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MOBILE INTELLECTUAL PROPERTY AND THE SHIFT IN INTERNATIONAL TAX POLICY FROM DETERMINING THE SOURCE OF INCOME TO TAXING LOCATION-SPECIFIC RENTS: PART ONE

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In recent decades, a number of fantastically successful, mainly American, MNEs—led and epitomised by the "Four Horsemen", Apple, Amazon, Facebook and Google, but also extending beyond the tech sector—have earned huge profits, while paying very low global taxes, through their use of IP. Since intellectual property, in contrast to tangible property, generally lacks a clear location, it empowers corporate tax avoidance at the expense of both the production countries where the MNEs' high-value owner-employees live, and the market countries where their customers live.

This two-part article assesses the challenges posed for countries' international tax systems by the rise of mobile intellectual property, including but not limited to the case where it is embodied in a digital platform. Part One in this issue assesses the challenges posed for the traditional income tax concept of source, and for the OECD's proposed focus on the site of "value creation". Part Two in the next issue will focus on proposals to shift taxing rights towards market jurisdictions that may enjoy location-specific rents with regard to the MNEs' access to their consumers, including via the use of DSTs.

I. INTRODUCTION

In recent decades, a number of fantastically successful, mainly American, multinational entities ("MNEs")—led and epitomised by the "Four Horsemen", Apple, Amazon, Facebook and Google[1] (also known as "FAANG" or "GAFAM" if one changes the names a bit)[2]—have risen to global economic hyper-prominence. While their market capitalisations and profits are high, reflecting that they earn substantial

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1 See *eg*, Scott Galloway, *The Four: The Hidden DNA of Apple, Amazon, Facebook and Google* (New York: Portfolio, Penguin, 2017).

2 "FAANG" or "FANG" consists of the Four Horsemen plus Netflix, while GAFAM subtracts Apple and adds Microsoft and Alphabet. See *eg*, Kinsey Grant, "FANG Stocks Are Getting Their Own Index" *The Street* (26 September 2017), online: The Street <https://www.thestreet.com/investing/stocks/fang-stocks-index-14320244>.

rents or quasi-rents,[3] their aggregate global taxes are generally quite low, reflecting their ability to create stateless income.[4]

Often, these MNEs are technology companies, like the Four Horsemen—but not always. Starbucks, for example, enjoys high global profits and low taxes despite following a "classic brick-and-mortar retail business model".[5] This reflects that, like its more obviously high-tech peers, it relies on valuable intellectual property ("IP"), pertaining here in particular to its "trademark and expertise and synergies in its worldwide operations".[6] Such assets are invaluable with respect to creating both global pretax profitability and stateless income.

While leading MNEs' success in either of these two realms might have sufficed to draw them widespread and not wholly favourable attention, the combination was bound to yield calls for pushback. Purely as a matter of instrumental rationality, national "[g]overnments have an interest in capturing. . . rents for their citizens or national treasuries".[7] This motivation may hold even if the high profits that look like rents ex post are merely normal returns as considered under uncertainty ex ante, and even if any given country's taxing them would thereby discourage new innovation that would have yielded global benefits.

However, the rise of globally untaxed MNE high profits does more than merely whet countries' rational (whether or not shortsighted) appetite for a highly caloric and nutritious meal. It also has strong symbolic valence, especially coming after the 2008 financial crisis, subsequent fiscal austerity, other controversies surrounding some of these firms,[8] and the rise of high-end inequality. The specter of hugely profitable, mainly United States ("US") MNEs, being lightly taxed on a global basis cannot reasonably be expected to yield a stable global political equilibrium. Indeed, from the standpoint of, say, European Union ("EU") countries that are struggling to tax US MNEs on profits derived from interacting with their residents, the observation that these companies also are not paying much tax to the US seems to add to the insult, whether or not it actually adds to the injury.[9]

Pushback by tax authorities has focused more directly on stateless income than on unusually high profits that might be rents—reflecting not just the "insult", but also such authorities' subject matter jurisdiction and expertise. Leading efforts and proposals to date to increase the taxation of MNE profits can conveniently be divided into three main categories—all founded on the shared recognition that residence-based corporate income taxation has long under-performed, and may reasonably be expected to continue doing so.

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[3] Joseph Bankman *et al*, "Collecting the Rent: The Global Battle to Capture MNE Profits" Tax L Rev [forthcoming in 2020].

[4] See *eg*, Edward D Kleinbard, "The Lessons of Stateless Income" (2011) 65 Tax L Rev 99.

[5] Edward D Kleinbard, "Through a Latte, Darkly: Starbucks's Stateless Income Planning" (2013) Tax Notes 1515.

[6] Bankman *et al*, *supra* note 3 at 17.

[7] *Ibid* at 2.

[8] *Eg*, John D McKinnon, "States to Launch Google, Facebook Antitrust Probes" *Wall Street Journal* (6 September 2019), online: Wall Street Journal <https://www.wsj.com/articles/states-to-launch-google-facebook-antitrust-probes-11567762204> (quoting New York Attorney General Letitia James discussing their investigation into Facebook).

[9] EU countries would not directly benefit from an increase in the taxes that US MNEs pay to the US Treasury, given that the tax revenues would presumably be used to benefit Americans, not Europeans.

First, the Organisation for Economic Co-operation and Development ("OECD"), both in its 2013-2016 Base Erosion and Profit-Shifting ("BEPS") project[10] and subsequently,[11] has aimed to organise coordinated global action towards requiring that MNEs report their profits where "value creation" occurred.[12] This term, as we will see, may refer either to production countries where IP is created and maintained, and/or to the market countries where consumers or users are located, or to some unspecified combination of the two. Its crucial departure from prior practice is leaving out tax havens in which MNEs' activity and presence might be of a merely formal character.

Second, a number of leading tax policy experts have advocated assigning the right to tax all, at least non-routine, MNE profits to market countries. This is based on claims about good policy, not semantic parsing of the term "value creation".[13] As it happens, the OECD has recently moved somewhat in this direction,[14] but—reflecting its multiple constituencies—such movement has been too partial and hedged to eliminate the two approaches' distinguishability.

Third, a number of market countries have adopted, or are considering, novel tax instruments, such as digital services taxes ("DSTs") and diverted profits taxes ("DPTs") that aim to raise revenue from large MNEs with particular business models. These, in turn, may prove to be either transitional or permanent, minor or major, as they overlap to a degree with the push towards expanding market country taxing authority.

DSTs to date[15] have generally been gross receipts taxes, targeting large companies (such as Facebook and Google) that (1) use digital platforms, (2) have two-sided business models, such as by reason of their offering advertisers targeted, data-rich

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[10] See *eg*, OECD, Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy,* Action 1 – 2015 Final Report (2015), online: OECD <https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1580315593&id=id=&=accname=ocid177380&checksum=1FB25BE28696CBA10085C25F94A36A95> [*BEPS Action 1*].

[11] See *eg*, OECD, Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy*, Public Consultation Document (2019), online: OECD <https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf> [*OECD BEPS Public Consultation on Digitalization*].

[12] See *eg*, Stanley I Langbein & 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 Intl Lawyer 259.

