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Taxing the Digitalised Economy: Targeted or System-Wide Reform?

Michael P. Devereux[*]

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Abstract

Digitalisation has brought the international corporate tax debate to a critical point, with different reform options being considered. In previous work the authors argued that digitalisation exacerbated problems that have long troubled the existing system thus necessitating system-wide reform. This position is broadly aligned with that of one of the two groups of countries favouring reform. The present article complements this work by focusing on the "long-term" targeted reform proposals favoured by another group of countries. These proposals are criticised on conceptual and practical grounds.

I. Introduction

The existing system for taxing corporate income in an international setting is at a critical juncture. Despite having only recently undergone "the most significant re-write of the international tax rules in a century",[1] there is a real possibility that the system will be reformed—including, perhaps, some of its fundamental features—in the not too distant future. Whether it is, and if so, what type of reform it will be, hinges on the outcome of the ongoing international debate on digitalisation.

As the OECD candidly explained in its March 2018 Interim Report, *Tax Challenges Arising from Digitalisation* (Interim Report),[2] countries have different views on how to address these challenges, but they broadly fall into three groups. One group of countries holds the view that there is a need to undertake targeted reform to address the problems posed by certain "highly digitalised businesses" (HDBs). In particular, this group favours reform that allocates taxing rights over the profits of certain HDBs to countries were users are located. A second group holds the view there is a need to introduce reform to address not only challenges posed by digitalisation, but also globalisation and other factors. Critically, this group believes that reform should extend

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[1] OECD/G20 Base Erosion and Profit Shifting Project, *2015 Final Reports: Information Brief*, available at: *https://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf* [Accessed 20 September 2018].

[2] OECD/G20 Base Erosion and Profit Shifting Project, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* (Paris: OECD Publishing, 2018), available at: *http://dx.doi.org/10.1787/9789264293083-en* [Accessed 20 September 2018].

to the system as a whole and should not be limited to certain HDBs. The difference between the positions of the first two groups is partly captured by identifying the source of the challenges as the "digital economy" or the "digitalisation of the economy". A third group holds the view that the Base Erosion and Profit Shifting (BEPS) project largely addressed concerns with double non-taxation. These countries are generally satisfied with the existing system and do not currently see the need for significant reform of the international tax rules. The immediate future of the international tax system depends on which of these views prevails. At the time of writing, reform options in line with the first two views are being considered by the 122 countries that comprise the OECD's Inclusive Framework, with the aim of reaching a consensus based solution by 2020. An update is expected in 2019.

It is not surprising that digitalisation drove the debate on the international corporate tax system to this point. Digitalisation exacerbates and exposes even more clearly the problems plaguing the existing system. Consider, for example, the problems caused by "hard to value intangibles" and how central they are in a digitalised economy.[3] It is also not particularly surprising that the debate has been driven to this point so soon after the BEPS project was concluded, because, as the OECD acknowledged, "BEPS measures do not necessarily resolve the question of how rights to tax are shared between jurisdictions, which is part of the long term issue".[4]

But a number of countries have been dissatisfied with the current allocation of taxing rights for some time, as the 2013 BEPS Action Plan noted,[5] and this dissatisfaction has spread further and intensified as a result of digitalisation. Ultimately, the underlying issue in this debate is nothing less than how to allocate taxing rights among countries in the digital age.[6]

This issue is currently at the very top of the international political agenda. The Communiqué from the G7 Summit that took place in Charlevoix on 8 to 9 June 2018 expressly noted that "[t]he impacts of the digitalization of the economy on the international tax system remain key outstanding issues" and the G7 countries thus reaffirmed their commitment to working together "to seek a consensus based solution by 2020".[7] However the debate is taking place against a challenging political background, both domestically and internationally. Media commentators, campaigners and members of the public—particularly in European countries—continue to demand immediate political action to ensure that large multinationals pay their "fair share" of tax.[8] There

[3] Although one should acknowledge the work done to address some of these problems in BEPS Actions 8–10: OECD/G20 Base Erosion and Profit Shifting Project, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports* (Paris: OECD Publishing, 2015), available at: *http://dx.doi.org/10.1787/9789264241244-en* [Accessed 20 September 2018].

[4] OECD, *Brief on the Tax Challenges Arising from Digitalisation Interim Report 2018* (March 2018), available at: *https://www.oecd.org/tax/beps/brief-on-the-tax-challenges-arising-from-digitalisation-interim-report-2018.pdf* [Accessed 21 September 2018], para.5.

[5] "In the changing international tax environment, a number of countries have expressed a concern about how international standards on which bilateral tax treaties are based allocate taxing rights between source and residence States." OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), available at: *https://www.oecd.org/ctp/BEPSActionPlan.pdf* [Accessed 20 September 2018], 11.

[6] Interim Report, above fn.2, 376.

[7] *The Charlevoix G7 Summit Communique* (9 June 2018), available at: *https://g7.gc.ca/en/official-documents/charlevoix-g7-summit-communique/* [Accessed 11 October 2018].

[8] "Faced with rising inequalities and perceptions of a lack of social justice, EU citizens are calling for member States and the Commission to take action to improve the fairness of the tax systems": EU Commission, *Communication from the Commission to the European Parliament and the Council: Time to establish a modern, fair and efficient*

are also increasing calls to rein in the power of dominant digital companies because of their influence on the dissemination of information, political debate and, possibly, even electoral outcomes. At the same time, it is impossible to ignore the fact that many of these companies are American. Proposals to tax HDBs could be perceived—and have been perceived by some on the other side of the Atlantic[9]—as deliberately targeting American companies. Rightly or wrongly, this could aggravate a sense of injustice resulting from the perceived unfairness of the trade system[10] and the EU Commission's state aid rulings concerning prominent American companies,[11] as well as other factors.

In March 2018 the EU Commission put forward two proposals targeted at certain HDBs and which are thus aligned with the views of the first group of countries. A number of influential EU Member States, including the UK—as evidenced by the position paper *Corporate tax and the digital economy* (the Position Paper) released by HM Treasury in November 2017, and updated in March 2018 (the Updated Position Paper)[12]—are also aligned with the views of this group. On the other hand, the US is aligned with the views of the second group.[13]

The political pressure to act is high—indeed there have been calls to shorten the timeframe for consensus to be reached[14]—but this delicate political environment makes it harder to have a sensible public and political debate on this issue and to reach a consensus. If no consensus is reached it is likely that a number of countries will proceed with uncoordinated unilateral measures that could potentially lead to an even more fractured, complex and distorting international tax system.[15] The stakes in this debate are high.

