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## Value Creation: A Constant Principle in a Changing World of International Taxation

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## Value Creation: A Constant Principle in a Changing World of International Taxation

Jinyan Li, Nathan Jin Bao, and Huaning (Christina) Li\*

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### PRÉCIS

Les auteurs considèrent la nouvelle nomenclature de la création de valeur en termes de signification, de base théorique et d'importance dans le contexte de l'imposition internationale des bénéfices des entreprises. L'argument principal des auteurs est que le principe de la création de valeur est une élaboration profonde de la doctrine de l'allégeance économique, qui constitue la base théorique du système fiscal international actuel; et que les normes fiscales internationales, telles que le principe de lien de dépendance, visent à donner effet à la doctrine de l'allégeance économique (et maintenant au principe de création de valeur). Comme l'a démontré le projet de l'Organisation de coopération et de développements économiques/Groupe des Vingt sur l'érosion de la base d'imposition et de transfert de bénéfices, il semble qu'il y ait un consensus mondial selon lequel le principe de création de valeur devrait guider l'élaboration de nouvelles règles — non seulement les règles visant à protéger les assiettes fiscales existantes des pays (par exemple, les règles anti-évitement), mais aussi les règles d'attribution de nouveaux droits fiscaux en ce qui concerne les revenus tirés d'une économie numérique et immatérielle. Les auteurs évaluent les propositions de réforme fiscale les plus récentes à la lumière du principe de création de valeur, et ils recommandent l'adoption d'une règle mondiale de partage des bénéfices comme moyen de refléter avec précision la création de valeur.

### ABSTRACT

The authors consider the new nomenclature of value creation in terms of its meaning, theoretical basis, and importance in the context of the international taxation of business profits. The authors' central claim is that the principle of value creation is a profound elaboration of the doctrine of economic allegiance, which is the theoretical basis for the current international tax system; and that international tax norms, such as the arm's-length principle, are meant to give effect to the doctrine of economic allegiance (and now to the principle of value creation). As demonstrated by the Organisation for Economic Co-operation and Development/Group of Twenty base erosion and profit shifting project, there is apparently global consensus that the value-creation principle should guide the development of new rules — not only the rules to protect countries' existing tax bases

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(for example, anti-avoidance rules) but also the rules to allocate new taxation rights in respect of income derived in a digital and intangible economy. The authors evaluate the most recent tax-reform proposals in the light of the value-creation principle, and they recommend a global profit-split rule as a way of accurately reflecting value creation.

**KEYWORDS:** BEPS ■ DIGITAL ECONOMY ■ TRANSFER PRICING ■ ARM'S-LENGTH PRINCIPLE ■ PROFIT-SPLIT ■ GLOBAL VALUE CHAINS

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## INTRODUCTION

The notion of value creation was cited by the Group of Twenty (G20) leaders when they launched the base erosion and profit shifting (BEPS) project in 2013: "Profits should be taxed where economic activities deriving the profits are performed and where value is created."<sup>1</sup> The BEPS action plan<sup>2</sup> refers to value creation specifically

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1 Group of Twenty, "G20 Leaders' Declaration," St. Petersburg, September 6, 2013, at paragraph 50 ([www.g20.utoronto.ca/2013/Saint\\_Petersburg\\_Declaration\\_ENG.pdf](http://www.g20.utoronto.ca/2013/Saint_Petersburg_Declaration_ENG.pdf)).

2 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as "the BEPS action plan"), at paragraph 50 (<https://doi.org/10.1787/9789264202719-en>).

in action 1 (the digital economy) and actions 8-10 (transfer pricing).<sup>3</sup> Merely by titling the project “base erosion and profit shifting,” the G20 and the Organisation for Economic Co-operation and Development (OECD) implied that there exists a fundamental tax base that is eroded or shifted by taxpayers, notably multinational enterprises (MNEs); and that this tax base is measured in terms of the value created in a country.<sup>4</sup> More specifically, the BEPS project seemed to intend the value-creation principle to have both negative and positive functions in the process of determining a country’s tax base. The negative function is the more prominent one, manifested in the anti-avoidance or base-protection measures of actions 2-4<sup>5</sup> and actions 6-10.<sup>6</sup> Profit cannot be allocated for tax purposes to a country where no economic activities take place.<sup>7</sup> The positive function is manifested mainly in action 1, in respect of developing rules for the allocation of new taxing rights in the digital age.

The BEPS project and (since 2016) the Inclusive Framework on BEPS<sup>8</sup> have recognized value creation as a guiding principle, and technical rules (either anti-avoidance rules or new allocation rules) have been re-worked to give effect to this principle.<sup>9</sup> Implicit in the BEPS project is the belief that (1) a country’s taxing right is based on the economic activities or value created in that country, and (2) the artificial manipulation of the location of profit should be prevented through better rules. The project has been viewed<sup>10</sup> as “the most significant re-write of the international tax

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3 Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Paris: OECD, 2015); and *infra* note 92.

4 “BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity,” see Organisation for Economic Co-operation and Development, “What Is BEPS?” ([www.oecd.org/tax/beps/beps-about.htm](http://www.oecd.org/tax/beps/beps-about.htm)), under the heading “What Is the Issue?”

5 Actions 2-4 address the issues of hybrid mismatch arrangements, use of controlled foreign companies, and interest deduction. See BEPS action plan, *supra* note 2.

6 Actions 6-10 address the issues of treaty shopping, the artificial avoidance of permanent establishment (PE) status, and transfer pricing. See BEPS action plan, *supra* note 2.

7 Stanley I. Langbein and Max R. Fuss, “The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the ‘Arm’s Length’ Standard” (2018) 51:2 *International Lawyer* 259-409, at 285.

8 OECD/G20 Inclusive Framework on BEPS (herein “the Inclusive Framework”) has 134 countries and jurisdictions (as of August 2019) that collaborate “on the implementation of . . . [BEPS] measures.” See “What Is BEPS?” *supra* note 4.

9 BEPS action plan, *supra* note 2. Implicit in the BEPS project is the belief that a country’s taxing right is based on the economic activities or value created in that country and that “artificial” manipulation of the location of profit should be prevented through better rules.

10 See for example, Hugh J. Ault, Wolfgang Schön, and Stephen E. Shay, “Base Erosion and Profit Shifting: A Roadmap for Reform” (2014) 68:6/7 *Bulletin for International Taxation* (published online, available on IBFD tax research platform); Reuven S. Avi-Yonah and Haiyan Xu, “Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight” (2016) 6:2 *Harvard Business Law Review* 185-238; Yariv Brauner, “What The BEPS” (2014) 16:2 *Florida Tax Review* 55-115; Allison Christians, “BEPS and the New International Tax Order” [2016] no. 6 *Brigham Young University Law Review* 1603-48; Allison Christians and

rules in a century,”<sup>11</sup> with the potential to significantly transform the international tax regime,<sup>12</sup> and it has been viewed as signalling the “emergence of a new international tax regime.”<sup>13</sup>

Through the Inclusive Framework, G20 countries and OECD countries, along with other countries, have committed to implementing the measures recommended by the BEPS project. By mid-2019, the international community had agreed on “a road map for resolving the tax challenges arising from the digitalisation of the economy, and committed to continue working toward a consensus-based long-term solution by the end of 2020.”<sup>14</sup> The road map focuses on technical issues to be resolved through the two pillars identified in the programme of work<sup>15</sup> of May

Stephen Shay, “General Report,” in International Fiscal Association, *Assessing BEPS: Origins, Standards, and Responses, Cahiers de droit fiscal international* vol. 102a (The Hague: Sdu, 2017), 17-63; Michael Devereux and John Vella, “Value Creation as the Fundamental Principle of the International Corporate Tax System,” European Tax Policy Forum Policy Paper 2018, at 1 (<https://ssrn.com/abstract=3275759>); Itai Grinberg and Joost Pauwelyn, “The Emergence of a New International Tax Regime: The OECD’s Package on Base Erosion and Profit Shifting (BEPS)” (2015) 19:24 *American Society of International Law Insights*, October 28, 2015 (online); Itai Grinberg, “International Taxation in an Era of Digital Disruption: Analyzing the Current Debate” (2019) 97:3 *Taxes: The Tax Magazine* 73-104; Mindy Herzfeld, “The Case Against BEPS: Lessons for Tax Coordination” (2017) 21:1 *Florida Tax Review* 1-59; Yariv Brauner and Pasquale Pistone, eds., *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015).