[13] See *eg*, Reuven S Avi-Yonah *et al*, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split" (2009) 9:5 Fla Tax Rev 497 at 498 (proposing a formulary apportionment of multinational corporation ("MNC") taxing rates based on the distribution of worldwide income sources); Michael P Devereux *et al*, *Residual Profit Allocation by Income*, Oxford International Tax Group Working Paper No 19/01 (March 2019).

[14] See OECD, *Secretariat Proposal for a "Unified Approach" under Pillar One*, Public Consultation Document (2019), online: OECD <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> [*OECD, Pillar One*]; OECD, *Global Anti-Base Erosion Proposal ("GloBE") – Pillar Two*, Public Consultation Document (2019), online: OECD <https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf> [*OECD, Pillar Two*]. Each document mentions value creation only once. *OECD, Pillar One* at 7; *OECD, Pillar Two* at 28.

[15] In Section IV.B, *infra*, I discuss in particular the recently announced United Kingdom ("UK") DST, which is scheduled for enactment in the Finance Bill 2019-20 (subject, presumably, to the broader short-term uncertainties in UK politics).

access to users/consumers, and (3) feature relatively active user participation (*eg*, posting on Facebook, rather than merely viewing content on Hulu).[16] I will argue, however, that the third of these factors lacks policy relevance, while the first two are only indirectly relevant, in particular to the choice of tax instrument. This suggests the possibility that the rationale for seeking to tax rents, via instruments that are tailored to particular industries, may potentially extend more broadly—both within the digital sector and beyond it.

One of this paper's main arguments is that DSTs, despite their mainly bad press,[17] have promise, not just in themselves, but as a model for broader rethinking of international tax policy. They clearly raise dangers of chaotic collective over-taxation, but it is not clear that these dangers outweigh those of sub-optimally low global taxation of MNE profits. So countries that rationally pursue their fiscal self-interest with regard to taxing rents—possibly in the face of strategic and political economy pressures not to do so—should not be viewed as harmful outlaws or norm-breakers.

More broadly, this paper's main conclusions include the following:

1) The OECD-led push for placing greater emphasis on "value creation"— As many have recognised, value creation is an ambiguous term,[18] in particular as between production countries (including those where valuable IP was developed), and market or consumption countries from which the MNEs derive gross revenues. To illustrate this key distinction in an extremely simple fact setting, suppose that I never leave New York City, but write novels in Tagalog that I sell directly to people in the Philippines (and no place else). Here the United States is the production country, and the Philippines is the market country. Both countries can reasonably claim tax nexus—whereas, say, Brazil and Germany cannot—if source requires only an adequate degree of connection between the taxing country and the taxed activity.[19] But if countries are only taxing domestic source *income*, then only the United States has a proper claim under what I call a production-based view of the source of income, and only the Philippines has a proper claim under what I call a market-based view.[20]

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[16] See Section IV, *infra*, for further discussion of what these criteria mean. Netflix might be viewed as somewhere in between Facebook and Hulu, given that customers post reviews on the site.

[17] See Wei Cui & Nigar Hashimzade, *The Digital Services Tax as a Tax on Location-Specific Rent* 2, CESifo Working Paper Series No 7737 (2019). Cui's work is a key exception that deserves broad attention.

[18] Critics of the value creation standard who note its ambiguity include, for example. Allison Christians, "Taxing According to Value Creation" (2019) 22 Fla Tax Rev 1; Michael P Devereux & John Vella, *Value Creation as the Fundamental Principle of the International Corporate Tax System*, European Tax Policy Forum Policy Paper (31 July 2018); Mindy Herzfeld, "The Case Against BEPS: Lessons for Tax Coordination" (2017) 21 Fla Tax Rev 1; Susan Morse, "Value Creation: A Standard in Search of a Process" (2018) 72 Bulletin for International Taxation No 4/5; Wolfgang Schön, *One Answer to Why and How to Tax the Digitalized Economy, Working Paper of the Max Planck Institute for Tax Law and Public Finance No 2019-10 (25 June 2019).*

[19] See *eg*, Restatement (Second) of the Foreign Relations Law of the United States §402(1) (2018) American Law Institute, Restatement of the Law (asserting US jurisdiction, *inter alia*, to: (a) persons, property and conduct in the US, (b) conduct that has a substantial effect in the US, and (c) US citizens and residents when outside its territory).

[20] I am abstracting here from such operative concepts in existing international income tax law as the requirement of a permanent establishment.

In effect, the OECD's aim in this scenario is to ensure that only the United States or the Philippines could tax the income from my book sales, without necessarily specifying which one should get to do so. Much of its discussion of value creation has a production-based flavour[21]—along, perhaps, with an implication that the location of productive "brains" may matter more than that of mere "hands".[22] However, OECD publications have also stated, for example, that "value creation in the *user/market jurisdiction*... is not [properly] recognised in the current framework for allocating taxing rights and taxable profits".[23] So the OECD has hinted from the start that it would take an at least partly market-based view of value creation, as was made more concrete (while remaining indefinite in magnitude) by its recent Pillar One proposal.

Such ambiguity may aid in the creation of short-term consensus with respect to addressing stateless income.[24] As an organising approach (or at least a battle cry), value creation has the distinct, if limited, advantage of providing a "negative source rule".[25] Thus, with respect to taxpayers, it can be invoked to rebut claims that profits arose in tax havens,[26] impeding the creation of stateless income. With respect to governments, it might help to prevent the rise of what I call "Monty Python taxation", exemplified by the bowler-hatted man who, in an episode of the famous British TV show, states: "To boost the British economy I'd tax all foreigners living abroad."[27]

Monty Python taxation—or that lacking a requisite connection to the taxing jurisdiction, and thus making possible a global free-for-all—has not to date been a significant international tax policy problem. It might conceivably become more so in the future, as countries respond unilaterally to stateless income and/or the tax-elusiveness of MNE rents and quasi-rents. However, the notion of taxing only one's own location-specific rents ("LSRs") offers a potential (if imperfect) coordinating device that is distinct from value creation—despite some conceptual overlap, as both involve a choice between the producer and market jurisdictions. Moreover, we do not yet know whether global over-taxation or under-taxation of such items is likely to prove the more serious problem.

Despite value creation's possible short-term advantages, it bodes ill over a longer timeframe for resolving hard and contentious tax base choices. It revivifies, without making resolvable, longstanding disputes regarding what the geographical "source of income" means[28]—in particular, as between the production and market countries for particular MNE profits. In addition, the semantic debates that it encourages are

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21 See *eg*, Morse, *supra* note 18 at 2.

22 See Schön, *supra* note 18 at 7; Christians, *supra* note 18 at 1381.

23 *OECD, Pillar One*, *supra* note 14 at 9 [emphasis added].

24 See *eg*, Christians, *supra* note 18 at 1383; Schön, *supra* note 18 at 6.

25 Adolfo Martín Jiménez, "BEPS, the Digital(ized) Economy and the Taxation of Services and Royalties" (2018) 46:8 Intertax 620 at 621.

26 See Schön, *supra* note 18 at 6.

27 Daniel Shaviro, "Taxing Potential Community Members' Foreign Source Income" (2016) 70 Tax L Rev 75 at 94.

28 See *eg*, Hugh J Ault & David F Bradford, "Taxing International Income: An Analysis of the US System and Its Economic Premises" in Assaf Razin & Joel Slemrod, eds, *Taxation in the Global Economy* (Chicago: The University of Chicago Press, 1990) 11; Mitchell A Kane, "A Defense of Source Rules in International Taxation" (2015) 32 Yale J Reg 311.

ill-suited for focusing attention on issues of genuine normative interest, such as that of deciding and coordinating where and how to tax rents. One therefore may be encouraged by evidence suggesting that the OECD may now be moving past it as a core motivating principle—albeit that this still leaves open the question of proper balance between production-based and market-based approaches.

