any consensus based on the term will be seen through different lenses, with the consequent possibilities of an uncertain investment environment and double taxation or even double non-taxation.

3. The European Union and value creation

The EU’s response to the digitalized economy throws further light on some of these issues. The EU has also adopted the term “value creation” in its work on taxation of the digitalised economy, noting in particular that¹⁹

... profits are not necessarily taxed in the country of the user (and viewer of the advert), but rather in the country where the advertising algorithms has [sic] been developed, for example. This means that the user contribution to the profits is not taken into account when the company is taxed.

This appears a quite narrow focus, but the EU proposal of 21 March 2018 for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence²⁰ notes more broadly that “[t]he application of the current corporate tax rules to the digital economy has led to a misalignment between the place where the profits are taxed and the place where value is created”.

¹⁸Idem., p. 13.

¹⁹European Commission (2018), “Fair Taxation of the Digital Economy”, https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en.

²⁰Available at https://ec.europa.eu/taxation_customs/sites/taxation/files/proposal_significant_digital_presence_21032018_en.pdf.

It seems that the EU approach of looking for a “significant digital presence” extends beyond merely looking at the supply side, and this is perhaps why some smaller European countries, with an eye to potential suppliers as residents now or in the future (e.g. Sweden with Spotify) have taken a traditional approach in apparent opposition. A statement on 1 June 2018 by the Ministers of Finance of Sweden, Finland and Denmark says²¹

We believe there are no reasons to deviate from internationally established principles regarding the allocation of taxing rights for the digital economy. The digital economy as well as the traditional economy should be taxed where value is created. Therefore, there should be a thorough analysis whether and to what extent, users in some specific digital business models contribute by creating value for the business and whether this should be somehow reflected in taxation.

This seems to imply that their collective view on what might be regarded as value *capture* through meeting the market should not in itself be regarded as “value *creation*”. The only relevant examination of the consumption side is in terms of whether the consumers have provided data that adds value.

The test proposed in the EU draft directive²² of a “significant digital presence” is very broad. It is based on a threshold of provision of “digital services” (itself a very broadly defined term)²³ of a certain value into a Member State, the number of users in a Member State or the number of business contracts in a Member State. This is all consistent with jurisdiction that is based on a certain level of engagement in the economy or, as the OECD Model puts it, “participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State”.²⁴ However, such an approach does not use geography and time-based approaches such as traditional permanent establishment tests as the sole basis for demonstrating this participation. The EU’s “significant digital presence” test also seems inconsistent with an approach based on any very narrow conception of value creation.

In addition, some services, such as video and audio streaming services, are taken out of the directive as not generating taxable revenues. It may be that these are considered better dealt with by a value added tax (VAT). Conceptually, however, it is hard to justify their removal, consistent with the broad definition of digital services. More globally (quite apart from any peculiarities of the EU), it should be left to

²¹ “Global cooperation is key to address tax challenges from digitalization”, <https://www.government.se/statements/2018/06/global-cooperation-is-key-to-address-tax-challenges-from-digitalization/>.

²² Article 4(3).

²³ Article 3(5).

²⁴ OECD Model, p. 154.

countries to decide whether and to what extent VAT or income taxes or both are applied to particular services.

The specific exclusion of “the making available of a digital interface where the sole or main purpose of making the interface available is for the entity making it available to supply digital content to users or to supply communication services to users or to supply payment services to users” may also be a recognition that streaming services can include interactive elements and may indicate data about the preferences of recipients that would be useful to potential advertisers. There is probably no clean break between interactive and non-interactive services, even if it is a useful distinction, and any borderline is likely to become even more blurred over time, thereby demonstrating the essential falseness of the distinction.

4. India’s Equalisation Levy Report

The Sweden, Denmark and Finland statement reflects one reading of value creation. The other view is essentially that the value chains, value networks and value shops²⁵ of the type referred to in the BEPS Interim Report are geared up not just to create demand but also to respond to it and *capture* value. The detailed report of an Indian government committee on the equalization levy,²⁶ delivered in February 2016, is instructive in this respect. The report is said to be consistent with “the need to ensure that profits are taxed where economic activities deriving the profits are performed and their value is created.”²⁷ It examines both the demand and supply sides of the market, however, and opines that²⁸

The market price as well the volume of sales, in turn, results from the interaction of demand and supply within a market, and are contributed by factors on both demand side and supply side. The supply side factors are related to production and marketing, whereas the primary demand side factor that influences the price of a good or service and the profitability of the enterprise supplying them, is the paying capacity of consumers.

The paying capacity of consumers is a function of the state of that economy, including availability of public goods, law and order, market facilitation, infrastructure as well as redistribution of resources (subsidies) to the consumers directly or indirectly, using public resources. The profits

²⁵Interim Report, pp. 36-41.

²⁶Indian Ministry of Finance (2016), “Proposal for Equalization Levy on Specified Transactions” (Report of the Committee on Taxation of E-Commerce, February 2016). Available at <https://www.incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf>.

²⁷Idem., p. 26.

²⁸Idem., pp. 26-27.

arise only when an economic good produced by supplier is paid for by a consumer during the sale transaction. The performance of sale, thus has two limbs – the buyer and the seller and their interaction leads to creation of value and profits. By stabilizing, promoting, preserving and augmenting the paying capacity of the consumers, the Government and the public resources belonging to that economy play a vital role in contributing to the profits generated by enterprises having a significant economic presence in that jurisdiction, and the resultant value of the enterprise.

The report thus seems to have no difficulty in reading the demand side into the value creation calculation. Although this report preceded the BEPS Interim Report, it does suggest less agreement on what value creation means than appears on the face of the latter report.