- 11 Organisation for Economic Co-operation and Development, *OECD/G20 Base Erosion and Profit Shifting Project 2015 Final Reports, Information Brief* (Paris: OECD, 2015), at 3 ([www.oecd.org/ctp/beps-reports-2015-information-brief.pdf](http://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf)). See also Tizhong Liao, “Shendu canyu quanqiu shuishou hezuo, chixu dazao guoji shuishou shengjiban” [Participating In-Depth in International Cooperation of Tax Administration and Continuing To Build Up an Upgraded Version of International Taxation] (2016) 71:5 *International Taxation in China* (in Chinese).
- 12 Reuven S. Avi-Yonah and Haiyan Xu, *China and the Future of the International Tax Regime*, University of Michigan Law and Economics Research Series Paper no. 17-017 (Michigan: University of Michigan, October, 2017) (<http://dx.doi.org/10.2139/ssrn.3056796>); Reuven S. Avi-Yonah, “A Perspective of Supra-Nationality in Tax Law,” in *BRICS and the Emergence of International Tax Coordination*, supra note 10, 33-40; and Richard Vann, “Current Trends in Balancing Residence and Source Taxation,” in *BRICS and the Emergence of International Tax Coordination*, supra note 10, 367-92.
- 13 See Grinberg and Pauwelyn, supra note 10.
- 14 Organisation for Economic Co-operation and Development, “International Community Agrees on a Road Map for Resolving the Tax Challenges Arising from Digitalisation of the Economy,” *OECD.org*, May 31, 2019 ([www.oecd.org/ctp/international-community-agrees-on-a-road-map-for-resolving-the-tax-challenges-arising-from-digitalisation-of-the-economy.htm](http://www.oecd.org/ctp/international-community-agrees-on-a-road-map-for-resolving-the-tax-challenges-arising-from-digitalisation-of-the-economy.htm)). In June 2019, the G20 leaders approved the Organisation for Economic Co-operation and Development, *Programme of Work To Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy: Inclusive Framework on BEPS* (Paris: OECD, 2019) ([www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf](http://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf)).
- 15 The Inclusive Framework published an interim report in March 2018: Organisation for Economic Co-operation and Development, *Tax Challenges Arising from Digitalisation—Interim*

2019. Pillar 1 concerns the allocation of new taxing rights to the jurisdictions where clients or users are located. Pillar 2 concerns the designing of anti-abuse rules to ensure that MNEs pay a minimum level of tax in jurisdictions where value is created. In this paper, we focus on pillar 1.

In this paper, we make two main contributions to the debates on international tax reform. First, we demonstrate that the value-creation principle has existed throughout the history of international taxation. We challenge the view that value creation is a “new mantra”<sup>16</sup> or is “fundamentally at odds with the arm’s length principle that serves as the backbone of transfer pricing rules.”<sup>17</sup> We argue that the criticism of value creation as being vague or subjective<sup>18</sup> is misplaced, because the value-creation principle is not a technical rule but “a useful, if not profound, elaboration of”<sup>19</sup> the doctrine of economic allegiance. The latter doctrine provided the theoretical basis for the existing international tax structure and norms (such as the arm’s-length principle). The value-creation principle helps sharpen the focus on rules to prevent “stateless income.”<sup>20</sup>

Second, we evaluate the pillar 1 proposals in light of the value-creation principle, and we explain why they are encouraging but inadequate. We recommend, in their stead, a global profit-split (GPS) rule that takes into account multiple factors (for example, assets, workforce, and sales) in allocating MNEs’ group profit to all relevant contributors to value creation or links in global value chains (GVCs).

The remainder of this paper is organized as follows. Below, in the second section, we provide an overview of the theory of economic allegiance. In the process, we

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*Report 2018: Inclusive Framework on BEPS* (Paris: OECD, March 2018); Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digitalisation of the Economy—Policy Note: As Approved by the Inclusive Framework on BEPS on 23 January 2019* (Paris: OECD, 2019); Organisation for Economic Co-operation and Development, *Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy 13 February–6 March 2019* (Paris: OECD 2019); and *Programme of Work*, supra note 14, in May 2019. On October 9, 2019, the OECD released a public consultation document, *Secretariat Proposal for a “Unified Approach” Under Pillar One* (Paris: OECD, October 2019). This unified approach received support from the G20 finance ministers during their meeting on October 17–18, 2019 ([www.brettonwoodsproject.org/2019/10/g20-press-briefing-analysis-annual-meetings-2019/](http://www.brettonwoodsproject.org/2019/10/g20-press-briefing-analysis-annual-meetings-2019/)).

16 Wolfgang Schön, “Ten Questions About Why and How To Tax the Digital Economy” (2018) 72:4/5 *Bulletin for International Taxation* 278–92, at 280, describing value creation as a new mantra.

17 Herzfeld, supra note 10, at 1.

18 Grinberg, supra note 10, at 29, mentioning “any exercise to define specific sources of value creation is entirely subjective”; and Johanna Hey, “‘Taxation Where Value Is Created’ and the OECD/G20 Base Erosion and Profit Shifting Initiative” (2018) 72:4/5 *Bulletin for International Taxation* 203–8, at 203, referring to “[t]he unclear concept of value creation as an allocation factor.”

19 Langbein and Fuss, supra note 7, at 262.

20 This term was coined by Edward D. Kleinbard in two papers: “Stateless Income” (2011) 11:9 *Florida Tax Review* 699–773; and “Lessons of Stateless Income” (2011) 65:1 *Tax Law Review* 99–171.

show that the value-creation principle is a modern articulation of that theory—that is, the theory that a country’s taxing rights are based on the economic allegiance that a given taxpayer owes to that country by being a resident in it or by having income sourced in it. We also show that the arm’s-length principle was meant to implement the doctrine of economic allegiance in respect of allocating the income of an enterprise between countries. We provide an overview of Canadian tax laws (domestic statutes and tax treaties) that adhere to the principles of economic allegiance (and value creation), and then we consider the legal constraints on the application of the value-creation principle.

In the third section of this paper, we describe departures from the value-creation principle, and we suggest that such departures are mainly the result of inadequate rules and problematic interpretations of the arm’s-length principle. In the fourth section, we examine the recent trend in favour of the value-creation principle, and we discuss the emerging consensus on a road map for redesigning the technical rules. In the fifth section, we discuss the ways in which pillar 1’s proposals—especially the unified approach, proposed in October 2019, to reallocate taxing rights to the market jurisdictions—are a step in the right direction but fall short of fully reflecting the value-creation principle. We also discuss why a global profit-split (GPS) rule, based on multiple factors, is a superior option. In the final section, we offer some key findings and conclusions.

## VALUE CREATION AS AN ELABORATION OF ECONOMIC ALLEGIANCE

### The Nomenclature of Value Creation

The BEPS project introduced the nomenclature of value creation and seemed to presume that a country’s tax base is defined by the value created in that country. As a nomenclature, value creation is not only modern, in that it can be applied to new business models and GVCs; it is also functional, in that it supports both new anti-avoidance rules and new rules on the allocation of taxing rights. The older concept of economic allegiance, by comparison, has been used to support the assignment of taxing rights.

### Economic Allegiance

It has been observed that

[i]nternational taxation as it was conceived in the 1920s and 1930s had two objectives that are difficult to reconcile: trade among nations undistorted by unwarranted and unjustifiable tax-induced barriers, and the preservation of national fiscal sovereignty as expressed through tax policy and tax legislation.<sup>21</sup>

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21 Scott Wilkie, “New Rules of Engagement? Corporate Personality and the Allocation of ‘International Income’ and Taxing Rights,” in Brian J. Arnold, ed. *Tax Treaties After the BEPS Project: A Tribute to Jacques Sasseville* (Toronto: Canadian Tax Foundation, 2018), 349-71, at 353.

The foundation of international taxation is the doctrine of economic allegiance, which was proposed by four economists (Bruins, Einaudi, Seligman, and Stamp) in their 1923 report on double taxation.<sup>22</sup>

The doctrine of economic allegiance,<sup>23</sup> as set out in the 1923 report, provided a theoretical basis “for an international convention to remove the evil consequences of double taxation”<sup>24</sup> while respecting the fiscal sovereignty of nations. This doctrine posits that a taxpayer’s income should be divided among countries according to the taxpayer’s relative economic interests in each country<sup>25</sup> or among “all those governments to whom the . . . [taxpayer] owes economic allegiance.”<sup>26</sup> The 1923 report posited four elements of economic allegiance: (1) the acquisition (or production) of wealth, (2) the location of wealth, (3) the enforceability of the rights to wealth, and (4) the consumption of wealth.<sup>27</sup> The first three elements correspond to source of income, and the last one corresponds to residence.

The production or acquisition of wealth, which corresponds to origin of income, is the most important in terms of business profits. The economists’ 1923 report stated:

*By production of wealth we mean all the stages which are involved up to the point [of] wealth coming to fruition, that is, all the stages up to the point when the physical production has reached a complete economic destination and can be acquired as wealth. The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the*

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22 Gijsbert W.J. Bruins, Luigi Einaudi, Edwin R.A. Seligman, and Sir Josiah Stamp, *Report on Double Taxation Submitted to the Financial Committee Economic and Financial Commission*, League of Nations document no. E.F.S.73.F.19 (Geneva: League of Nations, April 5, 1923) (herein referred to as “the 1923 report”).