In previous work the authors argued for the need to reform the system as a whole[16]; therefore, of the three groups, the authors' views are most closely aligned with those held by the second. This article complements that work and focuses on the position adopted by the first group of countries, particularly their favoured long-term reform. It argues that the proposed reform is

taxation standard for the digital economy (2018 Communication) (Brussels: 21 March 2018, COM(2018) 146 final), available at: *https://ec.europa.eu/taxation_customs/sites/taxation/files/communication_fair_taxation_digital_economy_21032018_en.pdf* [Accessed 20 September 2018].

9 See the discussion of this issue in M. Herzfeld, "Digital Economy Taxation: Fake Tax Policy", *Tax Notes International*, 7 May 2018.

10 See for example, "Trump lashes out at Canada and France ahead of G7", *Financial Times*, 8 June 2018; and "Economists reject Trump claims of unfair trade system", *Financial Times*, 8 June 2018.

11 See US Department of the Treasury, *The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings: White Paper* (24 August 2016), available at: *https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/White-Paper-State-Aid.pdf* [Accessed 20 September 2018].

12 HM Treasury, *Corporate tax and the digital economy: position paper* (November 2017); and HM Treasury, *Corporate tax and the digital economy: position paper update* (March 2018), both available at: *https://www.gov.uk/government/consultations/corporate-tax-and-the-digital-economy-position-paper* [Accessed 20 September 2018].

13 U.S. Department of the Treasury, press release, *Secretary Mnuchin Statement On OECD's Digital Economy Taxation Report* (16 March 2018), available at: *https://home.treasury.gov/news/press-releases/sm0316* [Accessed 20 September 2018].

14 S.S. Johnston, "OECD Mulls Faster Timeline for Taxation of Digital Economy Work", *Tax Notes International*, 7 May 2018.

15 Concern is also often raised about the possibility of increased double taxation as a result of such unilateral measures. Note, however, that the overall tax paid on a given profit is more important than the number of taxes imposed on it.

16 M.P. Devereux and J. Vella, "Are we heading for a corporation tax fit for the 21st century?" (21st Century) (2014) 35(4) *Fiscal Studies* 449 and M.P. Devereux and J. Vella, "Implications of digitalisation for international corporate tax reform" (Implications) in S. Gupta, M. Keen, A. Shah and G. Verdier (eds), *Digital Revolutions in Public Finance* (IMF, 2017).

questionable conceptually and problematic in practice. It also fails to address the wider problems faced by the existing system that threaten its long-term viability.

This article proceeds as follows. Section II provides some brief background. Section III critically evaluates the reform favoured by the first group of countries. In particular, it makes four high-level criticisms of their favoured long-term reform. Section IV makes the case for system-wide reform. Section V concludes.

II. Background

The international debate on how to address the challenges posed by digitalisation[17] can be traced back a few decades, with highlights including the 1998 Ministerial Conference on Electronic Commerce in Ottawa. For the purposes of this article, the debate can be taken up during the recent BEPS project by recalling that these challenges were considered in Action 1. However, consensus was not reached and the Final Report for Action 1 published in October 2015 did not propose any of the measures it discussed.[18] Instead, the Final Report explained that account had been taken of the specific issues raised by the digital economy when developing the general proposals put forward in the other BEPS action points. Work on these challenges was to continue, leading to an updated report by 2020.

In the meantime the number of countries adopting or openly considering unilateral measures increased.[19] The UK and Australia adopted Diverted Profits Taxes in 2015 and 2017 respectively. These taxes are of broad application, but they could be seen to address some of the challenges posed by digitalisation; recall that the UK tax was widely known as the "Google Tax".[20] Other countries adopted or openly considered adopting targeted measures. For example, India adopted an Equalisation Levy in 2016, while Germany, France, Spain and Italy issued a joint communication proposing similar levies in September 2017.

In March 2018, the EU Commission put forward two proposals for taxing the digital economy, partly to avoid the adoption of uncoordinated unilateral measures within the EU. The first—a "short-term measure"—is a tax on revenues created from: 1. selling online advertising space; 2. digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services between them; 3. the sale of data generated from

[17] Several other academic articles have already been written about the challenges posed by the digitalisation of the economy and potential responses to them. See for example, A. Báez and Y. Brauner, *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy* (White Paper Series IBFD, 2015); P. Hongler and P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy* (White Paper Series IBFD, 2015); M. Olbert and C. Spengel, "International Taxation in the Digital Economy: Challenge Accepted?" (2017) 9(1) *World Tax Journal* 3; W. Schon, "Ten Questions About Why and How to Tax the Digitalized Economy", *Bulletin for International Taxation*, April/May 2018; and the papers in *Intertax* (June/July 2018) 46(6 and 7).

[18] OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Action 1—2015 Final Report) (Paris: OECD Publishing, 2015), available at: *https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page3* [Accessed 20 September 2018].

[19] See Interim Report, above fn.2, Ch.4 for more detail.

[20] V. Holder, "'Google tax' take swells to £281m as levy starts to bite", *Financial Times*, 13 September 2017.

user-provided information.[21] The second—the "long-term solution"—consists in a proposal for a "significant digital presence" (a form of digital Permanent Establishment (PE)) and accompanying profit attribution rules.[22] Despite putting forward these two proposals, the EU Commission's preferred long-term solution remains the Common Consolidated Corporate Tax Base (CCCTB), which it re-launched in 2016.

The OECD also published its much-awaited Interim Report in March 2018.[23] The Interim Report identified three characteristics found in certain HDBs and the challenges they pose to the existing tax system. The first characteristic is being able to have large commercial operations in a jurisdiction with little or no physical presence, and hence no taxable presence there ("cross-jurisdictional scale without mass"). The second is heavy reliance on data and user participation. According to the OECD, this may indicate a deep participation in the economic life of the jurisdictions where they are found, however, the existing international tax system does not take these factors into account for the purpose of allocating taxing rights over companies' profit. The third is the increasing reliance on intangible assets, which pose considerable and well-known difficulties for the international tax system.

The Interim Report explains that there is "no agreement" amongst countries over the tax implications of the first and third characteristics.[24] There is also no agreement on whether, and if so how, data and users should be taken into account when allocating profit among countries; and this is where the divergence between the first two groups of countries can be seen particularly clearly. The first group favours reforming PE and profit attribution rules to allocate taxing rights over the profits of certain HDBs to countries where users are found, but the second group opposes such targeted reform, favouring system-wide reform.