2) Assigning MNE tax base to market countries—As noted above, a number of leading tax policy experts have advocated assigning the right to tax MNE profits to market countries, rather than to production countries. This would be the result, for example, of adopting either sales-based formulary apportionment ("SBFA") for the profits of global MNE groups,[29] or a similar (although somewhat more complicated) approach called residual profit allocation by income ("RPAI").[30] Sales to consumers would also govern the allocation of tax base if value-added taxes ("VATs") replaced origin-based corporate income taxes, as would happen under the so-called destination-based cash flow tax ("DBCFT").[31] All of these proposals aim to increase efficiency and reduce the efficacy of MNE tax planning, rather than to favour market countries as an end in itself, but their distributional effects as between differently situated countries are unlikely to escape notice by interested policymakers.

We will see that, while such proposals have significant advantages, their efficacy might anomalously vary with the particular business model of an MNE or industry. Starbucks, for example, ineluctably has consumer sales in high-tax countries, both because it offers coffee rather than free access to a digital platform (like Facebook or Google), and because it happens to prefer operating its own stores to licensing third party franchisees. Accordingly, under SBFA or RPAI, Starbucks might face higher taxes in consumer jurisdictions than either digital companies or (in the income tax versions) a hypothetical peer company—perhaps McDonald's?[32]—that might be viewed as similar except for making greater use of franchisees and third party intermediaries.[33]

While this problem would not arise under VATs/DBCFTs,[34] those taxes may also apply unequally across business models. For example, Facebook and Google do not charge users for access to their digital platforms. This reflects that, under their two-sided business model, they can price below marginal cost on one side and make up the difference on the other side.[35] Accordingly, the revenues that Facebook and Google derive by reason of offering their digital platforms within a given jurisdiction may

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29 See *eg*, Avi-Yonah *et al*, *supra* note 13.

30 See Devereux *et al*, *supra* note 13.

31 See Daniel Shaviro, "Goodbye to All That?: A Requiem for the Destination-Based Cash Flow Tax" (2018) 72 Bulletin for International Taxation No 4/5.

32 Like other leading US MNEs, McDonald's has attracted hostile attention for using common tax planning devices, such as a Luxembourg subsidiary that siphons off EU profits under the guise of licensing intellectual property. See *eg*, Nicholas Allen & Mary Joyce Carlson, "Focus: Why McDonald's Tax Practices Matter to the Global Labour Movement" (2018) 25:1 Tax Justice 8.

33 See Devereux *et al*, *supra* note 13 at 65-69 (describing the problem, and noting that it would not arise if third party sales could be traced through to the ultimate consumers).

34 Under a DBCFT or VAT, source country tax liability depends purely on the price to the consumer (minus domestically incurred business outlays), without regard to the MNE's worldwide profits or the amount paid to import the consumer good. See Section IV.A.2, *infra*.

35 See *eg*, Wei Cui, "The Digital Services Tax: A Conceptual Defense" Tax L Rev [forthcoming in 2020].

escape a conventionally structured VAT/DBCFT.[36] But even when this is not an issue, a standard VAT/DBCFT impedes taxing the LSRs earned by foreign MNEs at a higher tax rate than that which it applies to domestic consumption generally—potentially an important and undesirable constraint.[37]

In sum, while sales-based proposals have clear virtues, they are limited in their capacity both to achieve comparable effectiveness across MNE business models and to reach MNE profits to the extent that the governments in market countries might prefer. Meanwhile, general adoption of this approach would require production countries, along with MNE residence countries, to accede potential tax base to sales jurisdictions right off the bat, possibly contrary to their preferences and interests. Thus, even if one prefers one or more of the sales-based approaches to alternatives more rooted in longstanding international tax practice, one might still want to consider supplementing them with additional tax or other instruments that are aimed at particular, otherwise insufficiently reachable, MNE rents and stateless income.

3) More ad hoc and targeted approaches—This brings us to the third category of approaches—generally the most controversial among both tax experts and American policymakers. Their common theme is identifying particular types of MNEs to face novel tax instruments, such as DSTs and DPTs, that either expressly or in practice do not apply to businesses generally.[38]

DSTs' (and similar instruments') tailoring raises the concern that they will "create inequitable treatment between firms",[39] along with seemingly inefficient tax bias. Criticism also reflects such particular features of DSTs as their typically being gross receipts or turnover taxes[40]—typically a poor tax design.[41] However, I will argue—drawing on recent work by Wei Cui,[42] and by Joseph Bankman, Mitchell Kane, and Alan Sykes[43]—that there are special reasons why using properly designed DSTs and

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36 Another well-known problem with respect to imposing uniform tax burdens across industries relates to taxing the financial sector. VATs typically exclude financial flows, thereby missing the embedded service fee that intermediaries such as banks earn—for example, by paying depositors lower interest rates than those charged to borrowers. See *eg*, David F Bradford, *Untangling the Income Tax* (Cambridge: Harvard University Press, 1986) at 59-74 (proposing Bradford's X tax, akin to a VAT, which encounters similar issues with respect to taxing financial service flows).

37 See Bankman *et al*, *supra* note 3 at 30.

38 One might also view this category as including the recent EU state aid cases. See Daniel Shaviro, "Friends Without Benefits? Treasury and EU State Aid" (2016) 83:12 Tax Notes International 1067. The analogy between these cases and the likes of newly enacted DSTs is admittedly imperfect, as the former (1) on their face merely applied generally applicable existing law, and (2) were viewed by critics as unduly ex post and unanticipated.

39 Sean Lowry, *Digital Service Taxes (DSTs): Policy and Economic Analysis, Summary*, Congressional Research Service R45532 (25 February 2019).

40 But note the UK DST, Clauses 10(2) and (4), specifying certain "relevant operating expenses" that are allowable in group calculations under Clause 9. Digital Services Tax 2019, Explanatory Notes (Eng.), online: Gov.UK <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816359/Digital_Services_Tax_-_ENs.pdf>.

41 Lowry, *supra* note 39 at 1 (stating that, by reason of their being turnover taxes, "DSTs are likely to have the economic effect of an excise tax on intermediate services" and to be more regressive than corporate profits taxes).

42 Cui, *supra* note 35.

43 Bankman *et al*, *supra* note 3 at 30.

similar instruments may be reasonable—especially, but not just, in the absence of sufficient progress towards greater market country taxation in other respects.

As Cui notes, the standard criticism of gross receipts or turnover taxes loses force with respect to DSTs insofar as a given MNE has low (or even zero) marginal costs of operating—say, through a generally available digital platform—in the taxing jurisdiction.[44] Indeed, under such circumstances, a gross receipts tax might even come closer than a highly manipulable net income tax to identifying the true net revenue increase that an MNE anticipated by reason of its deciding to target a particular jurisdiction.[45] This point may apply to particular types of deductions, such as those between Starbucks or McDonald's affiliates that involve IP rights rather than specific tangible inputs such as coffee beans or ground meat (priced without regard to claimed IP value), even when a gross receipts tax would clearly be inappropriate.