It next addresses in a footnote the trend in US states towards “significant economic presence” tests and away from “physical presence” tests, a development and approach confirmed by the US Supreme Court Decision of 2018 in *Wayfair*.²⁹

5. Pragmatism versus Purity in Allocating Taxing Rights?

Drawing together some of these threads, one author has noted, that³⁰

Allocating taxation in accordance with value creation is meant to match tax jurisdiction with some “real” location of a corporation’s activity. But this does not make the meaning of value creation clear. Value creation might refer, for example, to one or more of the following factors: employee location, sales location, location of production capacity, location of management or location where capital is raised. What value creation is not is clearer: income should not be allocated to a jurisdiction where a corporation has only a paper presence.

The same author recognizes³¹ that any such discussion of value creation needs to involve consideration of “location savings”, a concept of value creation that is especially dear to the hearts of developing countries, including emerging countries

²⁹South Dakota v. Wayfair, Inc., 585 U.S. (2018): “When the day-to-day functions of marketing and distribution in the modern economy are considered, it becomes evident that Quill’s physical presence rule is artificial, not just ‘at its edges’ (504 U.S. at 315), but in its entirety. Modern e-commerce does not align analytically with a test that relies on the sort of physical presence defined in Quill. And the Court should not maintain a rule that ignores substantial virtual connections to the State”, pp. 3 and 14–15. Available at https://www.supremecourt.gov/opinions/17pdf/17-494_j4el.pdf.

³⁰Morse, S.C. (2018), “International/OECD – Value Creation: A Standard in Search of a Process”, Bulletin for International Taxation (72) 4/5, p. 196.

³¹Ibid.

such as India and China.³² It includes factors such as the lower costs of labour and real estate in most developing countries, which are seen as contributing an often unrecognised value to the multinational that should now be accounted for in transfer pricing analysis.³³ Many proponents of the “value creation” approach based on corporate activities would argue, however, that because such savings are not created by the multinational, but merely captured, they should not be considered in the taxation calculus.

The fact that several factors may be relevant to value creation inevitably means that “each nation has an incentive to establish and encourage ‘value creation’ meanings that will favour that nation, such as customer base for a market country, allocation of risk to capital for a financial centre or location savings for a developing country with inexpensive labour or other factors of production”.³⁴

6. Value creation and the supply and consumption sides

6.1. Echoes of other battles

In many respects any discussion of what constitutes value creation echoes complex discussions about the source of income. With so many factors, located in different places, potentially contributing to the creation of wealth, it has always been a difficult – perhaps impossible – task to find a coherent and widely accepted agreement on the meaning of “source”.³⁵ In discussions of this topic there are also resonances of the discussion of the pros and cons of “formulary apportionment” and its practicality or otherwise as a way of dividing internationally the profits of multinationals.³⁶ A common feature of such discussions is that the consumption side figures in the debate as well as the supply side. It is clear that any consensus solutions in relation to either source or formulas for apportionment, if they are even possible, would need to address to a greater or lesser extent the market and sales.

³² See, for example, Part D (Country Practices) of the UN Practical Manual on Transfer Pricing, especially Part D.2 (China) and Part D.3 (India).

³³ See, e.g. Deloitte (2015), “Location-Specific Advantages”. Available at <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-beps-changes-transfer-pricing-location-specific-advantages.pdf>.

³⁴ Morse, S. C. (2018) “International/OECD – Value Creation: A Standard in Search of a Process”, *Bulletin for International Taxation*, 2018 (Vol. 72) 4/5, p. 202.

³⁵ See, for example, Vogel K. (2005), “‘State of Residence’ may as well be ‘State of Source’ – There is no contradiction”, *Bulletin – Tax Treaty Monitor* (October), p. 420; Tadmore N. (2007), “Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age”, *Bulletin for International Taxation* (January), p. 2; Devereux, M. and J. Vella (2014), “Are We Heading towards a Corporate Tax System Fit for the 21st Century?”, *Fiscal Studies* (35) 449-475, pp. 453-454.

³⁶ See, for example, Clausing K. and R. Avi-Yonah (2007), “Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment”, *Brookings Institution*. Available at https://www.brookings.edu/wp-content/uploads/2016/06/200706clausing_aviyonah.pdf.

6.2. The relevance of sales

The perceived benefits or disadvantages of looking at sales as a proxy for market engagement and a basis of taxation vary, because of differences in developing countries in both objective situation (such as market size) and development policy (including the balance between the investment climate and revenue generation). On the revenue generation side of the equation, Durst has noted that³⁷

- (i) In an era of digital commerce it may be difficult to identify the destination of sales of various goods and services with sufficient reliability to support sales-based apportionment.
- (ii) Sales-based apportionment might generate undesirable results for some countries, especially developing countries in which much income is generated by capital- or labour-intensive activities, ranging from mineral extraction to providing outsourced business services.

Nonetheless, the market is a relatively immobile factor³⁸ and retail sales may be more difficult to manipulate than business-to-business sales,³⁹ especially between associated entities. Furthermore, some developing countries may see a sales-weighted formula as a useful way of attracting investment from mobile factors, including the jobs that will be created and the skills that will be introduced. This appears to be behind the gravitation of most US states away from a balanced (payroll, assets and sales) formula that is supposed (however inaccurately) to represent “the way MNEs generate profits”⁴⁰ to a purely sales-based or sales-dominant formula.⁴¹

³⁷Durst M. (2015), “The Tax Policy Outlook for Developing Countries: Reflections on International Formulary Apportionment”, ICTD Working Paper 32, p. 12. Available at SSRN: <https://ssrn.com/abstract=2587860>.