23 The 1923 report, *ibid.*, at 21, made it clear that this doctrine was not new in 1923 but had “come to be widely accepted in connection with the ordinary taxes on property and income.” The faculty or ability-to-pay theory influenced the income tax system in the United States, the United Kingdom, and other countries in the early 1920s. As is explained below, the Canadian Income War Tax Act also reflected this theory.

24 Recommending a basis for removing double taxation through a convention is one of the terms of reference for the four economists in the 1923 report, *ibid.*, at 2.

25 The 1923 report, *ibid.*, at 20, states: “A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual’s whole faculty should be taxed, but that it should be taxed only once, and that the liability should be divided among the tax districts according to his relative interests in each. The individual has certain economic interests in the place of his permanent residence or domicile, as well as in the place or places where his property is situated or from which his income is derived. If he makes money in one place he generally spends it in another.”

26 *Ibid.*

27 *Ibid.*, at 23.



consumer can use them. These stages, up to the point where wealth reaches fruition, may be shared in by different territorial authorities.<sup>28</sup>

More specifically, the economists said that

[w]hen we are speaking of the origin of the wealth, we refer naturally to the place where the wealth is produced, that is, to the community the economic life of which makes possible the yield or the acquisition of the wealth. This yield or acquisition is due, however, not only to the particular thing but to the human relations which may help in creating the yield.

The origin of the wealth therefore may have to be considered in the light of the original physical appearance of the wealth, its subsequent physical adaptations, its transport, its direction and its sale.<sup>29</sup>

In the case of “intangible personality or incorporeal movables” (for example, corporate securities), the economists emphasized the economic situs or the owner’s residence.<sup>30</sup>

From the perspective of the countries that seek to tax international income, the competence to tax is based on the government’s rendering of services to taxpayers,<sup>31</sup> such as providing the necessary legal framework within which legal rights can be enforced. To prevent double taxation, the economists offered four possible alternatives, including “exemption for income going abroad” and “classification and assignment of sources,”<sup>32</sup> that found their way into the original draft model tax conventions.

## **Economic Allegiance and International Tax Norms**

### ***The Assignment of Taxing Rights Under Earlier Model Tax Conventions***

The theoretical framework of economic allegiance influenced the work of seven technical experts<sup>33</sup> who were tasked by the League of Nations with developing practical solutions to the problems of double taxation and tax evasion. Their 1925 report<sup>34</sup> laid the foundation for the first draft model conventions in 1928. Drawing

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28 Ibid (emphasis in original).

29 Ibid., at 24.

30 Ibid., at 34-35.

31 Ibid., at 20.

32 Ibid., at 42.

33 They represented Belgium, Czechoslovakia, France, the United Kingdom, Italy, the Netherlands, and Switzerland. See Sunita Jogarajan, *Double Taxation and the League of Nations* (Cambridge: Cambridge University Press, 2018), at 26.

34 League of Nations, *Double Taxation and Tax Evasion, League of Nations: Technical Experts to the Economic and Financial Committee Double Taxation and Tax Evasion Report and Resolutions Submitted by the Technical Experts to the Financial Committee*, League of Nations document no. F.212 (Geneva: League of Nations, February 1925) (herein referred to as “the 1925 report”).

on national tax practices of the time,<sup>35</sup> these experts recommended the classification and assignment approach, and they endorsed the idea of the source taxation of business profits. The 1925 report sets out the following permanent establishment (PE) rule:

If the enterprise has its head office in one of the States and in another has a branch, an agency, an establishment, a stable commercial or industrial organisation, or a permanent representative, each one of the contracting States shall tax that portion of the net income produced in its own territory.<sup>36</sup>

Further technical experts were subsequently added, including representatives from the United States, to develop model tax conventions on the basis of the 1925 report. The 1927 report<sup>37</sup> by these experts treated a subsidiary enterprise as a PE.<sup>38</sup> Their 1928 report<sup>39</sup> contains alternative draft models, one of which (Draft Convention Ic) became the basis for the subsequent OECD model.<sup>40</sup> These models distributed taxing rights to the two contracting states, and they did not address the question of how to allocate business profits in a situation where both the residence and source country have taxing rights. This question was later addressed by article 9 of the OECD model, which was developed under the influence of the Carroll report.<sup>41</sup>

### *The Carroll Report and the Arm's-Length Principle*

During the 1920s and 1930s, member countries of the League of Nations adopted different methods of attributing profit to a branch or a PE: some used separate

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35 The 1923 report and the 1925 report took note of the fact that some countries imposed personal tax (similar to present progressive income taxes) and others impersonal taxes (separate taxes imposed at a proportional rate on different categories of income based on source).

36 1925 report, *supra* note 34, at 31.

37 League of Nations, *Double Taxation and Tax Evasion: Report*, League of Nations document no. C.216.M.85 (London: League of Nations, April 12, 1927) (herein referred to as “the 1927 report”).

38 Draft model in the 1927 report, *ibid.*, article 5.

39 League of Nations, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations document no. C.562.M.178.1928.II. (Geneva: League of Nations, October 31, 1928) (herein referred to as “the 1928 report”).

40 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Full Version 2017* (Paris: OECD, 2019) (<https://doi.org/10.1787/g2g972ee-en>) (herein referred to as “the OECD model”). See Jogarajan, *supra* note 33, at 177; and Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003), at 37–44.

41 Mitchell B. Carroll, *Taxation of Foreign and National Enterprises, vol. IV, Method of Allocating Taxable Income*, League of Nations document no. C.425(b).M.217(b).II.A (Geneva: League of Nations, 1933) (herein referred to as “the Carroll report”). For more discussion of this report, see chapter 1 in Richard S. Collier and Joseph L. Andrus, *Transfer Pricing and the Arm's Length Principle after BEPS* (Oxford: Oxford University Press, 2017).

accounting, and others used fractional apportionment. As a result, even when countries had agreed to the PE rule, double taxation could still arise owing to the different allocation methods. Mitchell B. Carroll, an American tax lawyer, was commissioned to formulate “a scientific regime of allocation.”<sup>42</sup> The acceptance of the doctrine of economic allegiance was not open to debate. The allocation regime set out in the Carroll report (1933) was, in essence, “technically an extension of the basic structure”; as such, it was “principally based upon and revolve[d] round arguments pertinent to determining the ‘origin of income’ viz. the value creation.”<sup>43</sup>

The Carroll report states that a general regime of allocation

entails abandoning all precepts of liability other than those of fiscal domicile and source, and requires that the concept of fiscal domicile be uniformly defined and that the concept of source be defined and strictly limited to sources obviously within the jurisdiction of the State.<sup>44</sup>

Such a narrow concept of source would “preclude the telescopic extension of the concept of source in order to trace profits through corporations created under the laws of another country.”<sup>45</sup> The Carroll report regards the “organic unity” or “fractional apportionment” method as “too wide an approach” and therefore as “violating the basic idea of source taxation.”<sup>46</sup>

The Carroll report adopts a legalistic view of income allocation.<sup>47</sup> It notes the “fundamental legal difference” between a subsidiary and a branch (that is, subsidiaries can enter into legally binding contracts with their parent or affiliated companies, and branches cannot).<sup>48</sup> It says that profit in law and in economic fact can be different:

In law, a taxable profit might accrue to the producing corporation if title to the goods were transferred to the selling corporation. In economic fact, no profit accrues to the enterprise consisting of the producing corporation and the selling corporation, until the goods have been sold by the selling corporation to outsiders.<sup>49</sup>

The report concludes with the following positions:

As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments

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42 Carroll report, *supra* note 41, at 198.

43 Langbein and Fuss, *supra* note 7, at 295.

44 Carroll report, *supra* note 41, at 169.

45 *Ibid.*, at 169.

46 Langbein and Fuss, *supra* note 7, at 298.

47 Carroll report, *supra* note 41, at 176-78, inferred legal principles for the allocation of business profits from a survey of existing practices.

48 *Ibid.*, at 176.

49 *Ibid.*

of an enterprise but treated as independent legal entities; and if it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise.<sup>50</sup>

The Carroll report concludes, further, that branches “should be treated in so far as possible as independent entities, in order that the income allocated to a branch may be equivalent to that which would have been derived by an independent enterprise.”<sup>51</sup> These are the forerunners of the arm’s-length principle.<sup>52</sup>

The Carroll report has been criticized for “derogating the principles which underlay the overall effort made by the League during the 1920s”<sup>53</sup> and for being biased in favour of capital-exporting countries.<sup>54</sup> The report’s legalistic approach to income allocation influenced the transfer-pricing rules for decades to come. While purporting to create a method of profit allocation within the framework of economic allegiance, the Carroll report narrows the scope of value created in the source state by permitting taxpayers to allocate profit through contractual arrangements.