Moreover, as Bankman, Kane, and Sykes note, whereas broadly applicable VATs are in some respects ill-suited to pursue MNE rents, a sales jurisdiction may benefit from "us[ing] excise taxes selectively in industries where. . . it suspects the presence of substantial MNE rents, and where it has sufficient leverage to extract rents.[46] They rely on the modern "strategic trade" literature, which shows that, in imperfectly competitive markets, market countries can use tax and other instruments, such as "optimal tariffs", to capture rents for themselves.[47]

DSTs can function, albeit imperfectly, as optimal tariffs. Moreover, while classic optimal tariffs exploit the market jurisdiction's monopsony power to impose global welfare losses that exceed the local distributional gain—as well as inviting retaliation in kind—both the global efficiency analysis and that concerning strategic retaliation have the potential to be relatively benign in the case of MNEs' LSRs.

While I will treat DSTs as a prime example of the third type of approach, I will not here closely examine their varying details in particular versions, or rate them against rival instruments (such as withholding taxes) that have been proposed.[48] Instead, after offering some context by describing the recently emergent United Kingdom ("UK") DST (which has many features in common with a model proposed by the European Commission), I will step back and examine the big picture regarding the shift that DSTs may betoken—including by reason of their basing tax nexus, not on the claimed existence of domestic source income ("DSI"), but rather on that of "significant economic presence".[49] Under that approach, nexus requires only that a foreign taxpayer "participate in the economic life of a country in a regular

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[44] See Cui, *supra* note 35 at 26, 27.

[45] Obviously, extending the DST concept to non-digital firms, such as a Starbucks, would require allowing deductions for such clear marginal costs, at least when paid to third parties, as rent, electricity, local advertising, employee salaries, and the cost of the beans used to make coffee. See Part IV, *infra*.

[46] See Bankman *et al*, *supra* note 3 at 46.

[47] Bankman *et al*, *supra* note 3 at 41. As Bankman, Kane, and Sykes also note, the best-suited tools for addressing LSRs are not always tax instruments.

[48] See Sandy Bhogal & Panayiota Burquier, *Taxing the Digital Economy and Digital Service Tax Proposals Impacting the United Kingdom and the European Union*, Gibson Dunn (20 June 2019) at 10, 11, online: Gibson Dunn <https://www.gibsondunn.com/wp-content/uploads/2019/06/taxing-digital-economy-and-digital-service-tax-proposals-impacting-the-uk-and-eu.pdf>.

[49] *BEPS Action 1*, *supra* note 10 at 102.

[or "purposeful"] and sustained manner"[50]—for example, via high-volume remote sales.

This article's main takeaways, for readers with distinct perspectives, include the following:

1) Non-US policymakers and commentators—I will argue that there is nothing greatly objectionable going on when market countries prioritise their own residents' welfare by taxing LSRs that US (or other) MNEs are earning with respect to their residents—often without facing significant US (or other) taxation. However, it is important from a global welfare standpoint that such countries seek to reach only their own (reasonably defined) LSRs, rather than engaging in Monty Python taxation of those arising in other countries. The limits to tax nexus ought in principle to address this concern, but in practice it is too soon to tell how well this will work out.

Two further important points that non-US policymakers should keep in mind are as follows. First, there is no need to focus on irrelevant issues such as whether their own residents are ostensibly "creating value"—such as by writing Facebook posts (for which Facebook does not pay them), as distinct from merely screening Netflix movies or buying Starbucks Frappuccinos. The important policy issues raised by DSTs and other efforts to reach LSRs are little if at all affected by such distinctions.[51]

Second, it would be prudent, as well as benign, for market countries to avoid unduly fostering the perception that they are targeting US MNEs. Perhaps no one can truly ignore the elephant in the room—*ie*, the fact that, at present, so many of the world's leading MNEs are US companies—and no one should really expect this not to affect countries' calculations. But demonstrating a reasonable degree of good faith could greatly ease the path to general acceptance of a regime in which MNE profits are less globally tax-favoured than they were at the peak of the stateless income era.

2) US policymakers and commentators—Even without suspected targeting of US MNEs in particular, Americans may reasonably prefer that other countries *not* tax the profits that these companies (owned primarily by American individuals) are earning through sales in foreign markets. All else equal, the United States is better off if its people retain a greater, rather than a lesser, pre-US tax share of total global wealth.

But there is a difference between preferring that peer countries not impose taxes that one's own residents might bear, and viewing this as sufficiently offensive to call for retaliation. As I noted with regard to the recent EU state aid cases, "the extent to which the other side is acting reasonably and in good faith (even if self-interestedly) . . . may affect one's own choice of strategic stance".[52] Surely Americans might likewise want to tax rents that foreign-owned MNEs earn in the domestic market, if that were the main direction of such activity. Indeed, given that the day may come when the roster of enormously successful MNEs is not so US-centric, Americans might at some point benefit from a functioning international regime in which inbound profits can regularly be reached.[53] All this argues in favour of a

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[50] *Ibid* at 107.

[51] Hence, for example, in the March 2019 OECD release on digitalisation of the economy, the user participation and marketing intangible proposals are too narrow.

[52] Shaviro, "Friends Without Benefits? Treasury and EU State Aid", *supra* note 38 at 1075.

[53] *Cf* patent and copyright protection, as to which Americans were notorious pirates in the nineteenth century but now are global champions.

circumspect American response to DSTs and similar instruments that would predominantly reach US companies—especially in an era of generally rising global discord, and in which American leaders appear to have set about systematically weakening important alliances and alienating non-authoritarian peer countries.

3) The global welfare perspective—The state of play in which highly profitable MNEs were generating substantial globally untaxed stateless income was both undesirable and unlikely to be politically stable. MNEs were being inefficiently tax-favoured relative to other businesses—whereas, to the extent that they had greater rents, they ought, from both an efficiency[54] and a distributional[55] standpoint, to have been *more* highly taxed. Nor, even without the red flag of anti-Americanism, were people in countries around the world, facing anxiety and austerity in the aftermath of the 2008 financial crisis, likely to deem it just fine that foreign MNEs' creative destruction was being so little accompanied by significant taxpaying.

The optimal response to the rise of stateless income and MNE rents would surely be globally coordinated. However, such coordination is costly, and it may be slow to emerge, if it does at all. Neither leading MNEs nor the United States government can be counted on to help accelerate agreement to a coordinated global solution. In the interim, the use of novel tax instruments by market countries, in lieu of their patient waiting for something to happen at the global level, is both understandable and reasonable.

Insofar as market countries' understandable impatience leads them to enact DSTs (or similar instruments) that address LSRs, the choice of ultimate coordinated solution involves a version of the same dilemma as that raised by calls to adopt SPFA and RPAI—that of overlapping claims by claims by production and market jurisdictions, respectively. For example, if a company like Facebook (acting purely through people in the United States) creates valuable IP that allows it to earn rents by interacting with users in multiple countries around the world, the sum of the LSRs it could earn in each country would tautologically equal the value of the IP thus created by Americans' efforts. However, evidently US reluctance either to define DSI in a rigorously production-based sense, or to tax what it has classified as foreign source income ("FSI") at anything close to the rate for DSI—a reluctance that, as we will see, has broad, non-idiosyncratic causes—reduces the likely global efficiency costs (if any) of collective global overreach. In addition, while such considerations may also weigh in favour of countries' unilaterally adopting market country-favourable approaches such as RPAI, we will see that the two sets of approaches, while partly overlapping, are also partly complementary.