³⁸Devereux M. and J. Vella (2014), “Are We Heading towards a Corporate Tax System Fit for the 21st Century?”, *Fiscal Studies* (35) 449-475, pp. 470-471.

³⁹Avi-Yonah, R. S., and I. Benshalom (2011): “Formulary Apportionment — myths and prospects”, *World Tax Journal*, 3(3), 371–399, p. 391.

⁴⁰Avi-Yonah, R. S., and I. Benshalom (2011): “Formulary Apportionment — myths and prospects”, *World Tax Journal*, 3(3), 371–399, p. 381.

⁴¹Clausing K. (2016), “The U.S. State Experience under Formulary Apportionment: Are There Lessons for International Taxation?”, *National Tax Journal* 69(2): 353-386 at 356.

The emergence of sales as the dominant factor in the US states is largely an expression of tax competition,⁴² and to the extent such tax competition is unneeded – that the investor would invest without it – it harms development. It may not lead to increased investment or employment to any noticeable extent,⁴³ but developing countries should have the policy space to consider taxation on the basis of relatively immobile factors so as to encourage investment on the basis of more mobile factors.

Finally, there is increasing interest in the possibility of destination-based corporation taxes, again relying upon the third-party consumer as a relatively immobile factor that cannot be readily manipulated.⁴⁴ Whatever the outcomes of this debate, consideration of corporate taxation on the basis of engagement with a market should, more than ever, not be closed down as a policy choice, whether it be an income tax or a destination-based cash-flow tax or other tax.

More broadly, the relevance or otherwise of mobility of factors deserves more consideration in the BEPS work on taxation of the digitalised economy, especially given the highly pragmatic nature of seeking to agree rules on the international allocation of taxing rights.

The most productive way forward for such consensus as may be possible on international taxation of the digitalised economy seems to be to avoid addressing the underlying jurisdiction of countries – the extent of their tax sovereignty – and instead have countries agree by treaty to stay their hands by not exercising all the domestic law rights they have in cases where a treaty applies. That is, the treaty overrides, to the extent of the inconsistency.

This mechanism has risks and costs, but the treaty as a whole is presumed to bring sufficient benefits (especially in terms of an attractive investment climate for developing countries and protection against double taxation for residents) to justify the costs, at least over the longer term, even if it not possible to closely track the balance between the two.

⁴²Durst M. (2015), "The Tax Policy Outlook for Developing Countries: Reflections on International Formulary Apportionment", ICTD Working Paper 32, p. 11. Available at SSRN: <https://ssrn.com/abstract=2587860>.

⁴³Clausing K. (2016), "The U.S. State Experience under Formulary Apportionment: Are There Lessons for International Taxation?", *National Tax Journal* 69(2): 353-386, pp. 381-382, cf. Martin Hearson (2013), "Some Academic Thoughts on International Tax Reform" (December 13), blog. Available at <https://martinhearsen.wordpress.com/tag/formulary-apportionment/>.

⁴⁴See for example, Devereux M. and J. Vella (2014), "Are We Heading towards a Corporate Tax System Fit for the 21st Century?", *Fiscal Studies* (35) 449-475, pp. 470-471; Auerbach, A. J., M. P. Devereux, M. Keen and J. Vella (2017), "International Tax Planning under the Destination-Based Cash Flow Tax", *National Tax Journal*, December, 70 (4), p. 783; Avi-Yonah R. and K. Clausing (2017), "Problems with Destination based Corporate Taxes and the Ryan Blueprint", *Columbia Journal of Tax Law*, 8, p. 229.

6.3. The OECD Technical Advice Group Report (2003)

We have seen that the emphasis in the BEPS work on the business models of corporates focuses very much on the supply side. In practice, there is, and will remain, a significant focus on the consumption side in deciding whether there has been sufficient engagement of the right kind by corporates in an economy to justify a country’s taxation of profits made in its market. Sometimes this justification has been made on the basis that the government has created the infrastructure necessary for a business to take advantage of the market, as some members of an OECD Technical Advice Group (TAG) reported in 2003.⁴⁵ The summary of the TAG debate on this point is important in suggesting the lack of consensus even among a body composed almost entirely of representatives of developed countries, corporates or advisors:⁴⁶

The members of the TAG disagreed, however, on an important related issue: i.e. whether a supplier which is not physically present in a country may be considered to be using that country’s legal and economic infrastructure and, if that is the case, whether and to what extent, such use of a country’s legal and economic infrastructure should be considered to be one factor which, under the supply-based view, would allow that country to claim source taxing rights on a share of the enterprise’s profits.

For some members, source taxation is justified in such a case because the business profits of the foreign enterprise derive partly from the enterprise’s use of important locational advantages provided by that country’s infrastructure which make the business operations profitable. These may include, but are not limited to, means of transportation (such as roads), public safety, a legal system that ensure the protection of property rights and a financial infrastructure.

Other members, however, disagreed. For them, business profits derive from the carrying on, by the enterprise, of business activities and a country is only justified to consider that profits originate from its territory if the enterprise carries on activities thereon. They do not regard an enterprise which may have access to a country’s market as necessarily “using” that country’s infrastructure and, even if that were the case, they consider that such mere use of a country’s general infrastructure would be too incidental to the business profit-making process to consider that a significant part of the profits are attributable to that country.

⁴⁵OECD, “Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-commerce?: Report of the OECD Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits” (2003). Available at <http://www.oecd.org/ctp/treaties/35869032.pdf>.

⁴⁶See Annex 1 of the TAG Report for the participation.

That disagreement prevented the TAG from articulating a single comprehensive conceptual base for evaluating the current rules for taxing business profits and the alternatives to these rules. One such alternative would be nexus rules that would allow a country to tax a foreign enterprise if the enterprise made use of that country's infrastructure even if it did not carry on activities (at least in the traditional sense) in that country. Members disagreed on whether economic principles could support such nexus rules.

