AN OCTOGENARIAN ON VALUE CREATION

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IFA's 80th. anniversary:

On May 18 the International Fiscal Association celebrated its 80 th. anniversary in Rotterdam (NL), 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 North America (Peter Blessing), Europe (Wolfgang Schön) and Asia (Porus Kaka) under the neutral chairmanship of Robert Danon (Switzerland). The presentations and following debate raised a lot of questions and criticisms on the role of value creation, which has been dominating international discussions on tax policy and legislation, since the release of the BEPS 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? One question that was not debated was about the consequences for double taxation of the use of value creation as an tool to allocate income between tax jurisdictions. The whole session, which was really a high wire academic performance, enough for a letter from Europe.

The many functions of value creation:

Value creation seems to fulfil several functions in international taxation. In BEPS action 8-10 value creation is being used to align the 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".[1] BEPS action 7 preventing the artificial avoidance of PE status is mainly focused on the question what is the minimal threshold for a PE. However the final paragraph of the discussion draft makes the link to value creation: "… these issues cannot be addressed successfully without coordination between the work on the PE status … and 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".[2] Finally BEPS action 6 preventing the granting of treaty benefits in appropriate circumstances, containing LOB rules and the 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 allocation of income with the economic activity that generates that income"[3] One could be excused to read "economic activity that generates income" as a definition of value creation, because the overall objective of the BEPS action was to "realign the value chain" and that had of course to do with where and how much value was created in the chain

In professor Schön's opinion value creation originally was about substance and tax avoidance with the purpose of cutting out tax havens from 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

[1] BEPS ACTIONS 8,9 and 10, Public discussion draft, no. 16.
[2] BEPS ACTION 7, Public discussion draft, no. 44.
[3] BEPS ACTION 6, Deliverable, no.2.

residence and source countries, but also between developed OECD countries, the BRIC states and developing countries. That opinion was supported by Porus Kaka, who raised the question 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 may be replaced by a new concept of significant economic presence for which he submitted a definition that could be inserted in art. 5 of the OECD model convention: "… 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 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.

What is value creation?

The multimillion dollar question is of course whether value creation can fulfil all those functions. In order to find the answer we must know what we mean by value creation. Apparently value creation is not identical to profits. Par.1 of the preamble of the EU Anti-tax avoidance directive, 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 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 that the taxpayer was taxable in his state of residence, unless he had a PE outside that state and the next question then of course was whether his business presence would qualify for a PE. The answer to the second question was to be found in the rules for the allocation of income. Traditionally these rules were the rules of the market, balanced by tax treaty rules and transfer pricing rules supporting the market rules. These rules allocating the tax jurisdiction and the rules allocating the taxable income between two jurisdictions fulfil two very different functions. Basically the two major international tax questions are still unchanged. But because of changing economic and technical conditions there is a consensus that existing rules do not function properly anymore.

In our attempts to find new approaches to these two old questions the standards of functional analysis used in the BEPS action plan to identify value creation are gradually eroding the difference between the two questions. The functional analysis determines on the one hand the jurisdiction where the income is to be taxed on the basis of the physical location where the function is exercised and on the other the amount of income that according to market rules, or proxies of market rules, should be allocated to that function. That distinction is being blurred because in the concept of value creation new elements have been introduced that contribute to taxable profits in particular in the area of digital activities. In the words of Peter Blessing value creation was a concept that originated in the technological development of Silicon Valley. 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 consulted. In the classical economic theory these elements were not considered as

production factors contributing to business profits and therefore never taken into consideration for defining neither the location of an economic establishment, nor the amount of profit to be allocated to such an establishment.