Given this divergence of views, at the time the Interim Report was written, agreement could only be reached to undertake a "coherent and concurrent review"[25] of the PE threshold and profit attribution rules with the goal of reaching a consensus by 2020. It will be up to the Inclusive Framework to decide whether to proceed with changes targeted at certain HDBs (in line with the views of the first group) or changes applicable to the broader economy (in line with the views of the second group). In the meantime "technical solutions [are being] explored to test the feasibility of the different options".[26]

Some countries—presumably from the first group—also favour interim solutions in the form of turnover taxes on certain digital companies. The Interim Report does not propose such turnover taxes—due to the divergent views among countries on the need for and merit of such taxes—but it sets out guidance for countries that wish to adopt them.

[21] EU Commission, *Proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services* (Brussels: 21 March 2018, COM(2018) 148 final).
[22] EU Commission, *Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence* (Brussels: 21 March 2018, COM(2018) 147 final); EU Commission, *Commission Recommendation relating to the corporate taxation of a significant digital presence* (Brussels: 21 March 2018, C(2018) 1650 final) (Significant Digital Presence Proposal).
[23] Interim Report, above fn.2.
[24] Interim Report, above fn.2, para.372.
[25] Interim Report, above fn.2, para.373.
[26] Interim Report, above fn.2, para.398.

III. Targeted reform

A. Digital PE and profit attribution rules

Under the EU Commission's proposal, a business will be deemed to have a significant digital presence in a Member State if one or more of the following criteria are met: if the revenues from providing digital services to users in a jurisdiction exceed €7,000,000 in a tax period; if the number of users of a digital service in a Member State exceeds 100,000 in a tax period; or if the number of business contracts for digital services exceeds 3,000. Attributing profits to a digital PE is harder than defining it. The Commission's proposal is said to maintain the authorised OECD approach (AOA) as the underlying principle for attributing profits to a digital PE, but adjusts it to a digital context. Little detail is given on these modified attribution rules and on how they are meant to apply in practice. After opining that "[t]he profit split method would therefore often be considered as the most appropriate method to attribute profits to the significant digital presence" the Commission then concedes that:

> "The proposed rules only lay down the general principles for allocating profits to a significant digital presence as more specific guidelines on the allocation of profits could be developed at the appropriate international fora or at EU level."[27]

Much more work is required to flesh out this proposal.

The approach put forward in the UK's Updated Position Paper appears to be more developed, but, clearly, it is also at an early stage of development. The basic idea behind this approach is to distinguish between a multinational's "routine" and "residual" profit. The part of the residual profit that derives from the contribution of users would then need to be identified, separated out and shared among countries where those users are located.

These proposals give rise to technical challenges, as the EU Commission and HM Treasury openly acknowledge.[28] This section does not address these challenges; instead it provides four high level critiques of these proposals: 1. they are based on a guiding principle that is conceptually flawed and unable to provide guidance in practice; 2. they seek to ring-fence a set of companies in a way that is conceptually unjustified and practically difficult; 3. they are likely to involve considerable complexity; and 4. they fail to deal with the broader challenges faced by the international tax system.

This section focuses primarily on HM Treasury's Updated Position Paper, as it provides the most carefully articulated case for proposals of this kind.

(1) Guiding principle: profit taxed where value created

Supporters of these proposals tend to start from the premise that "the international tax framework is based on a principle that the profits of a business should be taxed in the countries in which it creates value" (the "value creation principle").[29] Users, they then argue, create value, but existing rules do not allocate taxing rights to countries where they are located, thus producing a

[27] Significant Digital Presence Proposal, above fn.22, 9.
[28] Updated Position Paper, above fn.12, 15–21.
[29] Updated Position Paper, above fn.12, para.1.

misalignment between where value is created and profit is taxed. This misalignment "threatens to undermine the fairness, sustainability and public acceptability of the corporate tax system",[30] and, therefore, these proposals seek to correct it.

In previous work, the authors criticised the value creation principle at some length.[31] In this section the authors argue that the case for granting taxing rights to countries where users are located, on the grounds that the existing system is and should be based on the value creation principle, fails for a number of reasons.

a. The descriptive and normative claims

Value creation is a vague concept, which means different things to different people. Most countries in the first group, the Commission and HM Treasury deem value to be created by activities on the "supply" side (including R&D, production, marketing, etc.) but not those on the "demand" side (purchasing the good or service). In this article the authors refer to this as the "common understanding" of value creation.

i. Descriptive claim

For a start, the existing system *is* not based on the common understanding of the value creation principle, as claimed. Consider an example where P, a company resident in Country A, receives a loan from S, a company resident in Country B, and uses the loan to fund a productive activity in A. Under the existing system Country A is likely to allow P to deduct the interest paid to S, and Country B is likely to tax the interest received by S. In this case the value creating activity presumably would be deemed to take place in Country A, but Country B taxes the income generated in proportion to the interest payment. Consider also that a country can—and some countries still do—tax the foreign business income of resident companies. It might give a credit for tax paid at source, but even then it could still tax the foreign source income. The point here is that nobody would object to such a tax on the basis that it contravenes the principle on which "the international tax framework is based".

ii. Normative claim

The normative claim, that profit *should* be taxed where value is created, is also questionable.[32] It cannot be easily justified on *fairness* grounds—whether formulated along the lines of the benefit principle (profit is not commensurate with benefit, and benefit is provided by countries other than those where value is said to be "created", including the market country) or the ability to pay principle (which is generally thought to justify world-wide residence based taxation). It certainly cannot be justified on *efficiency* grounds because it is conducive to real distortions and, therefore, economic inefficiency.

[30] Updated Position Paper, above fn.12, 3.
[31] Devereux and Vella, 21st Century, above fn.16; and M.P. Devereux and J. Vella, "Value Creation as the Fundamental Principle of the International Corporate Tax System" (Value Creation), *European Tax Policy Forum*: Policy Paper, July 2018.
[32] See Devereux and Vella, Value Creation, above fn.31, for further detail.

b. Conceptual considerations

Supporters of these proposals tend to argue that users create value but consumers do not. They thus justify extending taxing rights to countries where the former but not the latter are located. This is problematic for the following three reasons.

i. An economically unsound understanding of value creation

As explained above, under the common understanding of value creation, value is deemed to be created only by supply side activities. In other words, consumers—found in the "market" or "destination" country—are not deemed to create any value. The OECD Interim Report explains

> "most of the countries in this group reject the idea that a country that provides the market where a foreign enterprise's goods and services are supplied on its own provides a sufficient link to create a nexus for tax purposes, regardless of the scale of these supplies. Instead, they consider that profits should continue to be taxed exclusively where the factors that produce the income are located, in accordance with long-standing principles of the existing tax system (e.g., aligning profit with value creation)."[33]

HM Treasury defend this position directly in the Updated Position Paper.[34] But this flies in the face of basic economic logic. From a standard economic perspective, it is simply incorrect to state that consumers are not "factors that produce the income". The income being allocated among countries owes as much to the market as it owes to the various parts of a supply chain. Income depends on the price charged at the point where supply and demand meet; it simply would not have arisen in the absence of a market. It is not entirely clear why the international corporate tax system should depart from a simple and uncontroversial economic understanding of value creation.[35]

Consumers' contribution to the production of income is seen particularly clearly where businesses generate a higher income simply because of *consumer preferences*. For example, due to higher demand in Japan for high quality tuna, businesses can sell such tuna at a higher price in Japan than anywhere else. This higher consumer demand clearly is a factor that generates value for the supplier, but this notion is absent from the usual understanding of the principle of value creation.