## **Embedded Principle in Canadian Tax Laws**

### *Canadian Domestic Law*

In the 1923 report, the four economists noted that the doctrine of economic allegiance was embedded in the tax systems of some countries. In Canada’s system, for example, the doctrine was enshrined in the Income War Tax Act, 1917.<sup>55</sup> The IWTA imposed taxes on “every person residing or ordinarily resident in Canada or carrying on any business in Canada.”<sup>56</sup> It identified economic allegiance with Canada through two tests: (1) the test of residence and (2) the test of carrying on business in Canada. With respect to value creation, a taxpayer’s income was created in Canada if one or both of the tests were met. From Canada’s perspective, under the doctrine

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50 Ibid., at 177.

51 Ibid.

52 The recommendations of the Carroll report were converted into model treaty provisions in 1933, and they subsequently became part of the 1943 Mexico and 1946 London Model Conventions. The forerunner of the current article 9 of the OECD model is regarded as derived from section 45 of the US Revenue Act of 1928. See Collier and Andrus, *supra* note 41, at 42-43.

53 Langbein and Fuss, *supra* note 7, at 295; Richard J. Vann, “Taxing International Business Income: Hard-Boiled Wonderland and the End of the World” (2010) 2:3 *World Tax Journal* 291-346, at 321.

54 Langbein and Fuss, *supra* note 7, at 295.

55 Income War Tax Act, 1917, SC 1917, c. 28 (herein referred to as “the IWTA”).

56 IWTA subsection 4(1).

of economic allegiance, Canada provided services<sup>57</sup> to the taxpayer or acted as a co-venturer with the taxpayer in earning the income.<sup>58</sup>

The intellectual backdrop to the IWTA was Edwin R.A. Seligman's theory of income tax in general and the international aspect of income tax in particular.<sup>59</sup> (Seligman was one of the four economists who wrote the 1923 report.) Moreover, Seligman's thinking influenced the design of the American income tax system, which influenced the IWTA.<sup>60</sup>

Since 1917, the technical rules supporting Canada's tax base have become more extensive and nuanced. Descriptive charging rules, such as withholding tax provisions, have been added, as have statutory deeming rules, such as section 253 of the Income Tax Act.<sup>61</sup> More significantly, the tax base is protected by an increasing number of anti-avoidance rules,<sup>62</sup> such as section 219, which imposes a "branch profits tax" on the after-tax profits of a Canadian branch; subsection 212(13), which deems certain base-erosion payments to be subject to withholding tax; and sections 91 and 95, which (1) characterize certain Canadian-source business income deflected to a controlled foreign affiliate as foreign accrual property income (FAPI) and (2) tax the income on an imputation basis.<sup>63</sup> At the heart of these rules is the concept of a business carried on in Canada, which is the concept of value creation.

In allocating income to a business carried on in Canada through a branch or PE, section 26 of the 1927 IWTA<sup>64</sup> recognized the principle of dividing the income between the country of production and the country of sale. Section 26 reads as follows:

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57 "Economic allegiance" is the expression used in the 1923 report, *supra* note 22, at 23: "A country of stable government and laws which will render him those services without which he could not enter into the third stage of consumption with confidence is a country to which he owes some economic allegiance."

58 For further discussion of the notion of source, see Jinyan Li and J. Scott Wilkie, "Source of Income and Canadian International Taxation," in Jinyan Li, J. Scott Wilkie, and Larry F. Chapman, eds., *Income Tax at 100 Years: Essays and Reflections on the Income War Tax Act* (Toronto: Canadian Tax Foundation, 2017), 10:1-42.

59 Colin Campbell and Robert Raizenne, "The 1917 Income War Tax Act: Origins and Enactment," in *Income Tax at 100 Years*, *supra* note 58, 2:1-96, at 2:16-17.

60 *Ibid.*, at 2:17, stating: "The architectural harmony in this regard between the 1917 Act and the recently enacted [1913] US revenue laws is striking."

61 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

62 A corporation is a Canadian resident if it was created under Canadian laws under subsection 250(4) of the Act or has, under case law, its central management and control in Canada (see *Fundy Settlement v. Canada*, 2012 SCC 14). These two tests are close to the notion of "fiscal domicile" of corporations in the 1923 report, *supra* note 22; and the Carroll report, *supra* note 41.

63 For further discussion, see Jinyan Li, Arthur Cockfield, and J. Scott Wilkie, *International Taxation in Canada*, 4th ed. (Toronto: LexisNexis, 2018); see back-to-back rules, *ibid.*, at 229-34; foreign affiliate dumping rules, *ibid.*, at 354-55; and surplus stripping rules, *ibid.*, at 390-92.

64 Income War Tax Act, RSC 1927, c. 97 (herein referred to as "the 1927 IWTA"). Section 27 of this act deems any non-resident person "who lets or leases anything used in Canada, or who

Where a non-resident person produces . . . anything within Canada and exports the same without sale prior to the export thereof, he shall be deemed to be carrying on business in Canada and to earn within Canada *a proportionate part of any profit ultimately derived from the sale thereof outside of Canada* [emphasis added].

This principle is now embedded in section 253 and section 4 of the Act.<sup>65</sup> Under section 4, the amount of income in Canada is computed on the assumption that the Canadian part of the business is an independent enterprise and that a reasonable allocation of revenue and expenses must be made.<sup>66</sup>

Canadian subsidiaries of foreign companies are taxed as residents. To prevent the shifting of Canadian-source income to a foreign parent, a fair-pricing rule was provided in subsection 3(2) of the 1917 IWTA, which reads as follows:

Where an incorporated company conducts its business, whether under agreement or otherwise, in such manner as either directly or indirectly to benefit its shareholders . . . , by selling its product or the goods and commodities in which it deals at less than the fair price which might be obtained therefor, the Minister may . . . determine the amount of which shall be deemed to be the income of such company for the year, and in determining such amount the Minister shall have regard to the fair price which, but for any agreement, arrangement or understanding, might be or could have been obtained for such product, goods and commodities.<sup>67</sup>

The fair-pricing rule was influenced by the arm's-length standard in the United States.<sup>68</sup> Subsection 3(2) implicitly recognizes separate accounting, and it authorizes

receives a royalty or other similar payment for anything used . . . in Canada” to be carrying on business in Canada. This deeming rule was replaced by a subsequent rule that subjected rent and royalties to withholding tax.

65 The origin of the current section 4 is paragraph 139(1)(a) of the Income Tax Act, RSC 1952, c. 148. The Carroll report classified the Canadian approach as “fractional apportionment”; see Carroll report, supra note 41, at 73.

66 Similarly, when a non-resident person offers anything for sale in Canada (such that Canada is a market country), regardless of where the contract may be completed, a proportionate portion of the taxpayer’s income is allocated to Canada by virtue of paragraph 253(b) and section 4.

67 Even though the wording of the provision does not specifically address cross-border transactions, historical records of Parliamentary debate on the draft legislation show that the minister of finance, Mr. White, clearly “understood the need to defend Canada’s fiscal border and acted accordingly” and understood that “[f]ailure to police cross-border dealings between persons not having separate economic interests would inevitably lead to reduced tax revenue.” See Campbell and Raizenne, supra note 59, at 2:50.

68 Section 45 of the US Revenue Act of 1928, Pub. L. no. 70-562 (predecessor of current section 482 of the Internal Revenue Code of 1986) read as follows: “In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses.”

the minister to adjust the taxpayer's income only if the intercompany pricing deviates from fair market prices. It influenced Carroll in his recommendation of the arm's-length principle.<sup>69</sup>

Subsection 3(2)<sup>70</sup> is the origin of the modern transfer-pricing rules in section 247. In 1948, the fair-pricing rule was broadened to apply to non-residents carrying on business in Canada.<sup>71</sup> In 1972, the phrase "reasonable amount" replaced the phrase "fair price."<sup>72</sup> In 1997, section 247 was enacted, with a view to modernizing the transfer-pricing regime so that Canada's fiscal border would be better defended.<sup>73</sup>

To summarize, the Canadian tax jurisdictional rules and allocation rules implicitly recognize the value-creation principle. Canada does not seek to tax income that is derived without Canada's involvement or contribution. Further, Canada adheres to the value-creation principle in its tax treaties by following the OECD model.<sup>74</sup>

### *Tax Treaties*

The OECD model can be traced to the 1928 draft conventions that were developed within the theoretical framework of the economists' 1923 report.<sup>75</sup> The model assigns taxing rights between two contracting states by reference to residence or source and by reference to the type of income. Under the residence-source paradigm, business income is taxable primarily in the source country (as per article 7 of the model), and other types of income, especially income from capital, is taxable primarily or exclusively in the residence country (as per articles 11 and 12). To the extent that income is taxable at source, the residence country bears the burden of relieving double taxation through a system of foreign tax credits or exemptions (as per article 23).