A far greater number of countries participated in the Inclusive Framework than in the TAG, and there was high participation by developing countries. Thus, it would be surprising if a higher level of agreement could be found now or in 2020 than in 2003, especially if the issue is articulated in the OECD work on the digital economy as clearly as it was in the TAG report.

6.4. Should taxation based on point of consumption be left to a VAT?

The view of those in the TAG opposing taxation based on engagement in a market is in line with the emphasis in the Interim Report on business activities as the foundation of taxing jurisdiction. Recently, Schön has also argued against considering the consumption side in addressing the income tax of the digitalised economy:⁴⁷

Proponents of a change of the international tax rules like to emphasize that the real world premises of the long-standing compromise between residence countries and source countries have been eroded by globalization and digitization. While this is true, one should never forget the simultaneous global rise of general consumption taxes, in particular VAT, since that international compromise on business taxation was forged in the 1920s. ... VAT/GST has been established since World War II as a huge revenue raiser for market countries; among the prominent economies in the world, only the United States has so far withstood the siren songs of this general consumption tax. One can draw the conclusion that, unlike in the 1920s, there now exists a broad and highly successful tax regime tapping the "consumption side" of the market. Against this background, anybody who pleads for taxation of inbound digital services has to show that the emergence of VAT/GST doesn't sufficiently perform this role.

It is true that VAT/GST has to struggle with practical issues of their own as regards the taxation of the digital economy, but nobody doubts the

⁴⁷Schön W. (2018), "Ten Questions about Why and How to Tax the Digitalized Economy", *Bulletin for International Taxation* April/May, 278-292, p. 286.

prominent role of VAT and GST as a source of revenue for destination countries.

Such a debate might be had, but the VAT is indeed a different tax with different incidence, and value added taxes and taxes based on income (or as some would prefer, cash flow) can sensibly co-exist in relation to the same products.

Further, if the civic concern about multinationals paying insufficient taxes where they profit from economic engagement is to be addressed, an additional tax on consumers is likely to be not only an unpopular response, but one that is seen as confirming the power of multinationals in shaping the policy-making process to favour their interests. Of course, a multinational may choose to pass on any extra corporate taxes it bears to the consumer, but it will have to take the risks of such an action and cannot blame the structure of the tax or its incidence for others.

Similar arguments for not taxing royalties and fees for technical services (on the basis that they will be passed on to local businesses and adversely affect their competitiveness) and for interest (which will be “grossed up” by the lender and paid by the borrower) are part of the mix in any policy discussion as to whether to tax and (perhaps more significantly) at what rate. However, they have hitherto not prevented developing countries from viewing such taxes, especially in the form of a withholding tax, as a relatively easily administered way of mobilising domestic resources for development.

The intention of the OECD/G20 work, as derived from its wording, seems to be to draw upon a consensus framework to deter countries from corporate income taxes, or other taxes such as those based on cash flow, which tax in effect the capture of value on the consumption side, instead leaving that side only to VAT. Such an alignment, which is contrary to the practice of many countries (including most of those adopting the so-called “interim measures” addressed by the Interim Report), should at least be done more openly, with a fuller discussion of its consequences and with neither side of the debate facing a higher burden of proof of the type suggested by Schön. The OECD did some valuable work on VAT regimes in its 2015 report on the digitalized economy,⁴⁸ but even that useful work bears some risk of becoming “collateral damage” if it is seen as having a larger agenda with negative implications for the income tax policy space of countries.

⁴⁸OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241046-en>.

7. “Interim Measures” and value creation

7.1. What are “interim measures”?

The 2018 Interim Report recognizes that, with no consensus on taxation of the digital economy, countries have resorted to “uncoordinated” unilateral measures. The report does not recommend for or against such measures but suggests that those adopting the report have agreed to certain design principles that should govern the use of such measures.⁴⁹ They are regarded as “interim measures”, pending the sought-for 2020 consensus which should render them unnecessary.⁵⁰

The Interim Report groups such measures into four categories: (i) alternative applications of the permanent establishment threshold (such as “significant presence” tests or “virtual” permanent establishments); (ii) withholding taxes (and in particular industries such as advertising, broader definitions of royalties or fees for provision of technical services); (iii) turnover taxes such as on internet advertising, digital services levies or “equalization” levies; and (iv) specific regimes to deal with large MNEs such as the UK and Australian Diverted Profit Taxes and the recent US Base Erosion Anti-Abuse Tax.⁵¹ How the Interim Report treats these measures seems to portend what those most active in the drafting envision as a 2020 consensus that they could accept, even though the discussion is said to be without prejudice to longer-term outcomes.⁵²

7.2. The design principles

The Interim Report is quite bold in proposing “design principles” to be followed in any interim measures put in place to tax the digitalized economy, even though it does not formally make a recommendation for or against such measures. It states that “there is merit in setting out guidance on the design considerations that need to be taken into account to limit the possible adverse consequences associated with any interim measure”.⁵³

The Interim Report continues to use the language of obligation when it provides that⁵⁴

Countries that are in favour of the introduction of interim measures recognise the need to take the following considerations into account: (i)

⁴⁹Interim Report, p. 178 ff.

⁵⁰*ibid.*

⁵¹Interim Report, p. 135 ff.

⁵²Interim Report, p. 180.

⁵³Interim Report, p. 180.

⁵⁴Interim Report, pp. 180-181.

be compliant with a country’s international obligations; (ii) be temporary; (iii) be targeted; (iv) minimise over-taxation; (v) minimise impact on start-ups, business creation and small businesses more generally, and (vi) minimise cost and complexity. ... These constraints may place significant restrictions on the design options for any interim measure.

