Value Creation: Old wine in new bottles or new wine in old bottles?
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*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 15 May 2018 on “value creation” in the new tax arena to celebrate the 90th anniversary of the International Fiscal Association. An erudite panel, comprising Prof Robert Danon, Peter Blessing, Prof Wolfgang Schön and Porus Kaka SA, contemplated the meaning of this latest buzz-word in international taxation. 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 classic exposition of the meaning and identification of the source of income has come from the courts of Commonwealth countries who adopted a common source based tax system that served through the 20th century. That is South Africa for example. Layjudges were told to locate income as “from a source within or deemed to be within the Union” (“South Africa” – the highest court, the Appellate Division of the Supreme Court noted as early as 1926 in Smidth & Co v Greenwood (1926) 1 TS 86, that the term “source” refers to the source of income, rather than where it was located. In other words, the source of income (as profit) is the originating cause of that income or profit. It is what the taxpayer has produced or sold, or paid tax on, in the sense that it is the reason why the income was produced or selling it – as well as providing the use of an asset such as land, intellectual property or money. Given a cause of income or profit (identified), it is necessary to determine its geographic location. The combination of identification of a source of income and its geographic location links the income with the relevant tax system.

Since that time a body of case law has developed in many Commonwealth countries that address the application of the source principle. This is achieved using both traditional and non-traditional principles.

If value creation is indeed no different from the originating cause of income or profit, then repackaging this fundamental concept is simply confusing – pouring old wine into new bottles to make the consumer believe there is a new product in vino. If value creation is just the originating source of income or profit, then the only real analytical task today remains the continued examination of modern income and profit generation to identify its originating cause and the location of that cause.

New wine in old bottles

Prof Wolfgang Schön spoke on the idea of “value creation” is indeed no different from what has been called “economic substance” which, in the ECI context, has in turn been conflated with tax avoidance and artificial arrangements. This in turn is supported by the 2016 BEPS Base Erosion and Profit Shifting (BEPS) Action 6 Report on “Addressing the Base Erosion and Profit Shifting opportunities created by thin capitalization (specifically, STI)” and the OECD 2013 report “Addressing Base Erosion and Profit Shifting” argued that current international tax rules are based on the allocation of taxing rights may well be simplified by remembering what seems to have been the key business activities that produce the profit or income. This is the central issue that remains to be addressed.

For example, the revised approach to transfer pricing of intangibles now in the Chapter VI of the 2017 OECD Transfer Pricing Guidelines take a selective approach to the originating cause of income or profit. The OECD discussion document on the allocation of taxing rights to the source of income proposed for discussion in Paris last year in 2016 was entitled “Proposal for the Allocation of Taxing Rights from the Source of Income”.

Paragraph 6.13 of the Guidelines expressly disavows the use of this transfer pricing approach for other tax purposes. If value creation is indeed no different from the originating cause of income or profit, then the only real analytical task today remains the continued examination of modern income and profit generation to identify its originating cause and the location of that cause.

Redefining source via value creation

Whichever approach one adopts, 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 VI of the 2017 OECD Transfer Pricing Guidelines take a selective approach to the originating cause of income or profit. The OECD discussion document on the allocation of taxing rights to the source of income proposed for discussion in Paris last year in 2016 was entitled “Proposal for the Allocation of Taxing Rights from the Source of Income”.

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Value creation in the service sector

In the digital economy, the discussion about the allocation of taxing rights may well be simplified by remembering what seems to have been the key business activities that produce the profit or income. This is the central issue that remains to be addressed.

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Value creation in intellectual property

Value creation, he noted has been invoked by the EU Commission to support different and contradictory policy outcomes in 2016 the EU Anti-Tax Avoidance Directive, the CCCTB Draft Directive and the Draft directive on “digital presence”. The context in which value creation is used is the modern debate about a shift to a source based tax system. This is really a political debate about which country is entitled to tax as a matter of legal analysis. A more honest policy analysis would be to accept the debate for what it is.

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