In the case of business income, manifestations of value creation are found in article 5, and the measurement of such value is governed by articles 7 and 9.<sup>76</sup> Article 5 defines a "permanent establishment" to be a fixed place of business through which

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69 Collier and Andrus, *supra* note 41, at 34.

70 See IWTA, *supra* note 55.

71 Subsection 17(3) of the Income Tax Act, SC 1948, c. 52.

72 See subsection 69(2) of the Income Tax Act, SC 1970-71-72, c. 63, which succeeded subsection 17(3), using the phrase "reasonable amount."

73 Campbell and Raizenne, *supra* note 59, at 2:50.

74 For further discussion of the history of Canadian treaty policy, see Brian J. Arnold and Jacques Sasseville, "A Historical Perspective on Canada's Tax Treaties," in *Income Tax at 100 Years*, *supra* note 58, at 11:1-53.

75 For further discussion of the role of the 1923 report, see Hugh J. Ault, "Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practice" (1992) 47:3 *Tax Law Review* 565-608, at 567; Reuven Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification" (1996) 74:6 *Texas Law Review* 1301-59, at 1305-10; and Jogarajan, *supra* note 33, at 32.

76 Other articles, such as 11(4) and 12(3) of the OECD model, *supra* note 40, also protect the source taxation of business profit by giving article 7 priority.

the business of an enterprise is wholly or partly carried on; a PE includes a place of management and a branch, and it excludes a fixed place of business maintained to conduct activities of a preparatory or auxiliary character. Article 5 deems a building site or construction or installation project to constitute a PE if it lasts more than 12 months. Article 5 also includes activities of dependent agents, but it excludes a subsidiary per se as a PE. Article 5 thus indicates that the factors in value creation include physical assets and premises (capital), human activities and human agency, and market (but only if the sales proper, as opposed to auxiliary activities, are done through a fixed place of business or agent). Article 5 ignores less significant value-creation factors in order to simplify tax compliance and administration.

Article 7 limits the amount of profit taxable in the source country to the amount that is attributable to a PE in that country. For the purposes of attribution, article 7 treats the PE as if it were

a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.<sup>77</sup>

Accordingly, the key factors are “functions,” “assets,” and “risks.” The same factors are relevant to the application of the arm’s-length principle, which is enshrined in article 9.

Article 9(1) reflects the approach recommended by the Carroll report, which is based on the arm’s-length principle. According to this approach, the profits of a subsidiary are expected to reflect an amount that would have accrued if the subsidiary were an independent enterprise. The profits of a subsidiary that would have accrued if it were an independent enterprise but have not accrued by reason of non-market-based conditions made or imposed between the subsidiary and its associated enterprises would be included for tax purposes. The 2017 transfer-pricing guidelines<sup>78</sup> are regarded as the most influential interpretation of the arm’s-length principle. Even though article 9(1) does not mention “price” or “transactions,” the OECD interpreted it as requiring tax authorities “to adjust the actual price to an arm’s length price, in order to arrive at a proper level of taxable income.”<sup>79</sup> Prices of non-arm’s-length transactions are compared with comparable arm’s-length transactions on the basis of an analysis that recognizes the actual transactions as the starting point and intragroup contracts as decisive evidence.<sup>80</sup>

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77 OECD model, *supra* note 40, article 7(2).

78 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, July 2017) (herein referred to as “the 2017 guidelines”). Earlier versions were published in 1979, 1995, and 2010.

79 Organisation for Economic Co-operation and Development, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979), at 9 (herein referred to as “the 1979 guidelines”).

80 See below, under the heading “Legalistic Interpretation of the Arm’s-Length Principle.”



## Legal Constraints on Implementing Value Creation

The value-creation principle needs to be “rulified”<sup>81</sup>—that is, translated into operating legal rules. As the earlier experiences of the League of Nations show, it is challenging to craft legal rules that give effect to the doctrine of economic allegiance. The technical experts of the league, along with Carroll, introduced legal constraints to the doctrine in order to accommodate country-specific tax practices and administrative difficulties. The proliferation of anti-avoidance rules in Canada demonstrates the need for constant legislative elaboration with respect to whether income (value) belongs to the Canadian tax base.

The value-creation principle must work in combination with other important legal principles, such as (1) the principle of fiscal sovereignty, which produces divergent national tax laws; (2) the principle of accessory, under which tax laws defer to or are accessory to general laws; and (3) the *Duke of Westminster*<sup>82</sup> principle, under which taxpayers are entitled to engage in tax planning in order to minimize their tax. The influence of these other principles has led to some serious deviations from the value-creation principle in practice, some of which are considered below.

## DEVIATIONS FROM VALUE CREATION

### “Stateless Income” and Fictional Allegiance

Stateless income<sup>83</sup> refers to the income of MNEs that, as a result of tax planning, is not taxable in either the “real” residence country or the source country. Instead of having an economic allegiance, the taxpayer has merely legal or fictional allegiance to a country. The “home state” of the income has no competence to tax in an economic sense. Such stateless income defies the theory of economic allegiance and deviates from the value-creation principle.<sup>84</sup>

Stateless income is not illegal, however. Taxpayers are entitled to take advantage of deficiencies in tax laws. These deficiencies may include outdated or inadequate rules and problematic interpretations, some of which are reviewed below.

### Residence Bias and Meaningless Corporate Residence

The current residence-source paradigm under the OECD model is biased in favour of residence by limiting the scope of source-based taxation. For example, article 7 permits the source state to tax business profits only if the profits are attributed to a PE in that state. Article 12 assigns exclusive taxing right to the residence state in

81 The term “rulified” was used in Susan C. Morse, “Value Creation: A Standard in Search of a Process” (2018) 72:4/5 *Bulletin for International Taxation* 196-202, at 196.

82 *Inland Revenue Commissioner v. Westminster (Duke)*, [1936] AC 1 (HL).

83 See the two papers in *supra* note 20.

84 The 1923 report, *supra* note 22, makes no reference to the phenomenon of “stateless” income. The Carroll report, *supra* note 41, contemplates that business profits will be allocated to the enterprise’s country of fiscal domicile on the basis of real centre of management; or will be allocated to the country of source on the basis of a PE.

respect of royalties. Article 22 assigns any “other income” (that is, income that is not covered by a specific article) to the residence state. Such a bias will not lead to stateless income if the residence state is where the income is earned. In the case of corporate residence, however, that is often not the case.

The definition of “corporate residence” is formalistic, permitting corporations to self-select their country of residence for tax purposes. Corporate residence is primarily a legal matter: it is determined on the basis of which country’s laws govern the constitution of the corporation or where the corporation’s central management and control reside under the governing law.<sup>85</sup> The legal concept of corporate residence has been criticized as “unsatisfactory,”<sup>86</sup> “incoherent,”<sup>87</sup> and “unworkable.”<sup>88</sup> It can be totally divorced from the economic origin of corporate income, and it represents a merely “legal” allegiance.<sup>89</sup>

### Inadequate Source Rules

The existing source rules and allocation rules are inadequate, contributing to the stateless income problem for two main reasons. First, they do not cover intangibles, which are key factors in value creation for MNEs.<sup>90</sup> For example, article 5 of the OECD model and section 253 of the Act do not define “source of business profit”;

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85 For more discussion of corporate residence, see Robert Couzin, *Corporate Residence and International Taxation* (Amsterdam: IBFD, 2002); David Elkins, “The Myth of Corporate Tax Residence” (2017) 9:1 *Columbia Journal of Tax Law* 5-43; Omri Marian, “Jurisdiction to Tax Corporations” (2013) 54:4 *Boston College Law Review* 1613-65; and Omri Marian, “The Function of Corporate Tax-Residence in Territorial Systems” (2014) 18:1 *Chapman Law Review* 157-83; Guglielmo Maisto et al., “Dual Residence of Companies Under Tax Treaties” (2018) 1:1 *International Tax Studies* 2-75.

86 Couzin, *supra* note 85, at 272.

87 Michael J. McIntyre, “Determining the Residence of Members of a Corporate Group” (2003) 51:4 *Canadian Tax Journal* 1567-73. According to McIntyre, at 1569, corporations simply cannot have a residence. For example, McIntyre noted that “[a]sking where a corporation ‘keeps house’ is like asking whether a corporation would be a carnivore if it happened to be an animal.” Similarly, “[a] corporation engages in business in much the same way that the owner of a baseball team plays baseball.” See *ibid.*, at 1569.