This might appear to be the basis for a consensus in 2020, as on its face there already seems to be broad agreement. Yet, the potential implications of these design principles might be more closely examined by participating countries.

The roll-out of the Interim Report by the OECD Secretariat reinforced the language of obligation.⁵⁵ Although such measures are clearly within the sovereignty of a country, such language in a report adopted by all Inclusive Framework members risks being construed as an attempt to bind countries, at least at a political level, in the exercise of their sovereignty. The national consequences of the adoption of reports by the Inclusive Framework might, objectively, benefit from clarification, though many countries might prefer that the consequences be left uncertain.

A first point to be made is that these interim measures potentially involve the two issues noted above – the question of whether they are justified as a matter of jurisdiction by the country, and the question of whether they may be valid as domestic law provisions – but their effect needs to be moderated in the give and take of allocating taxing rights at treaty level, to ensure double tax is avoided. Which level of exercise of tax jurisdiction is being talked about at any one point is not clear in the Interim Report.

It would be better to keep the rules defining the tax jurisdiction of a country in domestic law and the rules allocating the taxable income between two jurisdictions quite distinct, as they fulfil two very different functions.⁵⁶ Business interests would prefer countries to bind themselves at the level of domestic law principles, since that would apply even in the absence of a treaty. It might also particularly facilitate actions in domestic courts.

One can well conceive of taxpayers claiming that countries imposing such measures are bound by or “estopped” from contradicting a report that they have signed off on in an exercise of self-limiting tax sovereignty. With more than 110 countries signing onto the Interim Report, one might predict the argument that this is emergent customary international law of taxation that binds other countries also.

⁵⁵OECD, Tax Talk No 9. Available at <http://www.oecd.org/tax/beps/tax-talks-webcasts.htm>; Martin, J. “OECD report reveals disagreement on taxation of digital firms” (March 16, 2018). Available at <https://mnetax.com/oecd-interim-report-reveals-disagreement-among-nations-on-taxation-of-digital-firms-26655>.

⁵⁶Vanistendael F. (2018), “An Octogenarian on Value Creation”, *Tax Notes International* (18 June), p. 1385.

This argument, at least, seems easily rebutted – country practice is not enough to constitute customary international law, and the belief must exist in countries that they are bound as a matter of course, even without having signed up to the Report. This *opinion juris*, once described as the “philosopher’s stone which transmutes the inert mass of accumulated usage into the gold of binding legal rules”,⁵⁷ seems clearly to be lacking, but the apparent self-limiting by countries proposing interim measures does raise the risk of challenges to such measures.

Proposing limitations on domestic law jurisdiction as part of some agreement or under pretence of economic or policy coherence is far more serious and far less likely to be agreed to than some allocation of underlying taxing rights under a treaty. Perhaps for this reason, the Interim Report is quite muddled about what it proposes as the range of consensus for 2020. Developing (and developed) countries should ensure that the further work clarifies that all that is proposed as a consensus is a set of allocation rules to be agreed bilaterally or multilaterally, and that no intention exists to limit taxing rights independently of the overriding nature of such a treaty relationship.

7.3. The “interim” character of the measures

The Interim Report states that:⁵⁸

Any interim measure should be introduced recognising the policy intent of it being temporary; ceasing to apply once a global response to the tax challenges raised by digitalisation has been agreed and is implemented. This follows from the very policy rationale that justifies the introduction of an interim measure. It also reflects the consensus among all Inclusive Framework members that a comprehensive global solution is to be preferred over the adoption of unilateral measures It is essential that countries maintain a commitment to achieve a broader global consensus and ensure that, once a global solution is found, it can be implemented in a swift and coordinated manner and that the interim measure remains purely that, without undermining or jeopardising global action. Where a country has already adopted an interim measure, such measure should operate on a similar understanding.

A wide range of measures treated by the Interim Report have been introduced with no conception of them being “interim” by nature, such as fees for technical services. It therefore seems wrong and unhelpful to the countries implementing them to brand them as a temporary fix. Obviously if something better comes

⁵⁷ Thirlway H. (1972), *International Customary Law and Codification*, AW Sijthoff, p. 47.

⁵⁸ At p.184.

along as a consensus, *any* policy is up for review and possible overriding by a different treaty rule, so in that sense all is in flux. However, the measures under domestic law would still, presumably, operate under domestic law in the absence of a relevant treaty relationship. They should therefore not generally be treated as interim measures *per se* but only to the extent that they are later overridden by a particular treaty relationship applying to a particular set of circumstances.

7.4. Income tax-related measures

There is no doubt that international obligations should be taken account of when considering domestic policy. However, the Interim Report also somewhat muddies the point that for most countries, a domestic measure that is contrary to what tax treaties provide – such as by providing withholding tax rates in most countries – does not substantively conflict with any tax treaty obligation because it is overridden by them as a matter of domestic law. The domestic law will still operate with full force and effect for non-treaty cases, as it should.

Thus, the issue of the relationship between the interim measures and treaty obligations appears more nuanced, and less alarming, than appears from the Interim Report. This is perhaps another sign that key drafters would prefer a consensus operating directly at the domestic law level, rather than as an international law overlay that can, in relevant cases, override at the domestic level.

Even accepting the political importance of meeting international obligations, the fairly dismissive approach in the Interim Report⁵⁹ and its roll-out⁶⁰ as to the possibility of income tax-related measures does not reflect adequately, if at all, that the OECD Model (like the UN Model) recognizes that some anti-avoidance measures should be regarded as entirely consistent with the treaties – in a sense “under-riding” rather than overriding them.⁶¹ This appears to be one of the arguments used to defend

⁵⁹Interim Report, p. 181: “Tax treaties that are in line with the OECD Model Tax Convention on Income and on Capital (OECD, 2017[1]) will, therefore, generally prevent countries from imposing a tax on the income derived by a non-resident on the supply of digital services if it is in the form of a tax that is covered by that tax treaty.”