The rest of Part One discusses value creation, its relationship to determining the source of income, and the reasons why the rise of digital businesses (and, more broadly, of highly valuable, globally deployed IP) have undermined traditional source-based taxation. Part Two will then discuss production-based and market-based

[54] See *eg*, Laura Power & Austin Frerick, "Have Excess Returns to Corporations Been Increasing Over Time?" (2016) 69:4 Nat'l Tax J 831 (finding that MNEs have especially high levels of extra-normal returns).

[55] A number of the founders of leading MNEs have become billionaires, whose enormous gains one might want to tax at a high rate from a distributional standpoint.

approaches to taxing MNEs' global profits (including LSRs), along with DSTs and possible extensions thereof.

II. Value Creation: What is it, is it the Answer, and if so, then what is the Question?

A. *A New Concept, or an Old One?*

The OECD's value creation principle holds that "corporate profits are [and should be] taxed where value is created".[56] Its promulgation reflected the view that "[n]o or low taxation" of MNEs' cross-border activity becomes "a cause of concern . . . when it is associated with practices that artificially segregate taxable income from the activities that generate it".[57] Imposing tax where value actually was created would, almost by definition, prevent such separation. It also would be expected to increase taxation of MNEs' profits, if countries where significant income-generating activities can readily occur—unlike those that are more suited to hosting shell companies and incorporated cash boxes—tend not to be tax havens.

Such a focus on value creation involves making three closely linked claims. The first is that a geographical source concept with respect to income or profits is economically meaningful. The second is that existing source rules sufficiently implement this concept to suggest that it lies at their core aspirationally, even if they do not always fulfil it. The third is that source rules can and should be revised to match the site of value creation more accurately than they do at present.

While OECD BEPS publications treat value creation as a generally accepted approach to international tax law and policy,[58] critics call it a "brand new standard",[59] albeit only in the sense of adding the "overlay of a new 'substance' requirement over the existing system".[60] In disputing whether value creation is a familiar approach or a novel one, both sides have a point. Its relative familiarity versus novelty depends on which of the above three claims one emphasises.

The first two claims, concerning existing source rules' relationship to the true economic source of income, are long-familiar, albeit controversial. They simply restate a well-known set of premises regarding the putative underpinnings of the generally accepted principle which holds that, when a country purports to be taxing "income", only nonresidents' DSI from that country's standpoint, not their FSI, is properly reachable.[61] This inherently relies on a notion of geographic source, especially if rationalised on a view that the benefits provided locally to or on behalf

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[56] Devereux & Vella, *supra* note 18 at 1.

[57] OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), online: OECD <https://www.oecd.org/ctp/BEPSActionPlan.pdf>. For an example of the value creation principle's also being cited by the OECD in response to what I call Phase Two developments, see *eg, OECD BEPS Public Consultation on Digitalization* at 6-8.

[58] See *supra* notes 10-14 and accompanying text.

[59] Herzfeld, *supra* note 18 at 42; See also Schön, *supra* note 18 at 5.

[60] Herzfeld, *supra* note 18 at 42 and n 135 (citing Michael P Devereux & John Vella, "Are We Heading Towards a Corporate Tax System Fit for the 21*st* Century?" (2014) 35 Fiscal Studies 449 at 452).

[61] See *eg*, Reuven Avi-Yonah, *Advanced Introduction to International Tax Law*, 2d ed (Cheltenham: Edward Elgar Publishing Ltd, 2019).

of the taxpayer help to justify the source-based tax.[62] And while the third claim is on its face a call for legal change, value creation's critics often agree with its proponents that the rise of stateless income calls for significant change of *some* kind.

Source-based taxation was bound to become more challenging in recent decades, as both real activities and financial flows became ever more mobile, and with the rise of intangible assets as sources of economic value. Why, then, double down on it? The OECD's answer would appear to be twofold. First, it makes sense to work as best one can with the regime that is already in place, and the existing regime relies on source rules. Second, unforced and fixable errors in the particulars of prevailing source rules caused their deterioration to be greater than it needed to be. Thus, addressing those errors might yield significant improvement with respect to addressing the rise of stateless income.

These arguments rely in particular on two key doctrinal aspects of the longstanding international tax regime: (1) the principle of arm's length transfer pricing ("ALTP") as between related entities in affiliated corporate groups, and (2) bilateral tax treaties' permanent establishment ("PE") requirement for taxing nonresident companies on a source basis. Each of these two doctrines had conceptual problems from the start, but rising mobility and intangibles distinctively magnified their difficulties. We can start, however, with the question of what the source of income, or site of value creation, means to begin with.

B. *The Meaning of Source: Is There a There There?*

In the Tagalog book example, my income from writing and selling the books had only two possible sources: the United States under a production-based view, and the Philippines under a market-based view. One could easily alter the example to leave just one possible source. For example, if I grow vegetables in a New York City rooftop garden and sell them for cash to my neighbour, who cooks them for dinner, the income is US source under either view.

The existence of such clear-cut cases is in tension with Hugh Ault's and David Bradford's well-known argument that "the source of income is not a well-defined economic idea".[63] In their view, if income, by definition, "attaches to someone or something that consumes and that owns assets", then it "does not come from some place, even... [if we] keep track of payments that have identifiable and perhaps locatable sources and destinations".[64] Thus, *my* economic income under the Haig-Simons definition[65] accrues to *me*,[66] rather than to any locations where particular

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62 See *eg*, Robert A Green, "The Future of Source-Based Taxation of the Income of Multinational Enterprises" (1993) 79 Cornell L Rev 18; Kane, *supra* note 28 at 314, 315.

63 Ault & Bradford, *supra* note 28 at 30.

64 *Ibid* at 31.

65 See Henry C Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938) at 50 (defining economic or Haig-Simons income as the sum of the market values of the taxpayer's consumption and change in net worth during the relevant accounting period).

66 Ault and Bradford accept applying the Haig-Simons definition to corporations, even though legal entities cannot themselves experience utility, on the view that the analog of personal consumption is distributions to shareholders. Ault & Bradford, *supra* note 28 at 32.

transactions occurred, and thinking about income in source terms would appear to involve a "category mistake".[67]

Yet why is it non-economic to think of income as arising where the relevant people, assets, or activities were when it arose? Calling my hypothetical vegetable garden income US source seems less a category mistake than the product of invoking a classification metric that is orthogonal to, but not in tension with, the Haig-Simons definition of economic income.

The problems that Ault and Bradford have in mind are real enough, but somewhat narrower. They fall into two categories. The first is that of choosing between production-based and market-based views of source. The second is that of applying either view in circumstances where its logical implications are not so clear.

Production-based or market-based?—When a seller in Country A finds a buyer in Country B, can we say where the seller's income—that is, the excess of the sale price over its cost—actually arose? We have at this point a semantic question, not necessarily one about good policy. That is, we are asking what a term in common usage logically means. This is not equivalent to asking how it might best be taxed from either a global welfare standpoint, or that of a particular country.