88 Elkins, *supra* note 85, at 31.

89 The 1923 report, *supra* note 22, discusses the taxing right over business enterprises by reference to the origin of income, and it emphasizes (at 31) the location of the head office as “the real brains of the management.” (See also the discussion, at 23, of “control and direction by directors”). It also discusses, at 31, the enforceability of economic rights. The league’s technical experts found it particularly difficult to reach a conclusion regarding the “fiscal domicile” of companies in the 1925 report, and they recommended that the fiscal domicile be the place where the head office or real centre of management is located. See Jogarajan, *supra* note 33, at 79 and 81.

90 As a source of value creation, intangibles were presumably not significant enough in 1923 to cause double taxation or to be considered in the 1923 report, but are a major creator of value in today’s knowledge economy. Intangible income can be directed by MNEs to countries with mere legal allegiance.

they merely describe manifestations of value creation in an agricultural and industrial economy (such as production or human sale activities). These rules recognize rival factors of production (such as capital, land, and labour) and observable business activities, including human activities conducted in person. They do not encompass intangible and non-rival factors (for example, know-how, corporate synergy, and trademark) or remote human activities.

Second, the existing allocation rules focus on internal or supply-side factors in value creation. They do not consider the activities of a corporation's customers or users in adding value for the corporation. This shortcoming is clear in the debates about taxing digital businesses.

### Legalistic Interpretation of the Arm's-Length Principle

The legalistic approach to interpreting the arm's-length principle provides opportunities for tax planning, which is a major cause of stateless income.<sup>91</sup> The BEPS transfer-pricing report states:

The arm's length principle has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation. However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group.<sup>92</sup>

The legalistic approach grants significant fiscal respect to corporate personality, and it emphasizes contractual allocation as a basis for constructing the controlled transactions to be tested and for conducting functional analysis. In effect, such an approach treats each member of an MNE family as an "orphan," an approach that defies the business reality and causes "family" profits to be allocated to the "orphan" in a tax-friendly jurisdiction. As Wilkie has said,

[T]he corporate form provides the means for unlimited fragmentation and rearrangement of integrated business activities and their ostensible economic outcomes, without entailing corresponding changes in how business is actually conducted; and it supplies the "place"—a sealed repository located in an accommodating political jurisdiction—in which the formal separation of the owner of income from the place where it is earned is perfected and validated.<sup>93</sup>

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91 See, for example, Langbein and Fuss, *supra* note 7; Kleinbard, "Stateless Income," *supra* note 20; "G20 Leaders' Declaration," *supra* note 1, at paragraph 50.

92 Organisation for Economic Co-operation and Development, *Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10—2015 Final Reports* (Paris: OECD, 2015), at 9 (<http://dx.doi.org/10.1787/9789264241244-en>) (herein referred to as "the BEPS transfer-pricing report.")

93 See Wilkie, *supra* note 21, at 356.

Contracts between legal personalities in an MNE group are also respected, and contractual prices may be challenged only if they deviate from arm's-length prices. Proving arm's-length price is difficult, especially in cases where it does not exist. By default, income is contractually allocated to serve tax-minimization purposes. For example, through the pricing of base-erosion payments or sales, profits derived in production or market countries can be directed "at will to tax-friendly repositories."<sup>94</sup>

The 2017 transfer-pricing guidelines<sup>95</sup> are the most authoritative source of the interpretation of article 9 of the OECD model and the underlying arm's-length principle. The OECD has gradually downplayed the role of intragroup contracts and increased the relevance of underlying reality and economic substance, but the fundamental legalistic approach has remained, as the following chronology shows:<sup>96</sup>

- The 1979 guidelines viewed intragroup contracts as decisive and held that "underlying reality" should be considered only if contractual agreements were altered arbitrarily or otherwise suspicious.<sup>97</sup>
- The 1995 guidelines recognized the existence of residual profit; added two profit-based methods (that is, the transactional net margin method and the profit-split method) to the three traditional methods (comparative uncontrolled price, resale price, and cost plus); and took value creation into consideration when the functional analysis was being performed or when the transfer-pricing method was being selected and applied. The 1995 guidelines also articulated the process of analyzing "functions, assets used, and risks assumed" in comparative analysis and downplayed the significance of the legal ownership of intangibles.<sup>98</sup>
- The 2010 guidelines added a section (chapter 9) on restructuring, in order to address the concern that MNEs were (1) restructuring operations to centralize the functions, assets, and risks in a single entity based in a tax-friendly country; and (2) converting what had been full-fledged distributorships into "limited function" distributorships, primarily for transfer-pricing purposes. With respect to the contractual assignment of risks and the consequential profit attribution, the 2010 guidelines state that any "contractual allocation of risk between associated enterprises" will be respected only to the extent

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94 Ibid.

95 The 2017 guidelines, *supra* note 78.

96 For a more detailed examination of the OECD transfer-pricing guidelines and the influence of the American arm's-length standard on such guidelines, see Collier and Andrus, *supra* note 41; and Langbein and Fuss, *supra* note 7.

97 The 1979 guidelines, *supra* note 79, at 20.

98 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), at paragraph 2.26 (herein referred to as "the 1995 guidelines").

that it has economic substance.<sup>99</sup> Contractual allocations have economic substance when evidence exists that similar allocation is used in comparable arm's-length contracts (that is, in open-market comparables). In the absence of such comparables, economic substance will be based on a hypothetical market analogy—that is, based on “whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances.”<sup>100</sup> However, the 2010 guidelines emphasize that non-recognition of the contractual allocation of risk or restructuring is appropriate only if the allocation or restructuring lacks economic rationality, and only in a narrow class of cases.<sup>101</sup>

- The 2017 guidelines increase the emphasis on economic substance and the allocation of residual profit. With respect to intangibles,<sup>102</sup> the guidelines recognize the value created by parties who, although they are not legal owners, perform DEMPE (development, enhancement, maintenance, protection, and exploitation of the intangibles) functions. Legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. Through ex-post returns, income from hard-to-value intangibles after the transfer can still be allocated to the transferor that developed the intangibles. Centralized entities created to hold intangibles or to supply funding are entitled to a risk-free return.
- In June 2018, the OECD released revised guidance on an expanded use of the transactional profit-split method.<sup>103</sup> The guidance reiterates the position that only profits arising from the controlled transaction<sup>104</sup> are split according to either a contribution-based split or residual split method (the latter is more common). The guidance also says the following: “Additionally, it should be remembered that the starting point in the accurate delineation of any transaction will generally be the written contracts which may reflect the intention of the parties at the time the contract was concluded.”<sup>105</sup>

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99 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2010), at paragraph 9.12 (herein referred to as “the 2010 guidelines”).

100 *Ibid.*, at paragraph 9.19.

101 *Ibid.*, at paragraph 9.171.

102 The 2017 guidelines, *supra* note 79, chapter VI.

103 Organisation for Economic Co-operation and Development, *Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10* (Paris: OECD, 2018) (herein referred to as “the 2018 revised guidance”). The transactional profit-split method is considered the most suitable where “Each party makes unique and valuable contributions; [t]he business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other; [t]he parties share the assumption of economically significant risks, or separately assume closely related risks.” See *ibid.*, executive summary.

104 Such profits can be actual profits or anticipated profits.

105 2018 revised guidance, *supra* note 103, at 2.161.

To summarize, the OECD's approach to interpreting the arm's-length principle (despite recent revisions to its guidance in this regard) remains focused on transactional pricing, leaving residual profit to be allocated to an intermediary through intragroup contracts. The OECD continually rejects the "global formulary apportionment"<sup>106</sup> of profits as not "acceptable in theory, implementation, or practice."<sup>107</sup> The complexities created by the 2018 revised guidance increase the difficulties for countries, especially developing countries, that lack the necessary resources to engage in highly technical analysis.<sup>108</sup> Accordingly, profits derived from productive activities or from the sale of goods and services end up being stateless.

### Unilateralism in International Taxation

The goal of taxing profits according to value creation or economic allegiance would be easier to achieve if there were only two countries in the world: a residence country and a source country. These two countries could follow the OECD model so that income was taxed in either the source country or the residence country, but not in both or neither. They could also follow the transfer-pricing guidelines and use the two-sided profit-split method to allocate residual profit.<sup>109</sup> Such a bilateralist framework, however, does not fit well within the real world of multiple countries and MNEs that operate through GVCs. In the absence of a multilateral tax convention, the right to tax international income is expressed through domestic tax laws. Even though the domestic tax laws of many countries adopt the basic residence-source paradigm and the arm's-length principle, the respective tax regimes of these countries differ significantly from one another in terms of policy emphasis and technical implementation.<sup>110</sup>

Unilateralism in international taxation leads to gaps and overlaps between national tax laws in the taxation of international income. Even when two countries have a tax treaty, the treaty provisions may be interpreted differently in each country or be used by taxpayers in third countries, and the result is stateless income.