Given that this article is written in a World Cup year, it is fitting to add a football-related example. Blueland go into the World Cup as rank outsiders. Bookmakers offer the longest odds on Blueland winning the tournament (5,000–1) of any of the 32 participating teams. Sportclothing Ltd, a company resident in Yellowland, produces 10,000 limited edition Blueland World Cup replica shirts. The replica shirts are designed and manufactured in Yellowland before the competition starts, to be sold remotely to consumers in Blueland at £30 each. Under the usual conception of value creation all the profit resulting from this activity should be allocated to Yellowland because no value is created in Blueland. Against all expectations, the Blueland football team progresses through the group and then the knockout stages of the World Cup. They

[33] Interim Report, above fn.2, para.390.
[34] Updated Position Paper, above fn.12, paras 2.26–2.32.
[35] In future work the authors will discuss the relation between value creation and the return to investment.

reach and—unbelievably—win the World Cup final, sending Blueland residents into football-fuelled delirium. As the Blueland team progresses through the tournament, the demand by Blueland residents for the limited edition shirts shoots up. After the Final is won, Sportclothing Ltd charges £300 per replica shirt, making a vastly greater profit than expected. It is hard to comprehend how the additional profit made by Sportclothing Ltd can be understood as arising from factors in Yellowland, as would be the case under the common conception of value creation.

It might be argued that consumers do not create value—and therefore corporate profits should not be allocated to countries where they are located—because consumers merely consume, but this simply ignores the role of consumers in the generation of profits. Furthermore, arguing that no value is created in market countries because such countries (might) already levy value added taxes (VATs) or sales taxes on the same activity is equally unpersuasive. It suggests that the value creation principle has (had or will have) a different meaning in relation to countries that have (had or will have) a corporation tax but not a sales tax or a VAT.

Finally, note that proposals for unitary taxation and formulary apportionment systems often allocate taxing rights according to sales as well as labour and assets.[36] These proposed systems, therefore, do not allocate taxing rights according to the common understanding of value creation. But the EU Commission is a long-standing proponent of a formulary apportionment system *and* an ardent supporter of the value creation principle as commonly understood, arguing: “This principle is essential for a fair and effective taxation in the single market.”[37] At certain points the Commission even explicitly endorses the view that value is also created where sales take place:

> “The Commission continues to believe that the CCCTB provides an EU framework for revised permanent establishment rules and for allocating the profit of large multinational groups using the formula apportionment approach based on assets, labour and sales that should better reflect where the value is created.”[38]

ii. Value creation, users and consumers

From a basic economic perspective value is created by a wide-range of factors, including consumers and users. The narrower understanding adopted by proponents of these proposals, and which deems consumers not to create any value, presents them with a problem. It requires a distinction to be drawn between the contributions of users and consumers. Can this be done?

HM Treasury defines user participation as “the process by which users can generate value for certain types of digital businesses through their engagement and active contribution”.[39] Users are believed to create value through at least four channels: the generation of content; the depth of engagement with the platform; network effects and externalities; and contribution to the brand.

[36] Note also that in the US subnational context corporate profit is largely allocated to the market. See W. Hellerstein, “A US Subnational Perspective on the ‘Logic’ of Taxing Income on a ‘Market’ Basis”, *Bulletin for International Taxation*, April/May 2018.

[37] EU Commission, *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market* (2017 Communication) (Brussels: 21 September 2017, COM(2017) 547 final), 3.

[38] 2017 Communication, above fn.37, 9. Note, however, that under the CCCTB proposal, profit is allocated to a country on the basis of sales only if there is a PE there.

[39] Updated Position Paper, above fn.12, para.2.4

Through these channels "users can be seen participating in a non-traditional value chain and performing supply-side functions that would historically have been undertaken by the business itself".[40] The Updated Position Paper is at great pains to distinguish user participation from the role of consumers. However, it concedes that: consumers can play a role in product development, marketing and enhancement of a business's brand[41]; digitalisation will allow traditional businesses to "build stronger and more interactive relationships with customers"[42]; and traditional multi-sided and intermediation business models exist.[43]

The difference between users and "pure" consumers is clear in a number of cases. A consumer who walks into a bakery and pays for a loaf of bread in cash does not contribute in a way a user does. However, there is a continuous spectrum from here to the users described in the Updated Position Paper. Along this spectrum consumers perform an increasing number of functions undertaken by users. Consider a consumer who purchases a mobile phone app. While purchasing and using the app he provides valuable data to the vendor that is used for targeted advertising purposes and to improve the product. The consumer also reviews the app, provides guidance on its use, and even answers questions posed by other consumers on a digital forum. He is so taken by the app that he even sets up a digital fan club that quickly gathers a large number of followers. This consumer also seems to be a user. But if he is, do the functions he performs as a user suffice for taxing rights to be allocated to the country where he is located? Where is the tipping point? There are no good conceptual answers to these questions. And the difficulty in answering them will only increase over time.

The authors do not find the fine distinctions drawn in the Updated Position Paper between a user and a consumer persuasive. It is hard not to suspect that they are driven by a desire to tax certain companies whose users are located in the UK[44] while being careful not to justify the taxation of UK companies by countries where their consumers are located.

iii. Value creation and the purchase of inputs

Thus far the authors have argued that the common understanding of value creation is economically unsound, and is problematic on its own terms because it requires impossible distinctions to be drawn between users and consumers who perform similar functions. But even if these issues are set to one side, another issue arises. From a company's perspective a user is a third party who provides an input at a favourable price. Conceptually there is no reason to allocate taxing rights to countries where users are located but not to other providers of inputs at favourable prices. If one is deemed to create value, it is not clear why the other is not.