A first approach might be to ask where the income actually arose in a causal sense. Unfortunately, however, in a standard price theory framework, the realisation of any profit depends on both supply and demand. The point of intersection between the supply and demand curves presumably determines the market price, and therefore any participant's surplus given its cost or disutility on the supply side, or its subjective utility on the demand side.[68] Thus, both sides were necessary for transactional surplus to arise. If production occurred in one country and consumption in another, then asking which side gave rise to the profit is akin to asking, in Ronald Coase's famous torts hypothetical, whether a train spark's burning a wheat field was the railway's fault or the farmer's.[69] The two together generated the outcome.

Now suppose that, in keeping with the view that benefit principles underlie source-based taxation, we ask ourselves which government played a critical role in permitting the producer's share of the joint surplus (*ie*, its profit) to arise: that in the production country, or the source country. Unfortunately, however, we are still in Coase territory. When a seller in Country A finds a buyer in Country B, both countries' governments may have helped to create the preconditions for transactional surplus. For example, government-funded roads and education may have helped both to reduce production costs in Country A, and to increase consumer demand in Country B.

Another approach might be to try to derive the answer from the character of the tax base. Arguably, the fact that we are sourcing income, under fiscal instruments called income taxes, supports a production-based view. After all, the producer is the party that takes actions directed at realising the profits that are then taxable to it. By this logic, however, if we converted existing income taxes into consumption taxes, as

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[67] Kane, *supra* note 28 at 316. Kane in effect demurs to the Ault-Bradford argument, responding that the source of income is a legal concept, not an economic one, serving to aid countries in deciding how to allocate the global tax base among themselves.

[68] See *eg*, Johannes Becker & Joachim Englisch, "Taxing Where Value is Created: What's 'User Involvement' Got to Do With It?" (2019) 47 Intertax 161.

[69] See R H Coase, "The Problem of Social Cost" (1960) 3 JL & Econ 1.

has frequently been proposed,[70] then, all of a sudden, properly determined "source" would shift to the consumption jurisdiction.[71]

There are reasons for doubting that tax instruments' labels should so dictate the result. For example, existing "income" taxes frequently have significant consumption tax-type features—such as allowing expensing for capital outlays, and deferral of returns to saving under multiple circumstances. In addition, the central question in the vast literature debating the relative merits of income and consumption taxation—how to treat savings that imply deferred consumption—has little, if any, discernible relationship to the inter-nation tax base allocation question. Why, for example, should the question of how particular US or Philippine tax instruments treat savings for deferred consumption, relative to immediate consumption, be thought to predetermine the question of which country can claim source jurisdiction with respect to the profits from my cross-border book sales? The question of how to measure ability to pay domestically seems quite distinct from that of how countries should coordinate their taxation of cross-border transactions.

Another approach would proceed from the view that source rules are simply a device for achieving consensus between countries regarding allocation of the global tax base,[72] such that (under the "single tax principle") each dollar of a given MNE's profits is taxed exactly once.[73] Hence, perhaps the right question to ask is not which view stands on stronger logical ground, but which can better fulfil this underlying purpose. Unfortunately, however consensus may be hard to generate under either view, given countries' disparate interests.

Throughout the history of the corporate income tax, there has been a divide between countries that are primarily exporters, and those that are primarily importers, of MNEs' products. This is distinct from their status as net exporters or importers overall. The United States, for example, although in today's global economy a huge net importer of both capital and consumer goods, is the home base for a disproportionate share of the world's leading MNEs. The Four Horsemen and many of their American peers are not just US residents for corporate income tax purposes, but firms whose high-value, often stock-compensated, employees work mainly in the United States on creating and maintaining the IP that underlies the firms' global profitability.[74]

Accordingly, when market countries seek to tax the rents that these MNEs earn from sales to their own residents, they are going after income that is largely US source under a production-based view—even if not so treated for US federal income tax purposes[75]—but rightfully within their reach under a market-based view. This elephant in the room makes it difficult for policymakers from different countries

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[70] See *eg*, Daniel Shaviro, "Replacing the Income Tax with a Progressive Consumption Tax" (2004) 102 Tax Notes 91; Shaviro, "Goodbye to All That?: A Requiem for the Destination-Based Cash Flow Tax", *supra* note 31.

[71] Note, however, that, while consumption taxes are typically done on the destination basis, they can also be done on the origin basis. See *eg*, Bradford, *supra* note 36 (discussing Bradford's X-tax).

[72] See *eg*, Kane, *supra* note 28 at 361.

[73] See Avi-Yonah, *supra* note 61 at 5, 6.

[74] See *eg*, *infra* Section II.C.1 (discussing the "Starbucks Experience").

[75] See *eg*, James Anderson *et al*, *EU General Court Rules on Starbucks and Fiat State Aid Cases*, Skadden, Arps, Slate, Meagher & Flom LLP (30 September 2019), online: Skadden <https://www.skadden.com/insights/publications/2019/09/eu-general-court-rules-on-starbucks>.

disinterestedly to agree about whether income should be defined in such a way say, the Four Horseman should pay tax predominantly in the United States (if at all), or in market countries where they generate substantial revenues.

Divergent national interests thus impede finding consensual semantic paths out of the value creation maze. The term appears not to offer grounds based either on internal logic, common usage, or ready agreement for determining whether the income from cross-border commerce should be attributed to production countries or market countries. Further interpretive problems arise, however, even if one definitively chooses either view.

Lack of clear answers under a production-based view—Even if one settles on adopting a purely production-based view of value creation, the source concept often fails to offer helpful guidance. Consider the difficulty of sourcing passive income, such as interest earned on debt and dividends paid on portfolio stock. In practice, such income is typically sourced based on the payor's tax residence, but this is widely recognised as formalistic.[76] Likewise, when an MNE earns economic returns in multiple jurisdictions, it can be hard or impossible to specify the "correct" geographical treatment of costs that support its operations more broadly (such as headquarters expense) or that involve fungible inputs (such as the interest paid on loan capital).[77] In all such cases, formalism necessarily prevails, often with the consequence of giving MNEs tax planning opportunities to the detriment of both production and market countries.

Another set of problems concerns cross-border synergies. Suppose that a particular MNE combines a pair of affiliates in different countries, each bringing unique attributes to the table. For example, say that Acme's US and French affiliates would each have earned $75 if operating separately, but that they actually earned $250 in total, by reason of the unique synergies made possible by their joint ownership. In this scenario, where did the $100 of synergy profits arise?

Suppose we think of this as an ALTP issue, given that the owners of Acme-US and Acme-France (if unrelated) would each want as large a share of the synergy profits for themselves as possible. Then one needs to determine how they would have agreed to split the bilateral monopoly profit that they can only realise by cooperating. Unfortunately, bilateral monopoly negotiating problems generally lack clear answers. Their outcomes can depend on the parties' relative bargaining power, strategic judgments and other idiosyncratic factors that are hard to specify in a generalised hypothetical.[78]

Lack of clear answers under a market-based view—Market-based sourcing rules often give clearer answers than those that are production-based. Thus, suppose a given consumer good is produced in stages across five countries, and then is

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[76] See *eg*, Devereux & Vella, *supra* note 18 at 4. A more substantively oriented approach might focus on where the underlying funds earned (or were expected to earn) the return that permitted the payment of interest or dividends. This, however, would be challenging inquiry given the fungibility of money.