106 The glossary in the 2017 transfer-pricing guidelines defines this term to mean "an approach to allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined formula." See *supra* note 78, at 26.

107 *Ibid.*, at 1.15.

108 *Ibid.*, at 6.39. See United Nations, "Practical Manual on Transfer Pricing for Developing Countries (2017)," September 11, 2017 ([www.un.org/development/desa/capacity-development/tools/tool/united-nations-practical-manual-on-transfer-pricing-for-developing-countries-2017](http://www.un.org/development/desa/capacity-development/tools/tool/united-nations-practical-manual-on-transfer-pricing-for-developing-countries-2017)).

109 See Michael Kobestky, "The Transfer-Pricing Profit-Split Method After BEPS: Back to the Future" (2019) 67:4 *Canadian Tax Journal* 1077-1105.

110 See part 4 in B.J. Arnold, Hugh Ault, and Graeme Cooper, eds. *Comparative Income Tax*, 4th ed. (forthcoming).

## RECENT U-TURN TOWARD VALUE CREATION

### Political Endorsement

Departures from the value-creation principle prompted the G20 to launch the BEPS project, which provided political endorsement of the principle. In the name of improving tax fairness and justice, G20 and OECD countries—and, subsequently, countries participating in the Inclusive Framework—seem to have reached some consensus on the implementation of the value-creation principle and on a road map for future reforms. Some participating countries, such as China,<sup>111</sup> have emphasized the importance of value creation as a guiding principle. As some commentators have observed, “It is now widely taken as axiomatic that the existing international corporate tax system is based on the [value-creation] principle,” and there also appears to be “widespread agreement, at least amongst policy makers, that the system should be based on this principle.”<sup>112</sup>

### Rising Multilateralism

There are signs of increasing multilateral cooperation in tax matters in respect of substantive tax laws and tax administration. For example, the BEPS project<sup>113</sup> introduced minimum standards<sup>114</sup> and a multilateral convention<sup>115</sup> in order to address

111 Jinyan Li, “China and BEPS: From Norm-Taker to Norm-Shaker” (2015) 69:6/7 *Bulletin for International Taxation* 55; Liao, *supra* note 11; Conrad Turley, David Chamberlain, and Mario Petriccione, *A New Dawn for the International Tax System: Evolution from Past to Future and What Role Will China Play?* (Amsterdam: IBFD, 2017).

112 Devereux and Vella, *supra* note 10, at 1; and Richard Vann, “Policy Forum: The Policy Underpinnings of the BEPS Project—Preserving the International Corporate Income Tax?” (2014) 62:2 *Canadian Tax Journal* 433-41, at 441.

113 For the first time in recent history, the political influence of the G20 and the technical power of the OECD were married, with a view to recommending changes to treaty rules and domestic rules. This approach contrasted with previous OECD reform efforts, which followed a bottom-up approach and were driven by technocrats who specialized in fiscal policy and taxation. The BEPS project may also signal the end of American constructive unilateralism in setting international tax standards. See Grinberg and Pauwelyn, *supra* note 10.

114 These are the action 5 minimum standard, concerning the nexus or substantial activities requirement; the action 6 minimum standard, which requires countries’ treaties to include (1) an express statement on non-taxation (generally in the preamble) and (2) one of three methods of addressing treaty shopping; the action 13 minimum standard, concerning country-by-country (CbC) reporting by MNEs; and the action 14 minimum standard, concerning the enhancement of the effectiveness of dispute resolution mechanisms.

115 Organisation for Economic Co-operation and Development, Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting, adopted on November 24, 2016, and signed by Canada at Paris, France, on June 7, 2017 ([www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.pdf](http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.pdf)). For discussions, see David G. Duff, “Tax Treaty Abuse and the Principal Purpose Test: Part 1,” *International Tax Planning* feature (2018) 66:3 *Canadian Tax Journal* 619-77; and “. . . Part 2,” *International Tax Planning* feature (2018) 66:4 *Canadian Tax Journal* 947-1011.

vulnerabilities in existing tax treaties. The minimum standards are touted as “global” because they are expected to be adopted by the (now 134) countries and jurisdictions that are joining the Inclusive Framework.<sup>116</sup> The minimum standards hold out the promise of minimizing stateless income. For example, the action 13 minimum standard on country-by-country (CbC) reporting requires an MNE to prepare a CbC report with aggregate data on the global allocation of income, profit, taxes paid, and economic activity among countries in which the MNE operates.<sup>117</sup> These CbC reports thus prepared are shared with tax administrations in various countries for use in high-level transfer-pricing assessments.<sup>118</sup>

With respect to cooperation in tax administration and information sharing, the Multilateral Convention<sup>119</sup> facilitates international cooperation for a “better operation of national tax laws, while respecting the fundamental rights of taxpayers.”<sup>120</sup> The Global Forum on Transparency and Exchange of Information for Tax Purposes, which now has 154 members, is the international body for ensuring the implementation of the standards of tax transparency and the exchange of tax information.<sup>121</sup> Another example of international cooperation is the Platform for Collaboration on Tax, launched in April 2016 by the International Monetary Fund, the OECD, the UN, and the World Bank Group to provide technical assistance to interested developing countries.

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116 See “What Is BEPS?” supra note 4.

117 The CbC reporting required by action 13 contains a master (global) file and a local (country) file. The master file must describe, among other things, the important drivers of business profit; the supply chain for the group’s five largest products or service offerings by turnover and main geographic markets for the group’s products and services; the principal contributions to value creation by individual entities within the group (that is, the key functions performed, the important risks assumed, and the important assets used); the MNE’s overall strategy for the development, ownership, and exploitation of intangibles, including the location of principal research and development (R & D) facilities and the location of R & D management; and the identification of any members of the MNE group that provide a central financing function for the group, including the country under whose laws the entity is organized and the place of effective management of such entities. The local (country) file must include, among other things, a detailed description of the business and business strategy pursued by the local entity.

118 Organisation for Economic Co-operation and Development, “Action 13 Country-by-Country Report” (<https://www.oecd.org/tax/beps/beps-actions/action13>).

119 Organisation for Economic Co-operation and Development, *The Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol* (Paris: OECD, 2011) (<https://dx.doi.org/10.1787/9789264115606-en>).

120 See *ibid.*, at 33.

121 Organisation for Economic Co-operation and Development, *Global Forum on Transparency and Exchange of Information for Tax Purposes* (Paris: OECD, 2019) ([www.oecd.org/tax/transparency](http://www.oecd.org/tax/transparency)). For further discussion, see Arthur J. Cockfield, “Sharing Information in the 21st Century: Big Data Flows and Taxpayers as Data Subjects” (2019) 67:4 *Canadian Tax Journal* 1179-99.



## Increasing Recognition of the Business Reality of MNEs

Economic substance or business reality has gained progressively more recognition in the various OECD transfer-pricing guidelines.<sup>122</sup> The Supreme Court of Canada viewed business reality as relevant to the application of the domestic transfer-pricing rule.<sup>123</sup> The BEPS action plan “foresaw the possibility of introducing special measures . . . beyond the arm’s length principle,”<sup>124</sup> and this set the stage for innovative ways of allocating the global profits of MNEs. The BEPS project has authorized an expanded use of the profit-split method, especially in regard to allocating income that arises from the “synergistic benefits of operating as a group” and from “integrated global value chains.”<sup>125</sup> The BEPS project took a more global view of MNEs. For example, the earnings before interest, taxes, depreciation, and amortization (EBITDA) or earnings before interest and taxes (EBIT) rule in action 4 (limitation on interest deductions) takes into account the worldwide MNE group’s interest-to-EBITDA ratio.

Some G20 countries, such as China, take a more holistic, global, and substance-over-form approach to applying the arm’s-length principle.<sup>126</sup> The proposed common consolidated corporate tax base (CCCTB) in the European Union (EU)<sup>127</sup> is a proposal to allocate group profit by a method that is more aligned with business reality than is the transactional pricing approach. There is a growing body of literature on the allocation of MNEs’ global profits according to formulary apportionment methods.<sup>128</sup> The direction of the pillar 1 allocation methods proposed by the Inclusive Framework is consistent with this growing trend.

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122 See above, under the heading “Legalistic Interpretation of the Arm’s-Length Principle.”

123 *GlaxoSmithKline Inc. v. Canada*, 2012 3 SCC 52, at paragraph 53.

124 This is reiterated in the Tax Annex to the “G20 Leaders’ Declaration,” supra note 1; and BEPS transfer pricing report, supra note 92, at 9.