The authors have previously argued that the relation between a user and the company offering the service being used is akin to one of barter.[45] An individual does not pay to use a social media platform but provides content and reveals information valuable to the multinational enterprise in selling advertisements that subsequently appear on his or her screen. Suppose that the social

[40] Updated Position Paper, above fn.12, para.2.30.
[41] Updated Position Paper, above fn.12, para.2.27.
[42] Updated Position Paper, above fn.12, para.2.31.
[43] Updated Position Paper, above fn.12, para.2.32.
[44] The same applies to other countries in the first group.
[45] Devereux and Vella, Implications, above fn.16.

media platform provider is a multinational enterprise that charged a fee for its use, and also paid an equal amount to those using the site for the content and information that they supplied. Then the multinational enterprise's worldwide profit would be unaffected (apart from greater transactions costs); it would have revenue and costs, but no net profit, in the country of the user. Another possibility is that the value of the content and information collected by the multinational exceeds the cost of the provision of the social media platform. In this case, the barter is favourable to the multinational enterprise thus creating value for it.

This seems comparable to other situations where companies acquire a product or a service from a third party at a favourable price. But the existing system does not allocate taxing rights to countries where the third-party provider of this input is located. Consider the case of a cider manufacturer resident in the UK, purchasing apples with a market price of £2 per kilo for a discounted price of £1 per kilo from a farmer in France.[46] This is analogous to the acquisition of content and information at a minimal cost by the multinational running the social media platform. In a broad economic sense, some value is created in France; part of the profit made by the cider manufacturer results from the lower costs incurred on the purchase of apples there. Put in another way, if the discount was not secured and apples were purchased for the full price of £2 per kilo from farmers in the UK, the cider manufacturer's profit would have been lower.

The existing system would not allocate taxing rights over the cider manufacturer's profit to France, as this merely constitutes the purchase of an input. But if under the existing system value is not deemed to be created in France in this case, it is not clear why value should be deemed to be created by users of digital businesses in analogous situations. A number of countries appear to share the view of users being mere third-party contributors of inputs at a favourable price.[47]

c. Practical application

To allocate taxing rights among countries on the basis of the common understanding of the value creation principle it is not sufficient to identify the countries where value-creating activities take place. It is also necessary to establish *how much* value is created in each country. But this is extremely difficult, even impossible, in most cases, thus bringing the principle into question. A principle guiding the allocation of taxing rights among countries ought to be able to provide such guidance.

The value creation principle struggles to provide guidance in all sectors, not just in the digitalised economy. Consider the example of a multinational with a parent company and its headquarters in Country A, R&D activities in Countries B and C, production in Country D and sales and marketing teams in countries around the world. One could argue that the arm's length principle (ALP) could be relied on for these purposes, but the difficulties bedevilling this system are well known.[48] A clear difficulty here is how to allocate the residual profits arising from synergies or other factors, as one cannot easily identify the activities creating them.

But these difficulties are even more pronounced in a digitalised economy. As the EU Commission itself explained:

[46] On the point that this transaction is akin to a barter see Devereux and Vella, Implications, above fn.16, 107–110.
[47] Interim Report, above fn.2, para.39.
[48] R. Collier and J. Andrus, *Transfer Pricing and the Arm's Length Principle after BEPS* (OUP, 2017).

> "[I]n a digitalised world, it is not always very clear what that value is, how to measure it, or where it is created."
>
> "Arriving at a meaningful solution to capture and allocate the value created in the digital economy across countries can take time. This is further complicated by the multidimensional nature of this challenge, to the constantly changing nature of the digital economy, and the diversity of the business models and the complexity of ecosystems in which they create value."[49]

HM Treasury's Updated Position Paper concedes that "there would be challenges in coming up with a suitable approach to measuring that value directly [i.e. that created by users]"[50] and that while "[t]here may be indirect indicators of the value of a user base to a business…it would be difficult to use those indicators to calculate an appropriate reward".[51] So it reaches the inevitable, yet troubling, conclusion:

> "For that reason, the UK thinks that it might be necessary to reward user-created value through a percentage share of the residual profit realised by principal companies in the group…That share would be designed to approximate the value that users generate for the business. *This approach wouldn't be indicative of the deemed value of user participation relative to other group activities. It would instead be recognition of the complexities in measuring the value generated by user participation*."[52]

Once this process is completed, that percentage share of the residual profit has to be shared among countries where users are located. Again the value creation principle does not provide meaningful guidance, because in many cases one cannot know how much value is actually created by users in each country. The Updated Position Paper thus considers different allocation keys, based on rough proxies.[53]

The long-term solutions favoured by the Commission and HM Treasury do not achieve their goal of allocating taxing rights among countries on the basis of the value created by users in each country, because—as proponents themselves admit—the value created by users is not known. It is deeply concerning that, despite conceding the value creation's inability to provide guidance for allocating taxing rights among countries, the Commission, HM Treasury and others persist with this principle to guide the design of a tax system in the age of digitalisation.

d. The long-term sustainability of the value creation principle

Although the Updated Position Paper expressly confirms the UK's belief in and continued support for the value creation principle, it leaves open a question that casts some doubt on it. When discussing the issue of cross-jurisdictional scale without mass, the Updated Position Paper first rejects the notion that taxing rights should be allocated to market countries, and argues that this issue does not undermine the value creation principle. However, it then notes that:

[49] 2017 Communication, above fn.37.
[50] Updated Position Paper, above fn.12, para.3.16.
[51] Updated Position Paper, above fn.12, para.3.17.
[52] Updated Position Paper, above fn.12, paras 3.18–3.19, emphasis added.
[53] Updated Position Paper, above fn.12, 16–17.

> "Some countries might argue that increased business centralisation, and the increase in artificial intelligence and robotics, threatens the foundations of the existing international tax regime by making the allocation of taxable profits increasingly sensitive to the location of a small number of decision-makers."[54]

This argument is not dismissed; instead the Updated Position Paper simply notes that this "is a question about the long-term sustainability of the principle underpinning the international tax rules".[55] Could this be a crack in the otherwise unshakeable belief in the value creation principle?

e. Conclusion

The case for allocating taxing rights to countries where users are located on the grounds that they create value there is made in two steps. The first step posits that the existing system is and should be based on the common understanding of the value creation principle. The second argues that users create value. The case falls on multiple grounds.