[77] For interest expense, if one wants to be more sophisticated than simply tracing the use of particular funds, one might consider allocating interest expense pro rata to something—for example, assets or gross income. US income tax rules for interest allocation or apportionment often use such approaches. Such an approach does not, however, accurately track the marginal use of funds, in a case where extra loan capital would fund particular operations, not the MNE's cash needs in general.

[78] See *eg*, Daniel P O'Brien & Greg Shaff, "Bargaining, Bundling, and Clout: The Portfolio Effects of Horizontal Mergers" (2005) 36:3 RAND Journal of Economics 573 (modelling how bargaining power, influence the efficiency of transfer pricing and horizontal mergers).

consumed by an individual in a sixth country. A production-based view requires untangling the value added in each country during the production process. A market-based view faces no such difficulties. It may, however, depending on its structure, face such problems as:

(i) distinguishing between personal consumption and the use of items as business inputs, which is a classic problem under both income and consumption taxation;
(ii) determining whether an intermediate sale breaks the chain between a producer and the ultimate consumer, if the producer is not otherwise domestically taxable;
(iii) distinguishing between product lines, if relevant to a given rule's application, which we will see may affect profit allocations under some approaches;[79] and
(iv) evaluating physical presence or other grounds for asserting tax nexus (such as significant economic presence), if treated as a prerequisite to taxing the nonresident producer.

C. *Arm's Length Transfer Pricing (ALTP) and Permanent Establishment (PE) Requirements*

The difficulties both of choosing between production-based and market-based approaches to the source of income, and of applying the former approach in particular, are not new to international taxation. They have been muddled through for decades, and only the rise of global production and capital mobility, and of the relative importance of IP, have created the sense of urgency that underlies OECD efforts. Given the OECD view that muddling's adequacy might be restored by suitably modernising the rules around ALTP and the PE requirement, I turn next to those rules' main aspects, and to how recent decades' economic changes have undermined them.

1. *Arm's Length Transfer Pricing (ALTP)*

Suppose that, in 1958, General Motors' US parent company had spent $1,500 with respect to the manufacture and sale of a Cadillac that it then shipped to Paris, where (after undertaking storage and promotion) its wholly-owned subsidiary, GM-France, had sold the car to an independent French dealership for $4,000. How would prevailing legal doctrines have suggested dividing the GM group's $2,500 global profit,[80] as between the parent's US source income and the subsidiary's FSI?

Both in theory and as a matter of widespread statutory and treaty law, the answer was thought to depend on the hypothetical transfer price that GM-US would have charged GM-France had they been dealing with each other at arm's length, as if they were unrelated parties, each trying to maximise its own share of the profit. So there was in principle a right answer—assuming a single correct transfer price—as to the

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[79] See *eg*, Devereux *et al*, *supra* note 13 at 67, 68.

[80] This calculation of the GM group's global profit leaves out any expenses incurred by GM-France (for example, for sales and promotion) that are treated as pertaining to the sale of this particular car.

true US and French source income (as well as that of each affiliate) arising by reason of this transaction.

Suppose the real value here lay in GM-US's design and manufacture of cars that consumers around the world highly valued, whether for their quality or their association with a famous global brand. And suppose further that there was nothing special about GM-France's marketing and sales activities—*ie*, that it was merely performing routine functions that others could have performed just as well. Then a true arm's length negotiation between the US and French affiliates would have allowed the latter to capture but little of GM's profits from selling cars in France. The US parent would have had no reason to over-pay a third party for performing routine functions, and thereby to give away value that (taken as given the consumer side of the market) its actions had created.

This helps to show that ALTP is in principle a production-based concept. It posits hypothetical arm's length transactions within an integrated productive process. In that setting, one presumably must provide good value in order to be paid well. In practice, however, ALTP uses a range of methodologies that may not well track relative value provision at all. For example, it has long relied heavily on the notion of applying observed prices from true arm's length transactions that may actually have little in common with those at issue within a globally integrated MNE—allowing the use of misleading comparisons that cause substantial profit shares to be assigned to tax haven affiliates that do little if anything to add value.[81]

Suppose, for example, that—in keeping with tax planning technology that dates back at least to the 1950s—GM had inserted an affiliate in low-tax Luxembourg to buy the car from GM-US, hold it briefly, and then on-sell it, at a generous markup, to GM-France. GM might claim that the mark-up created Luxembourg-source income, reducing its worldwide tax liability if both the US and France had higher tax rates. In principle, this manoeuver could be challenged by asking whether the intermediate prices were arm's-length. This might have involved examining what, if anything, GM-Luxembourg did to earn its spread. Yet properly applying the transfer pricing rules proved so hard in practice that, in 1962, the United States enacted, as an apparent back-up, a rule (still in force today) that was designed specifically to make US parents currently taxable on the tax haven FSI created through such transactions.[82] This rule seemingly would have been unnecessary if the transfer pricing rules were working properly.

One reason for the enforcement difficulties may have been taxpayers' informational advantages over government auditors regarding their own operations. However, consider as well GM-France-type cases, in which the local affiliate is not a tax haven conduit but actually handles local consumer sales. If the MNE as a whole is earning extra-normal profits, one would be wholly unsurprised to see the local tax authorities seeking to claim more than a routine share thereof—indeed, perhaps with the MNE's blessing if the market country's tax rate lies below that of the marginal alternative source claimant (such as the production country).

[81] Note also transfer pricing methods in the US Section 482 regulations that can allow pro rata types of splits where value is not necessarily pro rata. IRC §482 (2018).

[82] See IRC §954 (2019) (establishing base company sales rules).

In such a case, extra-normal returns that reflected rents created in the production country might in effect be treated as if they were instead bilateral monopoly profits (and hence subject, in an arm's length negotiation, to being split up "fairly"). However, we need not posit that auditors or others were actually thinking in exactly these terms. Rather, given the large profits to be allocated, and the lack of a strong underlying consensus in favour of production-based sourcing, transfer pricing (in the absence of true comparable sales) could be a sufficiently flexible and underspecified instrument to allow for its partly implementing a market-based view in practice.

To illustrate transfer pricing's two-way flexibility (*ie*, either to the market country's benefit or detriment) through a modern example, consider Starbucks, which "claimed [tax] losses in 14 of the first 15 years of its existence in the United Kingdom and as a result paid virtually no UK company tax, despite a 31 percent market share and shareholder reports indicating solid profitability".[83] Transfer pricing was among the key elements in its claiming UK tax losses.[84] Unfortunately for Starbucks, however, public outrage, including consumer boycott threats, induced it to agree to pay £10 million in corporate taxes for each of the next two years, even if it continued reporting tax losses.[85]

Obvious though it was that Starbucks generated large profits by reason of having UK stores, it was not so obvious that much profit was actually generated there, if we define the term in a production sense. The company has elsewhere stated that its "fundamental corporate strategy is to deliver the Starbucks Experience to each customer, store by store", requiring "tightly integrated" operations that cause it to prefer company-owned stores to the use of franchisees. And "the brain center of the Starbucks Experience is its support center in Seattle; foreign operations appear to be reduced to the localisation of that centrally conceived experience".[86]

This suggests that true arm's length negotiations between Starbucks' central headquarters and third parties (such as franchisees), compensating the latter for what they did in the UK, would have yielded the latter only a routine return. Hence, in the scenario where franchisees could be trusted to behave the same as store employees, presumably they would have captured only a modest share of the overall marginal profits to be reaped by reason of deploying the preexisting "Starbucks Experience" in the UK. There is no reason to think that such UK actors would have been bringing sufficiently unique skills to the table to turn the hypothetical negotiation into one concerning the division of bilateral monopoly profits.