125 BEPS transfer-pricing report, supra note 92, at 11, 55, and 60.

126 Jinyan Li, *International Taxation in China: A Contextualized Analysis* (Amsterdam: IBFD, 2016).

127 See European Commission, “Common Consolidated Corporate Tax Base (CCCTB)” ([https://ec.europa.eu/taxation\\_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en)). Under the CCCTB, the profit of all entities of a corporate group above a specified threshold (€750 million) turnover would be computed under harmonized rules, and the consolidated profits (and losses) would be apportioned to each country involved according to a formula composed of fixed assets, payroll/workforce, and sales. The EU also proposed that the CCCTB would apply to the taxation of digital companies that have a “digital presence” in an EU member country. See European Commission, “Fair Taxation of the Digital Economy” ([https://ec.europa.eu/taxation\\_customs/business/company-tax/fair-taxation-digital-economy\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en)).

128 For a review of the main proposals, see the International Monetary Fund, *Corporate Taxation in the Global Economy*, Policy Paper no. 19-007 (Washington, DC: IMF, March 2019).

## ROAD MAP FOR THE FUTURE

### Value Creation as the Basis for Developing Global Consensus

The Inclusive Framework emphasizes the importance of developing a consensus-based solution to the allocation of profits that is “underpinned by sound economic principles and conceptual basis.”<sup>129</sup> In the absence of any explicit reference to other principles or theories, value creation or economic allegiance presumably continues to be the guiding principle for building consensus.

Value creation has been viewed by some as “a deceptively misleading claim” that “camouflages as neutral and apolitical the highly political and distributive nature of the international tax system,”<sup>130</sup> and it has been criticized for being vague or subjective.<sup>131</sup> In our view, these criticisms may actually point toward the strengths of the value-creation principle as the basis for developing global consensus, the achievement of which is, by its nature, politically difficult and technically complex. The Inclusive Framework members’ unprecedented achievement of consensus on the road map speaks to this point. As a conceptual basis for reform, the value-creation principle cannot be expected to provide “the practical guidance needed to answer all questions.”<sup>132</sup> New technical rules are needed. That is why the pillar 1 proposals are welcome first steps.

### Pillar 1 Proposals To Allocate New Taxing Rights to Market Jurisdictions

The pillar 1 proposals allocate “new taxing rights”—taxing rights on income generated from cross-border activities in the digital age.<sup>133</sup> Given the existence of a nexus based on user participation, marketing intangibles, or significant economic presence, new taxing rights would be allocated to the market jurisdictions according to three rules:

1. The modified residual profit-split (MRPS) method would allocate residual or non-routine profit to the market jurisdiction, using an allocation key, such as revenues. Routine profits would be allocated according to existing transfer-pricing rules.
2. The fractional apportionment method (FAM) would allocate a fraction of an MNE’s overall profit (or business line) to the market jurisdictions by using a formula based on factors such as employees, assets, sales, and users.

129 *Programme of Work*, supra note 15, at paragraph 13.

130 Allison Christians, “Taxing According to Value Creation” (2018) 90:13 *Tax Notes International* 1379-83, abstract ([https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3230370](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3230370)).

131 Grinberg, supra note 10, at 95, mentioning that “any exercise to define specific sources of value creation is entirely subjective.” Hey, supra note 18, at 203, refers to “[t]he unclear concept of value creation as an allocation factor.”

132 See supra note 128, at 18.

133 *Programme of Work*, supra note 15, at paragraph 30.

3. Distribution-based approaches (DBA) would specify a baseline profit (routine as well as non-routine profit) in the market jurisdiction for marketing, distribution, and user-related activities, and such baseline profit could function as a minimum or maximum return.

All three proposals recognize that physical presence in the market jurisdiction is not the only factor in value creation. Value creation can be manifested by indicators of an MNE's remote but sustained and significant involvement in the economy of a market jurisdiction, including indicators such as making their goods and services available to customers and users in a particular market and commercially exploiting the data created by such customers and users. The Unified Approach proposed by the OECD in October 2019 adopts a new nexus based on sales to customers and users in a jurisdiction. In terms of the allocation of profit, all three proposals are less legalistic than the alternatives, and all focus on total profitability (or business line or regional business) as opposed to price or profit from controlled transactions. The MRPS approach separates routine and non-routine profit in order to recognize value created by intangibles. It was presumed that the existing transfer-pricing rules would continue to apply to profit that does not generate "new taxing rights." The FAM ostensibly departs from the longstanding OECD position on global formulary apportionment. The DBA was intended to satisfy the "strong demand for simplicity and administrability."<sup>134</sup> The Unified Approach proposed by the OECD in October 2019 adopts a formulary apportionment method for allocating to market jurisdictions a multinational corporation's group profit derived from consumer-facing businesses. This new method is meant to "complement" the existing transfer-pricing rules and applies only to residual profit attributable to marketing intangibles. The sole allocation key is sales.

The OECD proposal to assign new taxing rights to market jurisdictions is aligned with the value-creation principle. The sales-based formulary apportionment method represents a major shift in the OECD's thinking about transfer pricing. However, because of the ring fencing of the new approach to consumer-facing businesses and the adoption of a single factor in the formula, this method falls short when it comes to recognizing value created by other factors. In the section below, we propose a general GPS rule that would be consistent with value creation.

### **Proposal: A General Global Profit-Split Rule**

The GPS rule that we propose would build on the pillar 1 proposals.<sup>135</sup> It would extend the MRPS method to all, allocating group residual profit to all members of

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134 Ibid., at paragraph 32.

135 It is beyond the scope of this paper to elaborate on the details of the GPS rule that we propose. For discussion of the details involved in designing formulary apportionment, see Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split" (2009) 9:5 *Florida Tax Review* 497-553; Devereux and Vella, *supra* note 10; and Grinberg, *supra* note 10.

the group according to a multi-factor formula (factors such as employees, assets, and sales) that is similar to the formula contemplated by the FAM. To determine the amount of routine profit for allocation, a baseline profit rate could be used to achieve simplicity.

The main strength of the GPS rule is that it allocates profit to all links of the GVCs and all factors that create or contribute to value and profit. A multi-factor apportionment rule is better aligned with value creation and more faithful to the doctrine of economic allegiance. The economists' 1923 report suggested that the production of income involves multiple stages.<sup>136</sup> The modern businesses of MNEs are globally integrated, and each link of the GVCs contributes to the overall profit.<sup>137</sup> Human capital development fuels the growth of GVCs.<sup>138</sup> Therefore, the value-creation principle requires that global profit be allocated to countries where production, marketing, and DEMPE take place.<sup>139</sup> Allocation of residual profit on the basis of a single factor or on the basis of the market jurisdiction alone does not reflect either business realities or the value-creation principle.<sup>140</sup>

## CONCLUSION

In this paper, we have demonstrated that the concept of taxing profits according to value creation is a new expression of an old idea—namely, the idea of economic allegiance. Economic allegiance provided the theoretical framework for the existing international tax system, including the arm's-length principle, and the value-creation principle has been a constant for the past century. Recent reforms, through the BEPS project and the Inclusive Framework, have brought the value-creation principle to the forefront of the debate over deviations from the principle that are caused by inadequate rules, legalistic interpretation of the arm's-length principle, and the artful manipulation of existing rules by MNEs. We view the pillar 1 proposals as a movement in the right direction, but we consider that they fall short when it comes to allocating profit according to the value-creation principle. We propose a

136 The 1923 report, *supra* note 22, at 23.

137 See Wolfram F. Richter, *Aligning Profit Taxation with Value Creation*, CESifo Working Paper no. 7589 (Munich: Munich Society for the Promotion of Economic Research, April 2019) ([www.ifo.de/DocDL/cesifo1\\_wp7589.pdf](http://www.ifo.de/DocDL/cesifo1_wp7589.pdf)).

138 Romero J.S. Tavares and Jeffrey Owens, "Human Capital in Value Creation and Post-BEPS Tax Policy: An Outlook" (2015) 69:10 *Bulletin for International Taxation* 590-601.

139 World Intellectual Property Organization, *World Intellectual Property Report 2017: Intangible Capital in Global Value Chains* (Geneva: WIPO, 2017) ([www.wipo.int/edocs/pubdocs/en/wipo\\_pub\\_944\\_2017.pdf](http://www.wipo.int/edocs/pubdocs/en/wipo_pub_944_2017.pdf)), reporting that intangibles accounted for over 30 percent of the value of manufactured goods sold throughout the 2000-2014 period.

140 Allocating residual profit to market jurisdictions is difficult to justify under the logic of the current system of source taxation, and doing so would not be supported by production countries or DEMPE countries. See Johannes Becker, Joachim Englisch, and Deborah Schanz, "Re-Allocation of Taxing Rights for Big Data Business Models," August 7, 2019 (<https://ssrn.com/abstract=3433715>).

method that extends these proposals and allocates both new and existing taxing rights to countries in which value is created.

To develop new allocation rules that affect countries' economic interests and MNEs' interest in maximizing their after-tax profits is a complex undertaking. Given the importance of a consensus-based approach, more research is needed to support the technical design of such rules.