The existing system is not based on the common understanding of the value creation principle and the case that it should be is not made. This understanding of value creation is also economically unsound. Distinguishing between value created by users and consumers who undertake similar functions, and between users and other third parties who provide inputs at favourable prices is problematic. This point does not question the claim that users may create value in a broad economic sense, but argues that consistency dictates that analogous situations should be treated in the same way. The case to adopt different allocation rules for users of certain HDBs is not made. Finally, the case falls because it is generally impossible to know how much value users create. A system that allocates taxing rights to users' location will not do so on the basis of the value created there.

f. Alternative rationale for taxing companies where users are located

A more compelling rationale for taxing multinational enterprises where users are located is that users are relatively immobile.[56] If the barter between the user and a multinational enterprise is favourable to the latter, as explained above, in effect, the profit, or economic rent generated by the multinational enterprise is to some extent location specific since it depends on the place of residence of the user of the social media platform. This gives that state an opportunity to impose a tax on the barter transaction, which in principle could be set at a rate that would not have any effect on the underlying activity, but would allow that state to capture a share of the economic rent earned by the multinational enterprise. This would be an attractive option for that state, in principle. However, practical difficulties remain, in particular the difficulty of determining the profit generated, and hence an efficient level of tax. The difficulty is made worse since there would be no actual transactions, nor, in all probability, any comparable transactions. If the level of tax were too high, then the service provider might not be willing to continue to provide the service.

[54] Updated Position Paper, above fn.12, para.1.16.
[55] Updated Position Paper, above fn.12, para.1.17.
[56] This analysis follows that in Devereux and Vella, Implications, above fn.16.

In principle this seems to be an interesting opportunity for countries to levy what could be an efficient tax on economic rents of digital multinational enterprises. However, further work is needed on whether and how such a tax could be constructed and levied in practice. Furthermore, and critically, such a tax appears open to the criticism set out in sub-sections 2, 3 and 4 below.

(2) Ring-fencing certain digital companies

The European Commission Expert Group on Taxation of the Digital Economy's report of May 2014[57] and the BEPS Final Report for Action 1[58] both concluded that the digital economy could not be ring-fenced. This was reiterated in the Interim Report:

> "The rapid spread of digitalisation, coupled with the liberalisation of trade policy, has increased the pace of globalisation and induced an ongoing structural transformation of the economy. As this transformative process is having an impact across the board, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy."[59]

Yet, proponents of targeted proposals seek to do just that. In fact, they seek to target a subset of digital businesses.[60]

As the Interim Report explains reliance on users and data is in fact "not exclusive to HDB models",[61] however, other "digital" businesses and "traditional" businesses[62] are excluded from the Commission and HM Treasury's proposals, even if they rely on users. The Updated Position Paper does not provide much clarity on the criteria which bring businesses within the ambit of HM Treasury's proposal. It simply states that user participation appears to be more important for the businesses targeted. These businesses are described as ones where "user participation represents significant contribution to value creation",[63] that "participation and engagement of users is an important aspect of value creation"[64] for these companies, and that user participation "will be materially relevant to their success or failure".[65] Once again the Updated Position Paper makes a number of unpersuasive fine distinctions here. For example, it acknowledges that users/consumers of businesses that are not within the ambit of the proposal can provide data that informs decisions on product selection, helps develop tailored marketing and pricing strategies, allows performance to be monitored, and the businesses to improve technologies and to enhance future revenue growth.[66] However, this data—which is said to be collected from consumers (or even users) through "passive or transactional relationships"—does not justify taxing rights being allocated to countries where the user/consumer is located.[67] On the other hand, data that results

[57] European Commission, Expert Group on Taxation of the Digital Economy, *Report of the Commission High Level Expert Group on Taxation of the Digital Economy* (2014).
[58] OECD, Action 1—2015 Final Report, above fn.18.
[59] Interim Report, above fn.2, para.375.
[60] HM Treasury's proposal only targets "certain" or "some" digital businesses. Updated Position Paper, above fn.12, 3, para.1.18.
[61] Indeed all three characteristics of HDBs identified above are shared by non-HDBs.
[62] Or "less digitalised companies" since companies which are entirely non-digital are a dying breed.
[63] Updated Position Paper, above fn.12, para.2.49.
[64] Updated Position Paper, above fn.12, 3.
[65] Updated Position Paper, above fn.12, para.2.46.
[66] Updated Position Paper, above fn.12, para.2.38–2.39.
[67] Updated Position Paper, above fn.12, para.2.40.

"from a much broader and more active user relationship", and is "central to how the businesses create value",[68] does.

The digital business models that are deemed to derive most value from users are online networks, such as social media platforms, search engines, file sharing platforms and online marketplaces.[69] Other companies might derive value from users but that is not deemed to suffice somehow. Digital software providers, for example, are among the businesses for which "user participation *appears to be a less important* source of value and *less integral* to the success of the business".[70]

The question here is one of degree, and very vague guidance is provided as to where the line is drawn. User contribution lies on a spectrum, and, *conceptually*, there is no point at which the value created by users (or consumers who also perform the functions of users) triggers a justification for a different tax treatment. The line drawn is necessarily arbitrary. This also poses immediate *practical* difficulties, which will undoubtedly worsen over time due the speed and broadening scope of technological change. As the Interim Report notes the

> "range of businesses intensively benefitting from data and user participation is likely to increase as a result of the continued digitalisation of the economy".[71]

The precise nature of the change is hard to predict, but it is easy to predict that any definitions enshrined in law or guidance to target specific "digital" businesses will have to be updated regularly to keep up with the change. The Updated Position Paper appears to concede this point, noting that

> "given the rapid pace of innovation in the digital sector there is a need to consider the relevance of user participation for newer digital business models".[72]

Proposals targeting specific (existing) types of digital businesses appear misguided. The pace and reach of digitalisation is likely to make a mockery of such attempts. They certainly do not seem to meet the oft-stated goals of being "future-proof"[73] or of providing a "long-term"[74] solution.

(3) Complexity

Measuring how much value is created by users in a particular country under revised profit attribution rules—as proposed by the Commission—will be difficult, requiring lengthy and complex guidance, increasing costs and uncertainty. Presumably different guidance will be required for different business models. After identifying four channels through which users create value, the Updated Position Paper recognises that "the relevance and materiality of these channels will differ between businesses".[75] As argued above, it appears likely that these rules

[68] Updated Position Paper, above fn.12, para.2.41.
[69] Updated Position Paper, above fn.12, para.2.45.
[70] Updated Position Paper, above fn.12, para.2.48, emphasis added.
[71] Interim Report, above fn.2, para.386.
[72] Updated Position Paper, above fn.12, para.2.59. The Updated Position Paper identifies two such developments that are not included in its analysis, those based on artificial intelligence and on augmented reality.
[73] 2017 Communication, above fn.37.
[74] Updated Position Paper, above fn.12, 3.
[75] Updated Position Paper, above fn.12, para.2.7.

and guidance will have to be updated regularly to keep up with technological development, thus exacerbating the problem. Legislators and/or authorities will find themselves playing a never-ending game of "catch up".