⁶⁰OECD Secretariat (2018), OECD Tax Talks no. 9 (16 March), <https://youtu.be/MthkxfnUnWI>, at 42:10 minutes (“the tax, whatever the tax might be, the tax cannot be an income tax. If it was an income tax you’d be violating your treaties if you applied them to non-residents in the absence of a permanent establishment”).

⁶¹OECD Model Commentary on Article 1, para. 7 and following. Para. 9.4 notes that “it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.”

the UK interim measure, the Diverted Profits Tax.⁶² The Australian legislation⁶³ is similarly constructed as an anti-avoidance measure to avoid conflict with double tax agreements.

7.5. The relevance or otherwise of user participation

Perhaps the most interesting design principle is one relating to cross-border transmission of services where there is said to be little user participation. The Interim Report states:⁶⁴

The interim measure should also be restricted to certain specified e-services and not apply to all services simply on the basis that they are provided over the internet. ...

A number of countries maintain that a targeted interim measure could focus on internet advertising and digital intermediation services because they perceive that these categories of e-services businesses typically operate remotely and rely heavily on intangible property, data, user participation and network effects and believe that therefore value is being created in their jurisdiction.

The Interim Report here very clearly rejects the relevance of engagement with a market by itself as a basis for tax jurisdiction – for example, seeking instead some active engagement with the consumer that a streaming service alone would not entail. Nonetheless, many countries and sub-federal authorities are introducing taxes on online video and audio providers, including streaming services such as Netflix and Spotify.⁶⁵ Many such countries will rely on a VAT, and even though the Interim Report and the EU directive carve out such services, it is hard to see why developed, much less developing, countries should tie their hands on such domestic measures and reduce their policy space going forward. If as part of the 2020 consensus they choose to override that ability to tax, they should be

⁶²Her Majesty's Revenue and Customs, Diverted Profits Tax: Open Day slides (8 January 2015), p. 5: "But even if the diverted profits tax were covered by UK tax treaties, the entry conditions for the diverted profits tax mean that it will only be applied to arrangements designed to exploit the provisions of tax treaties to avoid tax. Therefore the arrangements it targets are the kind where there is no obligation to provide relief under international law". Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/400340/Diverted_Profits_Tax.pdf. See also Buchanan H. and S. Bond, "DPT Myth Busting", *Tax Journal* (7 December 2017). Available at <https://www.taxjournal.com/articles/dpt-myth-busting-07122017>.

⁶³Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017. Available at <https://www.legislation.gov.au/Details/C2017A00027>.

⁶⁴At p. 185.

⁶⁵See, for example: "Some sort of 'Netflix tax' has to be in Canada's future", *Hamilton Spectator*, editorial (7 June 2018). Available at <https://www.thisspec.com/opinion-story/8655554-editorial-some-sort-of-netflix-tax-has-to-be-in-canada-s-future/>

calculating the likely revenue losses going forward and any preference the choice gives to remote providers of services, from abroad, over domestic providers.

The Interim Report indeed seems somewhat skewed in how it addresses the implications of taxing provision of services without significant user input. In particular, it takes note of the risks of provision of services being taxed more heavily than the provision of goods,⁶⁶ but not the risk of leaving the former untaxed while taxing the latter.⁶⁷

7.6. Fees for technical services

In practice countries take very different approaches to the taxation of services. In the OECD, a majority view has been that in a bilateral treaty the test for which country should have the right to tax profits should be the same as the equivalent test for services. That is, in terms of geographical presence, in deciding whether the country where the services are provided may retain its domestic law taxing rights under a treaty, the same physical presence tests should apply as for a “bricks and mortar presence”.⁶⁸

A minority of OECD countries have taken the view, however, that services are different from goods and that engagement in an economy that justifies retention of those taxing rights under the treaty can be shown with a lighter physical presence.⁶⁹

Where OECD countries *have* been in agreement is expressed in the OECD Model Commentary on Article 5:⁷⁰

It should be noted, however, that all [OECD] member States agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State. Under tax conventions, the profits from the sale of goods that are merely imported by a resident of a country and that are neither produced nor distributed through a permanent establishment in that country are not taxable therein and the same principle should apply in the case of services. The mere fact that the payer of the consideration for services is a resident of a State, or that such consideration is borne by a permanent

⁶⁶Interim Report, p. 185: “A broad tax on all e-services may also result in different tax treatment depending on whether the underlying supply is made in physical or digital form.”

⁶⁷This concept appears indirectly, noted as a positive in relation to Diverted Profit Taxes at pp. 147-148: “This regime usually improves the level of compliance of large MNEs that have an incentive to engage in aggressive international tax planning strategies, and restores a level playing field with more conventional businesses or SMEs that operate mostly at the domestic level.”

⁶⁸OECD Model, pp. 154-155.

⁶⁹OECD Model, p. 155.

⁷⁰OECD Model, p. 156.

establishment situated in that State or that the result of the services is used within the State does not constitute a sufficient nexus to warrant allocation of income taxing rights to that State.

Outside OECD countries that view is far from uncontested. Developing countries increasingly seek, and obtain, provisions in their treaties to allow for taxing income from the provision of a broad range of services into their countries in the form of fees for technical services provision, without any reference to the need for a permanent establishment. Such a provision has been added to the UN Model in 2017 to reflect that country practice.⁷¹

There is even less reason to doubt the legitimacy of such a constraint on tax jurisdiction under domestic law. No principle of international economic law prevents income taxation of services provided into a country, as the permanent establishment principle in treaties applies only if, and to the extent that, an applicable treaty exists.

