Value Creation: Old wine in new bottles or new wine in old bottles?

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"Value Creation" or "New Wine in Old Bottles?"

"Those who cannot remember the past are condemned to repeat it" - George Santayana, The Life of Reason in Common Sense (1905).

A service was held in Johannesburg on 18 May 2018 on "value creation" in the new tax arena to celebrate the 80th anniversary of the International Fiscal Association. For another post, considering Prof Patrickaramel, Peter Blessing, Prof Wolfgang Schön and Porus Kaka SA, contemplated the meaning of this latest buzz-word in the 80th anniversary of the International Fiscal Association. For another post, considering Prof Patrickaramel, Peter Blessing, Prof Wolfgang Schön and Porus Kaka SA, contemplated the meaning of this latest buzz-word in the 80th anniversary of the International Fiscal Association.

Value creation frequently appears in policy documents and new legal instruments as the justification for new international tax rules, but is nowhere explained.

Old wine in new bottles?

The discussion made one wonder if there is anything new in this concept. Much discussion focused on the relationship between "value creation" and "source".

The classical explanation of the meaning and identification of the source of income has come from the courts of Commonwealth countries that adopted a common-source based tax system that served through the 20th Century. This is South Africa for example. The courts were able to locate income and assets "from a source within or deemed to be within the Union" (of South Africa). The highest court, the Appellate Division of the Supreme Court noted as early as 1926 in "South Africa v CIR" that the term "source" refers to the origin of income, rather than where it was located. In other words, the source of income (or profit) is the originating cause of that income or profit. It is what the taxpayer does to produce or sell a product, or engages in an activity; it is the source of income or profit being taxed.

The extensive case law on the source of income or profit has provided clear guidelines to identify its originating cause and the location of that cause. The discussion made one wonder if there is anything new in this concept. Much discussion focused on the relationship between "value creation" and "source".

New wine in old bottles?

Prof Wolfgang Schön put the case that "value creation" is indeed new. It has been conflated with "economic substance" which, in the IPPS context, has in turn been conflated with tax avoidance and artificial arrangements. This is convincingly supported by the 1926 case in the location of the source of earning profits in Tuck v CIR [1926] 23 TD 169 (on the source of "corporate income") - that "the question is, where via the operations take place from which the profits in question are derived". The "source" of income is another way of saying, then, where and how does the profit really arise? The broken-down deed sat itself answer this.

Value creation, he noted, has been invited by the IC Commission to support different and contradictory policy outcomes in 2016 and 2018 (see also the OECD BEPS Lay Review). The OECD Transfer Pricing Guidelines express such a "digital presence". This is the source income or profit of the contract in which value creation is used to refer to the digital element added to a profit in the situation of taxing rights from that under the theoretical dispensation. It is disingenuous to present what is really a political debate about which country is entitled to be a matter of legal analysis. If value creation is indeed no different from the originating cause of income or profit, then the only real analysis that today remains is the continuous examination of modern income and profit generation to identify its originating cause and the location of that cause.

Redefining source via value creation

Whether value creation has become a malleable concept by its users. In its most extreme form, the revised approach to transfer pricing of intangibles now in the Chapter D of 2017 OECD Commentary on the Transfer Pricing Guidelines (TPG) includes a flawed and ineffective attempt to define the source of the income "value creation" as a substitute for the source of profit within the originating cause of income or profit. This use of the term "intangible assets" is what the pioneer of a theory receives in consideration of the payment.

Paragraph 6.13 of the Guidelines expressly disavows the use of this transfer pricing approach for other tax purposes. If, however, no value is to be attached to the asset in pricing the royalty, the practical effect may be different. Paragraph 6.13 also states that the use of value creation as the source of income is bound to cause confusion if it is used to mean different things for different purposes.

Complex originating causes of profit

The extension of the source of income or profit has provided clear guidelines to identify the originating cause of profit. These decisions have not provided a decisive analysis in the case of profit where there is more than one originating cause. Some cases have sought to identify the source or element originating cause (Off a Bank 1995) 33 TC 364 (S. Africa). In the context of the "value creation", this is a complex situation where the income is a mix of different things for different purposes.

Digital economy

The OECD 2018 report addressing BEPS issues and profit shifting argue that current international tax standards may not have kept pace with changes in global business practices. In the context of an IFRS 80 the Fisc said and the South African legislation agreed that assigning the source of income is a political matter of hard fee. Is this any different in the era of a digital economy? Debate about the allocation of taxing rights may well be simplified by determining who owns what and how to have been forgotten.

Schwarz on Tax Treaties, 3rd Edition can be purchased here. The book is also available online on Kluwer International Tax Law.