Countries with substantial capacity and resources will find it challenging to apply such complex rules. Countries without such capacity and resources—not only developing countries but also some EU Member States—are unlikely to be able to do so.

Of course, one could use cruder and arbitrary measures that may proxy for value creation—as HM Treasury appear to propose in their Updated Position Paper—because of the impossibility of measuring how much value is created in a particular location. Clearly, that would not remove all complexity, as the discussion in the Updated Position Paper demonstrates, but it should improve matters.[76] Reduced complexity and administrative burden would then be traded off against adherence to the principle that the proposal is meant to follow. But the use of such measures again brings into question the choice of value creation as a principle on which to base the design of an international corporate tax system in the first place.

(4) Other issues

These targeted proposals do not address the other two issues identified in the Interim Report: cross-jurisdictional scale without mass and the increasing reliance on intangibles. Even more significantly, they also fail to address the other pressing problems that trouble the existing system and threaten its long-term viability. These issues can only be addressed through system-wide reform, as discussed in section IV below.

B. Turnover taxes

Some countries in the first group also favour interim measures, primarily in the form of turnover taxes. As seen above, the EU Commission proposed one such measure in March 2018 and the UK Government has repeatedly expressed its willingness to proceed unilaterally if multilateral co-ordination proves impossible.[77]

The underlying policy justification for these *turnover* taxes is—again—that of aligning the location of value creation and taxable *profit*, more specifically that of "compensating for unrecognised user created value".[78] The Commission explained, for example, without apparent regard to the mainfest contradiction: "[The proposal for a turnover tax] remains fully grounded on the most basic principle of corporate taxation – namely, that profits should be taxed where value is created."[79] The criticism in section A above levelled at the value creation principle applies in the context of this proposal too.

Turnover taxes are not generally favoured from a tax policy perspective; their weaknesses—and their strengths—are well known and for this reason the authors do not cover them at any length. The OECD Interim Report sets out several weaknesses: turnover taxes can have a negative impact

[76] See for example Updated Position Paper, above fn.12, 18–19.
[77] Updated Position Paper, above fn.12, para.4.11.
[78] Updated Position Paper, above fn.12, para.4.6.
[79] European Commission, *Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market* (Brussels: 21 March 2018). See, similarly, Updated Position Paper, above fn.12, paras 4.5–4.6.

on investment, innovation and welfare; the incidence of the taxes might be borne by other businesses and consumers; they might lead to over-taxation; they might prove not to be "interim" measures, even if intended as such; and they can give rise to significant compliance and administrative costs.[80] The Interim Report explains that countries considering these taxes themselves acknowledge the challenges they pose,[81] indeed this is why they have only been proposed as interim measures (although there is a distinct possibility that they will become permanent).[82] But these countries are driven by "a strong imperative to act"[83] while the long-term solution is agreed. The EU Commission is surprisingly frank about the political drivers behind these proposals: "*Member States are under increasing political pressure to act now* on taxing the digital economy, to safeguard revenues and ensure a level playing field."[84]

IV. System-wide reform

The countries in the second group

> "take the view that the ongoing digital transformation of the economy, and more generally trends associated with globalisation, present challenges to the continued effectiveness of the existing international tax framework for business profits. Importantly, for this group of countries, these challenges are not exclusive or specific to highly digitalised business models."[85]

They thus favour system-wide reform. The Interim Report does not provide more detail on the reasoning behind this view, however this view chimes with that held by the authors.[86] This section outlines the reasoning that led the authors to their view and also their favoured type of reform.[87]

Digitalisation exacerbates long-standing problems that plague the international tax system.[88] Under the existing system companies have an incentive to move their real activities to low tax countries,[89] thus causing distortions and real economic inefficiency. Companies also have an incentive to shift their profit to low tax countries by using well-known techniques. The BEPS project addressed some of these techniques, however the problem has not been eliminated. As

[80] Interim Report, above fn.2, 178–179.
[81] Interim Report, above fn.2, 178. See also Updated Position Paper, above fn.12, para.4.10.
[82] Consider the EU proposals. The short-term *measure* is intended to be in force in EU Member States "only until" they agree and implement the long-term *solution*. But the long-term solution requires existing double tax treaties to be amended. (2018 Communication, above fn.8, 9.) The political will to amend treaties between EU Member States should be in place once agreement on the long-term solution is reached, but there is no guarantee that non-EU Member States will agree to such amendment. Crucially, of course, for the long-term solution to be implemented in a meaningful manner in EU Member States, existing treaties with the US will have to be amended, but the US is unlikely to acquiesce.
[83] Interim Report, above fn.2, 179.
[84] 2018 Communication, above fn.8, 8 (emphasis in original).
[85] Interim Report, above fn.2, 172.
[86] These views are set out at length in Devereux and Vella, 21st Century, above fn.16, and Devereux and Vella, Implications, above fn.16.
[87] To be clear, this reasoning does not necessarily match, at least not in all respects, that which led the second group of countries to their view. It is the reasoning that led the authors to a similar view.
[88] Devereux and Vella, Implications, above fn.16.
[89] Or countries offering favourable tax regimes.

the Updated Position Paper explained, "there remain weaknesses in the international tax rules".[90] The ever-growing set of anti-avoidance rules necessary to dampen the profit-shifting activity that would otherwise be rampant under the existing system contributes to a third problem: the great complexity and hence administrative and compliance costs involved in running the system. A fourth problem follows from the first two: because companies move their real activities and shift their profits to countries offering low tax rates, countries, in turn, have an incentive to lower their tax rates to attract real activities and profit. But this leads to a race to the bottom, as evidenced by steadily declining corporate tax rates across the world. As the OECD recently noted: "CIT rate reductions are continuing" and, in fact "CIT rate cuts have accelerated in the last few years".[91] The critical point here is that the existing system generates competitive forces that threaten its long-term viability.