It is therefore hard to conceive of any real consensus among the members of the Inclusive Framework on limiting their domestic measures to cases with significant user input,⁷² especially since the Interim Report says that “[g]iven that businesses in the era of digitalization are increasingly concerned with the provision of services, as opposed to the manufacture of tangible goods, it makes good sense to broaden our consideration of value creation along those lines.”⁷³

8. The prospects for a consensus by 2020

Taxation of a multinational based on engagement with an economy on the consumption side reflects a current and legitimate reality of State exercise of sovereignty over taxation. It can also be justified on the basis that income taxes are not – and should not be – directed only to cases where value has been *created* by a business model, to which consumers have responded, but also to where value has been *captured* by a business, whether or not it can be seen to have created anything (such as in the case of a purchase and immediate sale of shares or property).⁷⁴

⁷¹United Nations (2017), Model Double Taxation Convention between Developed and Developing Countries, Article 12A. Available at http://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf. See also Moreno, A.B. (2015), “The Taxation of Technical Services under the United Nations Model Double Taxation Convention: A Rushed – Yet Appropriate – Proposal for (Developing) Countries?” World Tax Journal (7) 3. See also the Interim Report, p. 140.

⁷²Interim Report, p. 185.

⁷³Idem., p. 35.

⁷⁴Haslehner, W (2018) “Taxing where value is created in a post-BEPS (digitalized) world?” Kluwer International Tax Law Blog (30 May 2018). Available at <http://kluwertaxblog.com/2018/05/30/taxing-value-created-post-beps-digitalized-world/>.

Such profits are frequently treated as subject to an income or similar tax, rather than being left to a VAT (as evident from the Interim Report’s analysis of tax policy developments, including so-called “interim measures”).

Thus, the only way forward to any comprehensive and genuine consensus to address taxation of multinationals through a value creation approach would seem to be to allow such a broad use of the term *value creation* as to address *value capture*. This creates its own uncertainties, but they can to a great extent be mitigated by transparency in country interpretations. And country disagreements on interpretation are nothing new, as the UN and OECD commentaries on the respective models make clear, as do the helpful OECD Member Observations disagreeing with particular OECD Commentary interpretations and similar non-OECD Member “positions” on them.

If the disagreements cannot be resolved, the best way forward is to encourage countries to make their positions clear and, where achievable, to make sure one interpretation or other is clearly chosen during treaty negotiations to govern its interpretation.

To nudge perceptions of what is an internationally justifiable domestic tax policy away from the consumption side and towards the supply side, as some aspects of the Interim Report seem to support, without specific debate on the issues and clear conclusions, would seem contrary to the promise in the Action Plan that:⁷⁵

[w]hile 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.

Perhaps the BEPS outcomes have already diverged somewhat from that promise by introducing the “value creation” or “substance” component into the allocation formula.⁷⁶ However, if that approach is seen as selectively focussing on the supply side and suggesting that the consumption side be left to VAT, the promise of the Action Plan will be well and truly in question.

⁷⁵At p. 11.

⁷⁶Devereux, M. and J. Vella (2014), “Are We Heading towards a Corporate Tax System Fit for the 21st Century?”, *Fiscal Studies* (35) 449-475, p. 463.

8.1. Is a consensus the holy grail?

It seems that a full debate on this issue of limiting consideration to the supply side would probably not lead to a consensus by 2020. And, in fact, to revert to Schön's analogy, the siren song for developing countries (among others) might be the push for consensus by 2020. Caution and a degree of scepticism are warranted, and developing countries may need to show a willingness to prefer no deal in 2020 over a bad deal that may effectively constrain policy space for decades.

Moving from the more readily accepted activities excluded by the term "value creation" to the more contested issues, it should be borne in mind that attempts to achieve a consensus in so large a body of countries as the Inclusive Framework, especially one composed of developing, emerging and developed economies, are unlikely to exhibit complete coherence in either legal or economic terms. As Schwarz has noted, it would be disingenuous to treat what is really a political debate as a matter of legal analysis.⁷⁷ The same could be said for economic coherence. The lack of overall economic coherence in the current tax treaty allocation rules dating from the 1920s has been noted,⁷⁸ as so-called "source States" have the primary taxing right for active income and so-called "residence States" have the primary taxing right for passive income. The consequent allocation of taxing rights on the basis of the type of gain does not fit neatly into an approach based on either a benefit or an ability to pay.⁷⁹

Other issues deserve a separate article on the depth, timing and practical ability, for many developing countries, of participation in developing the approach taken in the Interim Report, even though the Inclusive Framework (essentially an implementing body⁸⁰ incorporating what amounts to a monitoring role for the digital economy⁸¹) has formally made the Interim Report its own.

Even in that body, non-OECD/G20 countries participate as "associates" on an "equal footing" (another undefined term). In determining to what extent the associates have truly become partners, an assessment would need to be done of the future drafting and interpreting roles of the OECD Secretariat (overwhelmingly, especially in policy development, from OECD country governments) and OECD Working Parties (such as WP 1 on treaties and WP 6 on transfer pricing), of which the non-OECD countries are only observers.

⁷⁷Schwarz, J. (2018), "Value Creation: Old wine in new bottles or new wine in old bottles?", Kluwer International Tax Law Blog, 21 May 2018.

⁷⁸Devereux, M. and J. Vella (2014), "Are We Heading towards a Corporate Tax System Fit for the 21st Century?", *Fiscal Studies* (35) 449-475, p. 451.