Nonetheless, the fact that Starbucks' US-developed business model induced it to prefer direct ownership of its UK retail stores meant that there was room for the UK tax authorities—however little they initially did about it—to use transfer pricing, among other tools, in order to claim that more than a routine share of the profits resulting from Starbucks' sales to UK consumers was actually UK source. This would not require that they be disingenuous in any way, or depart from accepted practices. Profit-split approaches, for example, may lead to a more even split between foreign

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83 Kleinbard, *supra* note 5 at 1519.

84 See *ibid* at 1526, 1527. Outbound royalties and interest payments may have played an even larger role than transfer pricing in creating the UK losses.

85 *Ibid* at 1519.

86 *Ibid* at 1525.

parent and local affiliate than would result from asking rigorously where economic value actually is being created in a production sense.

2. *Permanent Establishment (PE) Rules*

Bilateral tax treaties have long committed the signatories to forgoing source-based taxation of each other's resident companies absent a physical PE through which the companies were locally conducting business. It is easy to see how this fits with a production-based source of income concept. From such a perspective, it may seem obvious that a company cannot earn income in a given country unless it has employees or property physically located there. Otherwise, surely all the production activity must be taking place somewhere else.

Yet, had it been sufficiently obvious that one cannot earn income in a given country without a physical presence there, specific PE rules would seemingly have been unnecessary. Under a production-based view, merely requiring DSI, as a pre-requisite for one signatory's taxing the other's residents, seemingly would have offered protection enough. Yet one of the main things that made PE rules relevant and potentially important, rather than superfluous, was the possibility that countries would employ market-based views of source.[87] After all, under such a view, having sales in a jurisdiction, especially if one is deliberately targeting it, may mean that one is truly earning income there. Thus, the existence of PE rules indirectly testifies to the source concept's underlying ambiguity as between production-based and market-based understandings.

Once an MNE has a PE in a given market country, the PE's presence can serve as a ratchet that empowers the country to exploit the source concept's ambiguity as between production-based and market-based definitions. Consider *Taisei Fire & Marine Ins. Co. v. Commissioner*,[88] a prominent US case holding that the taxpayers, a group of Japanese property and casualty insurance companies that engaged in reinsurance in the US market, did not have PEs in the United States, and hence were exempt from US tax under the US-Japan tax treaty. The taxpayers' victory followed from the court's conclusion that their only representatives in the United States with authority to conclude contracts on their behalf were independent, rather than dependent, agents.

Whether dependent or independent, the agents themselves were taxable in the United States on whatever amount the Japanese insurance companies paid them. But only if they were deemed dependent agents could the companies be taxed on some measure of *their* own profits from participating in the US reinsurance market. An obvious takeaway was that foreign MNEs should plan, if possible, to use only independent, not dependent, agents under such circumstances. A further corollary was that those whose business models made this feasible could avoid US source-based US tax that those with different models might have to pay. For example, banks, which may need on-site dependent agents to play a prominent role in meeting with customers, may therefore be exposed to greater source-based taxation than some

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[87] PE rules also, however, could result in assigning tax jurisdiction to countries where intermediate parts of the production process took place.

[88] 104 T.C. 535 (1995).

of their peers, despite the increasing interchangeability of the alternative business models in other respects.[89]

The difference was not that US production was necessarily greater when dependent, rather than independent, agents were being used—with any local participants being compensated, in either case, based on market conditions. Rather, the difference was that attributing their activities to the foreign MNEs would permit the United States to tax income that was derived from US source in a market sense, but less plausibly so in a production sense. So the US tax consequences of having a US PE might exceed the choice's effect on pre-tax global profits, via its offering a ratchet for the imposition of market-based income sourcing on an outside MNE.

3. *The Decline of ALTP and PE as Instruments for Enabling Effective (albeit ambiguously defined) Source-based Taxation*

In recent decades, an effectively shrinking globe and the rise of intangibles have reduced the efficacy of both ALTP and PE rules. As to the former, MNEs' integrated productive processes, involving multiple sites around the world, bring synergies to the fore, while also raising the number and complexity of imputed intra-group transactions. Consider the iPhone, often assembled in China but using components that were manufactured in dozens of different countries around the world,[90] and using valuable IP that Apple took great care to ensure was largely sited in tax havens. It comes as little surprise, therefore, that neither production nor market jurisdictions—including the United States, as the country where much of Apple's (at least partly stock-compensated) owner-employee brainpower was located—have blocked Apple from using conventional transfer pricing doctrine to place a large share of its global profits in tax havens.[91]

Likewise, with the rise of the digital economy (and of cheaper communications and transport generally), MNEs far less frequently need to use in-country PEs to perform, say, local distribution and marketing functions. If the PE were truly what mattered for its own sake, then, as Wei Cui notes, it would be "bizarre to claim that countries remain entitled to impose a tax based on the old business model because the new model replaces it".[92] But insofar as PEs are merely a prerequisite for allowing consumption jurisdictions to stake a larger claim on cross-border income than would be available to them otherwise—reflecting the lack of any definite consensus that only the place of production should count—this may logically be viewed as undermining the previously prevailing international tax regime.

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89 See Edward D Kleinbard, "Competitive Convergence in the Financial Services Markets" (2003) 81:3 Taxes 225.

90 Sam Costello, "Where Is the iPhone Made?" *Lifewire* (31 March 2020), online: *Lifewire* <https://www.lifewire.com/where-is-the-iphone-made-1999503>.

91 However, this is not to say that Apple couldn't have been reined in more on transfer pricing. See *Offshore Profit Shifting and the US Tax Code - Part 2 (Apple Inc.): Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security & Governmental Affairs*, United States Senate 113th Congress 1 (21 May 2013) (statement of Senator Carl Levin, Chairman, Subcommittee on Investigations), online: Homeland Security & Governmental Affairs <https://www.hsgac.senate.gov/imo/media/doc/OPENING STMT - LEVIN-Carl Offshore Profit Shifting (Apple) 5-21-13.pdf>.

92 Cui, *supra* note 35 at 19.

D. *Going Beyond Value Creation*

The OECD's effort to revivify the existing international tax regime, through a focus on value creation that includes paying particular attention to existing ALTP and PE rules, has virtues. Those rules need updating insofar as their use continues (*ie*, leaving aside more dramatic changes), and the "negative source rule" aspect of value creation can strengthen both production-based and market-based approaches to income sourcing. Yet value creation's ambiguities are dismayingly unhelpful, and the effort to shore up old approaches should not crowd out also looking for new ones, whether to complement or replace them.

In considering possible next steps, it is important to adjust the analytical perspective. The OECD, quite logically given its character as an international intergovernmental organisation, offered proposals for multilateral adoption, based on claims of collective benefit. Given, however, that individual countries are the prime actors in the international tax policy realm, one must also consider their motivations with regard to taxing MNEs.

Part Two of this article will be examining that issue and will focus on proposals to shift taxing rights towards market jurisdictions that may enjoy location-specific rents with regard to the MNEs' access to their consumers, including via the use of digital service taxes.