These problems existed pre-digitalisation, but are exacerbated by it. Consider intangibles. They are increasingly central to corporate value in a digitalised world, however they pose several formidable challenges for the existing system, including profit shifting. Despite efforts to address this issue in BEPS Actions 8, 9 and 10 the Interim Report concedes that

> "…it may still often be very difficult to determine how to allocate income from intangible assets among different parts of an MNE group. In turn, this may increase the responsiveness of business decisions to tax competition between countries. For instance, the location of the ownership and management of some important intangibles for digitalised firms (e.g., various types of knowledge-based capital) may not always be clearly discernible. In addition, intangible assets may easily be shifted around within an MNE group provided there is a correlation with a certain level of physical activity…."[92]

Ideally, reform should address all these issues. Furthermore, as these issues affect all companies and ring-fencing a subset of HDBs is problematic, the system should be reformed as a whole.

The question then is: what type of reform should be favoured? The authors have argued that many problems faced by the system ultimately stem from its fundamental framework. The key underlying problem is that the existing system seeks to tax companies' profit where *mobile* factors are located, including their place of residence, where production takes place and where IP is located. This results in distortions of real economic activity, profit-shifting and instability due to competition among states.

But if this is the underlying problem, it is best addressed by moving towards a system that seeks to tax companies' profit where more *immobile* factors are located. Consumers are considered to be relatively immobile—and therefore one option is to tax companies where their consumers are located—which in the jargon is known as the place of destination (or the market country). Moving towards a destination basis for taxing business profit would have significant advantages on the points mentioned above—though the advantages depend on exactly what tax base is chosen. To be clear, the case for such a move is based on immobility, and not on the view that

[90] Updated Position Paper, above fn.12, para.1.7.
[91] OECD, *Tax Policy Reforms 2018: OECD and Selected Partner Economies* (Paris: OECD Publishing, 2018), available at: *https://doi.org/10.1787/9789264304468-en* [Accessed 21 September 2018], 65–69.
[92] Interim Report, above fn.2, para.385, footnote omitted.

value is created in the market country. As argued above, the authors do not believe that the value creation principle can or should be used as a guide for allocating taxing rights among countries.

A move towards a destination basis can take different forms. One option would be to move to a pure destination system such as a Destination Based Cash Flow Tax,[93] which would have significant advantages in relation to all four points identified above. The intuition behind this is that if a multinational is taxed where its consumers are located it cannot lower its overall tax paid by moving its real activities or shifting its profits—which in turn means that countries are released from competitive pressures to cut their tax rates. Other reform options move towards a destination basis but only partially. One possibility currently being studied by the Oxford International Business Tax Group—a Residual Profit Allocation system—allocates the right to tax routine returns to countries where economic activity takes place and the right to tax any residual profit to the destination country.[94] It will be noted that HM Treasury's proposal for allocating taxing rights to countries where users are located adopts this approach, distinguishing between routine and residual profits. However, the proposal applies this approach to a narrow group of companies and only for the part of the residual profit that is deemed to reflect the contribution of users.

Proposals that move towards a destination basis in a partial way can be more politically palatable than a pure destination system, while still harnessing some of the benefits brought by a move in that direction. Further work is needed on these proposals before they can be put into practice, and no doubt they will give rise to challenges of their own. However, moving towards a destination basis in a coherent and comprehensive way should allow the tax system to have a stronger conceptual underpinning that is also less distortive, less avoidance ridden, more stable, and viable in the long run.

It is not clear what type of system-wide reform the countries in the second group favour. Clearly, a move towards a destination basis would constitute a departure from the existing system, where—in line with the widespread understanding of value creation—taxing rights are not allocated to market countries. However, it seems that countries in the second group are in fact considering a move in this direction. Commenting on their views, Pascal Saint-Amans, Director, Centre for Tax Policy and Administration at the OECD explained that:

> "If you will read between the lines, it looks like it's a plea for reconsidering international tax rules, to give more space to the marketplace."[95]

A system-wide move in this direction can constitute a significant improvement, although, it should be emphasised, this depends on how it is done.

[93] A.J. Auerbach, M.P. Devereux, M. Keen and J. Vella, *Destination based cash flow taxation*, Oxford University Centre for Business Taxation working paper 17/01 (2017).

[94] Residual profit splits are well known in current transfer pricing practice. This proposal can be seen as building on this practice to some extent, but it also diverges from it in some important respects. See the discussion in J. Andrus and P. Oosterhuis, "Transfer Pricing After BEPS: Where Are We and Where Should We Be Going" (March 2017) 95(3) *Taxes - The Tax Magazine* 89.

[95] S.S. Johnston and Alexander Lewis, "Countries Agree to Disagree on Taxing Digital Economy, OECD Says", *Tax Notes International*, 26 March 2018.

V. Conclusion

At a different point in time, each of a number of recent developments would have dominated attention in tax policy circles for a protracted period: country-by-country reporting; developments in Exchange of Information; the Multilateral Instrument; the creation of the Inclusive Framework; an EU direct tax Directive; and US corporate tax reform. But these are particular times, even in the tax policy world. While much practical and academic work is being done on, and in response to, these developments, the focus of attention is now firmly on the challenges posed by digitalisation.

Digitalisation has brought the international corporate tax debate to a critical point, with different reform options being considered. In previous work the authors argued for system-wide reform in response to the challenges posed by digitalisation, as well as other broader issues facing the existing tax system. This position is aligned with that of one of the two groups of countries favouring reform. The precise reform favoured by this group of countries is yet unclear, but there are signs it is a partial move towards a destination basis. This could bring significant benefits, depending on how this is done. This article focused instead on the reform favoured by another group of countries. This reform, which targets certain HDBs that rely on users, can be criticised on conceptual and practical grounds. It also fails to address the broader issues that threaten the long-term viability of the existing system.

This article considered the position of these groups of countries from an academic and policy perspective. In practice, of course, political considerations and negotiation will determine whether a consensus can be reached and, if so, what it will be. The negotiations will certainly be challenging. Agreement on a number of issues could be reached among G20/OECD countries participating in the BEPS project because it essentially sought to reallocate taxing rights away from tax havens or countries offering favourable regimes. But these negotiations concern the allocation of taxing rights among countries that believe they have strong claims to tax the income in question, thus making it harder to reach a consensus. If no consensus is reached it is likely that a number of countries will adopt unilateral measures, such as turnover taxes, which could have severe negative consequences. Of course, matters could become even worse if other countries responded through retaliatory unilateral measures of their own.

Targeted reform is politically attractive to the countries proposing it, not least because it would reallocate taxing rights in their favour. It might also be argued that system-wide reform is harder to achieve. But the existing system is gradually wasting away under competitive forces, and the ever-increasing complexity threatens to bring the system crashing down in its own right. This is the hard reality that will have to be faced, sooner or later.

Attribution; Base erosion and profit shifting; Digitisation; Economics and law; Indirect taxes; International taxation; Multinational companies; Profits; Ring-fencing; Tax reform

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