This new idea of value creation allows to allocate profits to tax jurisdictions, where there is no or almost no physical presence of the taxpayer. Ironically it originates in the dissatisfaction of some leading economic powers with the huge gap between the effective but minimal presence of a taxpayer in a particular jurisdiction and the huge amount of profits realised that are subject to tax in that particular jurisdiction[4]. The idea was to solve this problem by searching for a certain proportion between the economic presence of the taxpayer in a jurisdiction and the amount of income in the same jurisdiction. By widening the concept of economic activity beyond the concept of an "establishment", let alone a "permanent establishment", tax jurisdiction of source countries was extended to the concept of all significant types of income generating activity performed even without any tangible presence. At the same time similar indices were used to calculate the amount of taxable income to be allocated to the extended jurisdiction. Their value was to be determined in accordance with market rules, thereby reducing the discretionary power of the contracting parties to distribute profits in accordance with their business objectives.

What about double international taxation?

Needless to say that the introduction of the new elements of value creation in the minimal economic presence that justifies source taxation and the functional analysis of the value chain to allocate income between jurisdictions has an unsettling effect, is rather vague and will create instances of double taxation. That is illustrated by the allocating rules presented by Porus Kaka for the deemed PE in the digital economy. In the case of a deemed PE … the determination of profits shall be made after deduction of expenses, incurred directly or indirectly for earning the said income, including an allocation of executive and general administrative expenses, whether incurred in the state where the PE is situated, or elsewhere. In any case where the correct amount of profits attributable to a PE is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the PE 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 double international taxation resulting from this new concept was not discussed in this panel, except for a unanimous rejection of the new proposal of the European Commission for a digital services tax (DST) in the form of an equalisation turn over tax. Such a tax was considered as an additional layer of taxation that would be difficult to integrate either in the income tax or in the VAT/GST system.

In addition there were objections that such equalisation turn over tax would violate the basic WTO rule on non-discrimination of products of foreign origin, because the tax was seen as mainly aimed against the services of major digital service providers established outside the EU. Yet there is already 50 year old case law of the European Court of Justice on a turnover

[4] One example was this gap was the case C-196/04, Cadbury Schweppes, of 7 September 2006, decided by the European Court of Justice. The UK 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 CFC legislation in the UK, because there was a disproprotion between the size of the physical presence of the office in Dublin and the amount of profits realised in Ireland.

equalisation tax in Germany[5]. In that case the Court decided that an internal turn over 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 a discrimination of the old art. 90 EC treaty, which is a carbon copy of the national treatment rule in art. III of GATT. The only question is whether the DST would provide indirect protection to digital services provided internally within the EU. I.e. if the DST would not only in law, but also in fact be applicable to digital service suppliers established inside the EU, the indirect protection argument probably would not apply.

Conclusion: the need for an open political debate

The conclusion was also unanimous but rather very basic. The issue is which country is entitled to tax and how much it is entitled to tax. In the end 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 a **open political debate**. During the last century that debate was conducted within the framework of the League of Nations and resulted after WWII in the OECD model convention. The global changes in the economic relationships and the fundamental changes in technology require a reassessment of the fundamental rules, but the basic relationship between source and residence countries and the common claim of source and residence countries to share the base of taxable income will remain unchanged. Prima facie such open political debate looks like mission impossible. The opposed interests of the three groups of countries identified by professor Schön, the developed OECD countries, the BRICS, and the developing countries, seem insurmountable and there is the question of the appropriate forum where this debate should be held.

Yet none of the three groups has on its own the power to impose its view on the others and all three groups need each other not only for increasing economic growth and welfare within the 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 UN working parties on taxation, the G20. Cooperation between these fora may facilitate an open debate. Also the relative positions of major countries in the world picking order are changing quite rapidly and these changes also modify the outlook of their economic interests. Countries may rapidly change from camp from source to residence country and vice versa. That means that in less than a generation the economic interests of those 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 International Fiscal Association is in the forefront of conducting the debate on the future of international taxation. Of course the panel did not provide a satisfactory final solution, but it raised some useful question on how to use value creation as an instrument for ordering the new tax universe. Not only the panel members of the anniversary seminar, but the whole IFA organisation deserves tribute for this effort.

[5] Umsatzausgleichsteuer, decision 27/67, Firma Fink Frucht GmbH v Hauptzollamt München, 04.04.1968, ECR 1968, 223.