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

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Jonathan Schwarz (Temple Tax Chambers; King's College London)

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"*Those who cannot remember the past are condemned to repeat it*" George Santayana, The Life of Reason: Reason in Common Sense (1905).
A seminar was held in Rotterdam on 18 May 2018 on "value creation" in the new tax universe to celebrate the 80th 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 me wonder if there is anything new in this concept. Much discussion focussed on the relationship between "value creation" and "source".

The clearest explanation 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. Thus in South Africa for example, taxpayers were liable to income tax on income "from a source within or deemed to be within the Union [of South Africa]". South Africa's then the highest court, the Appellate Division of the Supreme Court noted as early as 1926 in *Overseas Trust Corporation Ltd v CIR* 1926 AD 444, 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 in return for which he receives the income. This includes work in all forms – inventing, making, producing or selling – as well as providing the use of an asset such as land, intellectual property or money. Once a source of income or profit is 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, thus articulated to specific transactional or business patterns.

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 or idea. If value creation is just the originating cause of income or profit, then the only real analytical task today remains the continuing 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 put the case that "value creation" is indeed new. It has been conflated with "economic substance" which, in the BEPS context, has in turn been conflated with tax avoidance and artificial arrangements. This is certainly supported by key UK case law on the location of the source of trading profits. In *Smidth & Co v Greenwood* (1921) 8 TC 193 the House of Lords noted that "the question is, where do the operations take place from which the profits in substance arise?" Substance in the context of source is another way of saying, from what, and where do the profits really arise? The headcount does not itself answer this.

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 in the allocation of taxing rights from that under the pre-BEPS dispensation. It is disingenuous to present what is really a political debate about which country is entitled to tax as a matter of legal analysis. A more honest approach would be to accept the debate for what it is.

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 2017 OECD Transfer Pricing Guidelines take a selective approach to the originating cause of income or profit. The effective elimination of the ownership of intangible assets and the role of funding in the value creation puts value creation as understood in this way at odds with the source of income being its originating cause. The use of an intangible asset is what the payer of a royalty 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 no different from saying the asset is no longer to be viewed as the source of the royalty. Furthermore, the use of value creation as the new litmus test for allocating taxing jurisdiction in a variety of contexts is bound to cause confusion if it is used to mean different things for different purposes.

Complex originating causes of profit

The extensive case law on the source of income or profit has provided clear guidelines to identify the originating cause of income. 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 main or dominant originating cause (*CIR v Black* (1957) 3 SA (A)). This results in a winner-takes-all assertion of taxing jurisdiction. Others have found more than one originating cause which produces an apportionment between them (*Tuck v CIR* (1988) 3 SA 819 (A)). These domestic law analyses view the question in isolation from other foreign tax systems so that double or non-taxation may occur. This is the central issue that remains to be addressed.

Digital economy

The OECD 2013 report Addressing Base Erosion and Profit Shifting argued that current international tax standards may not have kept pace with changes in global business practices. In *Rhodesia Metals v COT* 1940 AD 432 the Privy Council and the South African Appellate Division agreed that ascertaining the source of income is a practical matter of hard fact. Is this any different in the era of a digitalised economy? Debate about the allocation of taxing rights may well be simplified by remembering what seems to have been forgotten.