⁷⁹Ibid.

⁸⁰OECD (2017), "Background Brief: Inclusive Framework on BEPS". Available at <http://www.oecd.org/tax/beps/background-brief-inclusive-framework-for-beps-implementation.pdf>, p. 8 and p. 10.

⁸¹Idem., p. 14.

The relevance of a short tour of these issues is the recognition that developing countries need to evaluate carefully, with the assistance of regional bodies and academia, any proposed consensus as it is developed. They need to know in good time what policy space any consensus leaves them or does not leave them, how interpretations that may affect the dimensions of that policy space are to be made, and how it will be implemented, monitored and enforced.

In this context, Christians reminds us that the term “value creation”, while lacking history or coherence, has become popular because it is a mode of⁸²

allocating income to one or another jurisdiction [which] has very little to do with capturing income accurately, and everything to do with preserving a distributive status quo that cannot be defended on normative grounds. As such, the idea of value creation seems likely to disappoint the assumptions and expectations of some, while preserving those of others. The former likely will be those whose interests do not seem particularly attended to in traditional international tax processes. If so, the legacy of BEPS will not be enhanced tax cooperation to the mutual benefit of all participating nations. Instead, it will be deeper division until those who gather nations together in tax coordination exercises can understand and acknowledge that tax allocation is a fundamentally distributive task, and not fundamentally about anything economic or scientific. As such, whether the distribution is accomplished through arm’s-length pricing, unitary taxation, or some other method, we cannot expect those distributed the least to cooperate indefinitely.

That seems a useful assessment and means that developing countries should focus on what the reports in 2018, 2019 and 2020 are likely to imply for their taxing rights – without feeling bound by any sense of historical developments or allegiance to theory. They should carefully consider the potential consequences of adopting any reports and join with each other on establishing or agreeing to the contents.

The very important quest for more certainty for both administrations and taxpayers is best served not by rigid rules on tax jurisdiction, especially at the domestic level below the operation of tax treaties, but rather by several actions: achieving transparency in rule-making and understanding of the practical effect of proposed rules, not signing on unless countries are satisfied on these points, supporting each other in this approach regionally and inter-regionally, and establishing a way of developing interpretations that is highly inclusive both in theory and in practice.

⁸²Christians A. (2018), “Taxing According to Value Creation”, *Tax Notes International* (June 18), 1379.

More specifically, developing countries should seek to clarify that their domestic jurisdiction of tax will not be diminished but should rather address only an overlay of treaty-level agreements on that domestic law, as governed by the terms of any treaty.

9. Conclusions

Lack of consensus is given as the reason why the Interim Report makes on interim measures.⁸³ It is also, however, noted as a reason why countries have looked to such “uncoordinated” interim measures for a solution.⁸⁴ This suggests that in the absence of consensus on a single set of rules (unattainable and probably undesirable), a consensus on the matrix of options – noting their potential pros and cons, and on transparent and predictable approaches, is the best way of satisfying as many participants in tax systems as much as possible, with as much coordination and as much certainty for countries, taxpayers and their advisers, as is realistically possible.

Curiously, the Interim Report, though formally adopted by the now 116 member countries⁸⁵ of the Inclusive Framework, seems even less supportive than the OECD’s 2003 TAG Report of members’ legitimate taxing rights based on companies profiting from engagement with the domestic market. This seems to reflect some push for norms restricting the taxing rights of the takers in the digitalized world in favour of the makers. As such, it seems to reveal that the BEPS and Inclusive Framework structures and processes are not providing the checks and balances likely to produce a consensus borne out of close consideration.

Even if absolute consensus and absolute coherence exist as individually attainable goals in this arena of taxing the digitalised economy, they seem not to be attainable together. There is great pressure on many actors to achieve the first. Developing countries should not feel that pressure as the driving force. Consensus achieved by agreeing to an unreasonable bargain would be a failure rather than a success. And although businesses may laud such an outcome, it is unlikely to be reflected in practical implementation.

What does need to be given more consideration, including in any 2019 and 2020 BEPS reports on the digitalized economy, is what exactly it is that we are seeking to tax – and to what extent that can legitimately vary among countries owing to differing positions and priorities. In particular, is the passive versus active income distinction still (as) useful? Or is the question of mobility or immobility more useful in

⁸³Interim Report, p. 178.

⁸⁴Idem., p. 134.

⁸⁵As of May 2018: <https://www.oecd.org/ctp/beeps/inclusive-framework-on-beeps-composition.pdf>.

crafting a tax system that reflects current economic business and political realities and best serves development in countries generally?

A better approach to balancing consensus and coherence, and taking into account differing but legitimate views, would therefore be to have in 2020 a consensus document that has five basic pillars: (1) it recognizes the relevance of differences between countries realities and priorities and what such differences may mean for taxing policy and administration; (2) it fairly outlines the perceived pros and cons of different approaches, addressing which may be more or less relevant for countries that are in different stages of development and have legitimately differing priorities; (3) it tries to minimize the ways in which different approaches are expressed – reducing permutations in achieving the same goals and providing a common and well-understood language for discourse; (4) it emphasizes commitments to transparency about decisions taken; and (5) it expresses a commitment to meet obligations assumed as part of a consensus, including cases where similarity of views allows for a credit or exemption for taxes paid.

There could also be a sixth pillar – a peer review process – but that would have to be carefully calibrated and implemented with recognized areas of policy space reserved to States within the framework of the consensus. It could not formally or in practice take sides on matters on which consensus cannot be reached.

Such an approach seems to achieve the best balance in recognizing both legitimate country sovereignty in taxation and the need for maximizing taxpayer certainty, the best friend of which is a sense of ownership of the outcomes by all participating States.

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