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OECD interim digital tax report debates new value creation concepts

The OECD's interim report on taxation of the digital economy examines the implications new nexus and profit allocation concepts could have on the international tax system. A re-evaluation of where value creation takes place will heavily impact big tech companies that use transfer pricing to shift profits to low-tax jurisdictions.

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This week's OECD's report, 'Tax Challenges Arising from Digitalisation – Interim Report 2018', showed that there is no clear consensus on how international tax rules should be amended to provide for the drastic changes digitalisation has introduced to the world economy.

The report identified the constraints of short-term measures and did not recommend any stop-gap measures due to the lack of international consensus. Ultimately, it outlines the various challenges of the undertaking and gathers a pledge by the 113 jurisdictions that make up the Inclusive Framework on BEPS to tackle long-term solutions.

Pascal Saint-Amans, director of the Centre for Tax Policy and Administration at the OECD, said in a webcast on March 16, that the document will "pave the way towards long-term solutions to be adopted quite fast if countries are willing to work together despite tensions".

A final report, which will propose a consensus-based long-term solution, is expected to follow in 2020.

According to the interim report, some countries maintain that user-generated value is an important driver of value creation in digitalised businesses and a solution needs to reflect this. However, sources have expressed concerns to *TP Week* that basing a solution on user-generated value could lead to more tax avoidance and disputes.

The three key factors that are prevalent in highly digitalised businesses are cross-jurisdictional scale without mass, meaning highly digitalised businesses are often highly involved in the economic life of a without mass, meaning highly digitalised businesses are often highly involved in the economic life of a jurisdiction without any significant physical presence there; a heavy reliance on intangible assets, including intellectual property (IP); and data, user participation and their synergies with IP.

However, countries do not agree on whether these activities should be taxed, and most importantly where they should be taxed.

User participation

While businesses analysing internal data from sales, inventories and production to optimise processes and decisions is nothing new, what has changed with digitalisation is that users play an increasingly significant role as their data is analysed by businesses to gain insights about markets and demand trends, the report stated. Countries disagree on whether customer data and user-generated content contribute to value creation and how this should be allocated to jurisdictions for taxation purposes.

David Bradbury, head of the Tax Policy and Statistics Division at the OECD's Centre for Tax Policy and Administration, told *TP Week* there are two schools of thought on user participation, where one of those says that user participation is a unique feature of highly digitalised businesses, and that it is a source of value creation for some firms, and the other view presented in the report is that user participation is not value creation and is probably no different to the sourcing of any other input from a third party. "In many of the cases considered in the context of digitalisation, the transaction is one that occurs without any financial consideration being provided in return of the input of that user contribution," Bradbury said.

"User-generated value is an area where further work needs to be undertaken. Clearly attempting to do this presupposes that there is some form of value creation arising from user participation, and that is a view held by a number of countries. But how you would go about doing that is a much more complicated question, and this will form the basis of future work and considerations of the task force. Clearly there will be a whole range of practical considerations that will need to be overcome before it can be achieved. That will certainly be one part of our deliberations in the next phase of our work," Bradbury said.

The current rules are based on risks managed, functions performed and assets employed, said Chia Seng Chye, partner at EY in Singapore, and these may not adequately address the issue of value creation associated with the digital or electronic aspects of a business. "A key part of where the value could be created for a business is where users are located and where data is collected and processed," Chia said.

"The real challenge is in the implementation and in particular, getting countries to agree on a consistent and consensual taxation framework for the digital economy, and this in itself, may be a protracted process," he said.

Lack of consensus

The report outlines many ways in which collection of user data could be used to create value, for example by selling targeted advertising, allowing digital businesses to harvest data through monitoring behaviour, and the contribution of content by users which helps to attract more users.

Tommaso Faccio, head of secretariat the Independent Commission for the Reform of International Corporate Taxation, said it remained unclear how to determine where the value creation takes place in the digital economy, creating room for future disputes.

“For some businesses user data is monetised, e.g. Google, for others it is not clear whether this is the case, e.g. Uber,” Faccio said. “Determining where value is created is very artificial and subjective, and therefore a recipe for tax avoidance and optimisation. Even people within the business often struggle to identify where value is created, so using user participation or even value creation as determinants of how profits are allocated is likely to increase complexity and disputes.”

Faccio said clear, objective metrics should be the basis to allocate the profits of MNEs, such as sales, tangible assets and number of people employed.

There is no consensus on these issues, the report found, and added that “differences in views over whether and the extent to which data and user participation contribute to value creation will have an impact on whether there are considered to be tax challenges arising from changing business models, or whether those are unique to the application of international tax rules to digitalised firms, or whether any challenges apply to the international tax rules more broadly”.

Heather Self, partner at Blick Rothenberg, questioned whether user-generated value really exists. “It could be said that the user merely drives profit for the advertiser who buys space on the platform, and who is already being taxed,” Self told TP Week.

The UK is one of the advocates for a solution that reflects the value of user participation, as it believes the participation and engagement of users are important aspects of value creation for certain digital business models. In an **updated position paper** on corporate tax and the digital economy in the UK released with the Spring Statement on March 13, the HM Treasury stated that user participation “contributes to the service-offering, supports the strength of the brand and builds a user network that underpins the success of many businesses in the digital sector”.

Ken Almand, partner at Moore Stephens, said a number of issues arise when seeking to tax foreign businesses based on such user-generated value.

“It can be argued that what the UK is exploring is the attribution of profits not to the local activities of the business itself but to its users. The UK is seeking to justify this on the basis that such users are taking on a number of the supply-side activities that historically would have been undertaken by the business itself,” Almand said.

"Nonetheless, this is fundamentally different to the usual approach of attributing value based upon the functions, risks and assets of the group companies and their employees. It is one thing to recognise that user participation generates value, but attributing an arm's-length taxable profit to it is quite another. This approach may be viable, but requires consensus from multiple countries, as it would mean fundamental changes to transfer pricing and permanent establishment principles," he explained.

Dan Neidle, partner at Clifford Chance, appeared to disagree with the position paper view as he said it was not clear how someone viewing a video on YouTube is fundamentally different, in terms of value creation, from someone watching TV.

"Or take Airbnb. Are the users really creating value in a qualitatively different way from hoteliers and tourists using a conventional travel agent?" Neidle asked.

User participation is also likely to feature in the EU's digital tax proposal, which is expected to be released on March 21. Leaked drafts of the report have indicated that the EU is planning to propose an interim measure in the form of a 3% tax on EU revenue for certain companies above a €750 million threshold ($ 922 million).

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